

ARCH CAPITAL GROUP LTD.  
Form 10-K  
March 03, 2014

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

FORM 10-K

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

For the Fiscal Year Ended December 31, 2013

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File No. 0-26456

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)

Securities registered pursuant to Section 12(b) of the Exchange Act:

Title of each class	Name of each exchange on which registered
Common Shares, \$0.0033 par value per share	NASDAQ Stock Market (Common Shares)
6.75% Non-Cumulative Preferred Shares, Series C, \$0.01 par value per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Exchange Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.  
Yes  No

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates, computed by reference to the closing price as reported by the NASDAQ Stock Market as of the last business day of the Registrant's most recently completed second fiscal quarter, was approximately \$6.62 billion.

As of February 24, 2014, there were 133,805,667 of the registrant's common shares outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of Part III and Part IV incorporate by reference our definitive proxy statement for the 2014 annual meeting of shareholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A before April 30, 2014.

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CAUTIONARY NOTE REGARDING FORWARD LOOKING STATEMENTS

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

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

- our ability to successfully implement our business strategy during “soft” as well as “hard” markets;
- acceptance of our business strategy, security and financial condition by rating agencies and regulators, as well as by brokers and our insureds and reinsureds;
- our ability to maintain or improve our ratings, which may be affected by our ability to raise additional equity or debt financings, by ratings agencies’ existing or new policies and practices, as well as other factors described herein;
- general economic and market conditions (including inflation, interest rates, foreign currency exchange rates, prevailing credit terms and the depth and duration of a recession) and conditions specific to the reinsurance and insurance markets (including the length and magnitude of the current “soft” market) in which we operate;
- competition, including increased competition, on the basis of pricing, capacity, coverage terms or other factors;
- developments in the world’s financial and capital markets and our access to such markets;
- our ability to successfully enhance, integrate and maintain operating procedures (including information technology) to effectively support our current and new business;
- the loss of key personnel;
- the integration of businesses we have acquired or may acquire into our existing operations;
- accuracy of those estimates and judgments utilized in the preparation of our financial statements, including those related to revenue recognition, insurance and other reserves, reinsurance recoverables, investment valuations, intangible assets, bad debts, income taxes, contingencies and litigation, and any determination to use the deposit method of accounting, which for a relatively new insurance and reinsurance company, like our company, are even more difficult to make than those made in a mature company since relatively limited historical information has been reported to us through December 31, 2013;
- greater than expected loss ratios on business written by us and adverse development on claim and/or claim expense liabilities related to business written by our insurance and reinsurance subsidiaries;
- severity and/or frequency of losses;
- claims for natural or man-made catastrophic events in our insurance or reinsurance business could cause large losses and substantial volatility in our results of operations;
- acts of terrorism, political unrest and other hostilities or other unforecasted and unpredictable events;
- availability to us of reinsurance to manage our gross and net exposures and the cost of such reinsurance;
- the failure of reinsurers, managing general agents, third party administrators or others to meet their obligations to us;
- the timing of loss payments being faster or the receipt of reinsurance recoverables being slower than anticipated by us;
- our investment performance, including legislative or regulatory developments that may adversely affect the fair value of our investments;
- the impact of the continued weakness of the U.S., European countries 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



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rating agencies, and the resulting effect on the value of securities in our investment portfolio as well as the uncertainty in the market generally;

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

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

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

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

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

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

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PART I

ITEM 1. BUSINESS

As used in this report, references to “we,” “us,” “our” or the “Company” refer to the consolidated operations of Arch Capital Group Ltd. (“ACGL”) and its subsidiaries. Tabular amounts are in U.S. Dollars in thousands, except share amounts, unless otherwise noted. We refer you to Item 1A “Risk Factors” for a discussion of risk factors relating to our business.

OUR COMPANY

General

Arch Capital Group Ltd. is a Bermuda public limited liability company with \$6.55 billion in capital at December 31, 2013 and, through operations in Bermuda, the United States, Europe and Canada, writes insurance and reinsurance on a worldwide basis. While we are positioned to provide a full range of property and casualty insurance and reinsurance lines, we focus on writing specialty lines of insurance and reinsurance. For 2013, we wrote \$3.35 billion of net premiums and reported net income available to common shareholders of \$687.8 million. Book value per common share was \$39.82 at December 31, 2013, compared to \$36.19 per share at December 31, 2012.

ACGL’s registered office is located at Clarendon House, 2 Church Street, Hamilton HM 11, Bermuda (telephone number: (441) 295-1422), and its principal executive offices are located at Waterloo House, Ground Floor, 100 Pitts Bay Road, Pembroke HM 08, Bermuda (telephone number: (441) 278-9250). ACGL makes available free of charge through its website, located at [www.archcapgroup.bm](http://www.archcapgroup.bm), its annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. The public may read and copy any materials ACGL files with the SEC at the SEC’s Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling 1-800-SEC-0330. The SEC also maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC (such as ACGL) and the address of that site is [www.sec.gov](http://www.sec.gov).

Our History

Our current operations were built on an existing underwriting platform through an underwriting initiative in October 2001 to meet current and future demand in the global insurance and reinsurance markets. Since that time, we have attracted a proven management team with extensive industry experience and enhanced our existing global underwriting platform for our insurance and reinsurance businesses. It is our belief that our underwriting platform, our experienced management team and our strong capital base that is unencumbered by significant pre-2002 risks have enabled us to establish a strong presence in the insurance and reinsurance markets.

Prior to the 2001 underwriting initiative, our insurance underwriting platform consisted of Arch Insurance (Bermuda), a division of Arch Reinsurance Ltd. (“Arch Re Bermuda”), our Bermuda-based reinsurer and insurer, and our U.S.-licensed insurers, Arch Insurance Company (“Arch Insurance”), Arch Excess & Surplus Insurance Company (“Arch E&S”) and Arch Specialty Insurance Company (“Arch Specialty”). We established Arch Insurance Company (Europe) Limited (“Arch Insurance Company Europe”), our United Kingdom-based subsidiary, in 2004, and we expanded our North American presence when Arch Insurance opened a branch office in Canada in 2005. In January 2013, Arch Insurance Canada Ltd. (“Arch Insurance Canada”), a Canada domestic company, commenced operations and replaced the Canada branch of Arch Insurance. In 2009, we established a managing agent and syndicate at Lloyd’s of London (“Lloyd’s”). Our Lloyd’s syndicate 2012 (“Arch Syndicate 2012”) commenced underwriting in 2009. See “Operations—Insurance Operations” for further details on our insurance operations.

Prior to the 2001 underwriting initiative, our reinsurance underwriting platform consisted of Arch Re Bermuda and Arch Reinsurance Company (“Arch Re U.S.”), our U.S.-licensed reinsurer. Our reinsurance operations in Europe began in November 2006 with the formation of a Swiss branch of Arch Re Bermuda, and the formation of a Danish underwriting agency in 2007. In addition to the U.S. reinsurance activities of Arch Re U.S., we launched our property facultative reinsurance underwriting operations in 2007, which underwrite in the U.S., Canada and Europe. We formed Arch Reinsurance Europe Underwriting Limited (“Arch Re Europe”), our Ireland-based reinsurance company, in 2008. In 2011, we formed Arch Mortgage Insurance Limited (“Arch MI Europe”), which is authorized to underwrite mortgage insurance from its base in Ireland, and launched treaty operations in Canada. We completed the acquisition of the credit and surety





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reinsurance operations of Ariel Reinsurance Company Ltd. (“Ariel Re”) based in Zurich, Switzerland in April 2012. See “Operations—Reinsurance Operations” for further details on our reinsurance operations.

On January 30, 2014, our U.S.-based subsidiaries completed the acquisition of CMG Mortgage Insurance Company from its current owners, PMI Mortgage Insurance Co. (“PMI”), which has been in rehabilitation under the receivership of the Arizona Department of Insurance since 2011, and CMFG Life Insurance Company (“CUNA Mutual”). We also acquired PMI’s mortgage insurance platform and related assets from PMI. In connection with the closing of the transactions, PMI and Arch Re Bermuda entered into a quota share reinsurance agreement pursuant to which Arch Re Bermuda 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 are not in default as of an agreed upon effective date. Other than this quota share, no PMI legacy exposures were assumed in the transaction. At closing, we paid aggregate consideration of \$253.0 million. Additional amounts may be paid based on the actual results of CMG Mortgage Insurance Company’s pre-closing portfolio over an agreed upon period. In addition, we 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.

CMG Mortgage Insurance Company has been renamed “Arch Mortgage Insurance Company” (“Arch MI U.S.”) subject to receipt of applicable state approvals. As part of the transaction, Arch MI U.S. has been approved as an eligible mortgage insurer by Fannie Mae and Freddie Mac (each a “GSE”), subject to maintaining certain ongoing requirements. Prior to the acquisition, CMG Mortgage Insurance Company had been a GSE-approved mortgage insurance company limited only to credit union customers. The completion of the transaction enables us to enter the U.S. mortgage insurance marketplace immediately and allows us to serve all lenders nationwide, including Arch MI U.S.’s existing credit union customers. The acquisition provides us with mortgage insurance licenses across the United States and a comprehensive mortgage insurance operating platform. Arch MI U.S. is rated “BBB+” with a stable outlook by Standard & Poor’s Rating Services (“S&P”). In addition, we entered into a distribution agreement with CUNA Mutual and a reinsurance agreement with an affiliate of CUNA Mutual. These arrangements with CUNA Mutual will provide Arch MI U.S.’s existing customer base with a seamless transition and also will enable us to provide uninterrupted access and services to the credit union marketplace.

The growth of our insurance and reinsurance platforms was supported through the net proceeds of: (1) an equity capital infusion of \$763 million led by funds affiliated with Warburg Pincus LLC and Hellman & Friedman LLC in late 2001; (2) a public offering of 7.5 million of our common shares with net proceeds of \$179 million in April 2002; (3) the exercise of class A warrants by our principal shareholders and other investors in September 2002, which provided net proceeds of \$74 million; (4) a March 2004 public offering of 4.7 million of our common shares with net proceeds of \$179 million; (5) a May 2004 public offering of \$300 million principal amount of our 7.35% senior notes due May 2034; (6) a February 2006 public offering of \$200 million of our 8.00% series A non-cumulative preferred shares; (7) a May 2006 public offering of \$125 million of our 7.875% series B non-cumulative preferred shares; (8) an April 2012 public offering of \$325 million of our 6.75% series C non-cumulative preferred shares which was used to redeem all series A and series B preferred shares; and (9) a December 2013 public offering of \$500 million principal amount of 5.144% senior notes due November 1, 2043 by Arch Capital Group (U.S.) Inc. (“Arch-U.S.”), a wholly owned subsidiary of ACGL, and fully and unconditionally guaranteed by ACGL.

The board of directors of ACGL has authorized the investment in ACGL’s common shares through a share repurchase program. Repurchases under the share repurchase program may be effected from time to time in open market or privately negotiated transactions. Since the inception of the share repurchase program in February 2007 through December 31, 2013, ACGL has repurchased 109.9 million common shares for an aggregate purchase price of \$2.79 billion. At December 31, 2013, the total remaining authorization under the share repurchase program was \$712.1 million.

### Operations

For the periods presented, we classified our businesses into two underwriting segments, insurance and reinsurance. For an analysis of our underwriting results by segment, see note 3, “Segment Information,” of the notes accompanying our consolidated financial statements and “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Results of Operations.”



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### Our Insurance Operations

Our insurance operations are conducted in Bermuda, the United States, Europe, Canada, Australia and South Africa. Our insurance operations in Bermuda are conducted through Arch Insurance (Bermuda), a division of Arch Re Bermuda. In the U.S., our insurance group's principal insurance subsidiaries are Arch Insurance, Arch Specialty, Arch E&S and Arch Indemnity Insurance Company ("Arch Indemnity"). Arch Insurance is an admitted insurer in 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands and Guam. Arch Insurance operated a branch office in Canada through January 1, 2013, at which point its operations were assumed by Arch Insurance Canada. Arch Insurance Canada is a Canada domestic company which is authorized in all Canadian provinces and territories. Arch Specialty is an approved excess and surplus lines insurer in 49 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands and an admitted insurer in one state. Arch Indemnity is an admitted insurer in 49 states and the District of Columbia. Arch E&S, which is not currently writing business, is an approved excess and surplus lines insurer in 47 states and the District of Columbia and an admitted insurer in one state. The headquarters for our insurance group's U.S. support operations (excluding underwriting units) is in Jersey City, New Jersey. The insurance group has additional offices throughout the U.S., including four regional offices located in Alpharetta, Georgia, Chicago, Illinois, New York, New York and San Francisco, California. Arch Insurance Canada is headquartered in Toronto, Ontario with other regional offices in Canada.

Our insurance group's European operations are conducted on two platforms: Arch Insurance Company Europe and Arch Syndicate 2012 (the U.K. insurance operations are collectively referred to as "Arch Insurance Europe"). Arch Insurance Europe conducts its operations from London. Arch Insurance Company Europe is approved as an excess and surplus lines insurer in 27 states and the District of Columbia and also has branches in Denmark, Germany, Italy and Spain. Arch Underwriting at Lloyd's Ltd ("AUAL") is the managing agent of Arch Syndicate 2012 and is responsible for the daily management of Arch Syndicate 2012. Arch Syndicate 2012 has enhanced our underwriting platform by providing us with access to Lloyd's extensive distribution network and worldwide licenses. Arch Underwriting at Lloyd's (Australia) Pty Ltd, based in Sydney, Australia, and Arch Underwriting Managers at Lloyd's (South Africa) (Pty) Limited, based in Johannesburg, South Africa, are Lloyd's services companies which underwrite exclusively for Arch Syndicate 2012.

As of February 24, 2014, our insurance group had approximately 1,200 employees.

**Strategy.** Our insurance group's strategy is to operate in lines of business in which underwriting expertise can make a meaningful difference in operating results. The insurance group focuses on talent-intensive rather than labor-intensive business and seeks to operate profitably (on both a gross and net basis) across all of its product lines. To achieve these objectives, our insurance group's operating principles are to:

**Capitalize on Profitable Underwriting Opportunities.** Our insurance group believes that its experienced management and underwriting teams are positioned to locate and identify business with attractive risk/reward characteristics. As profitable underwriting opportunities are identified, our insurance group will continue to seek to make additions to its product portfolio in order to take advantage of market trends. This may include adding underwriting and other professionals with specific expertise in specialty lines of insurance.

**Centralize Responsibility for Underwriting.** Our insurance group consists of a range of product lines. The underwriting executive in charge of each product line oversees all aspects of the underwriting product development process within such product line. Our insurance group believes that centralizing the control of such product line with the respective underwriting executive allows for close management of underwriting and creates clear accountability for results. Our U.S. insurance group has four regional offices, and the executive in charge of each region is primarily responsible for all aspects of the marketing and distribution of our insurance group's products, including the management of broker and other producer relationships in such executive's respective region. In our non-U.S. offices, a similar philosophy is observed, with responsibility for the management of each product line residing with the senior underwriting executive in charge of such product line.

**Maintain a Disciplined Underwriting Philosophy.** Our insurance group's underwriting philosophy is to generate an underwriting profit through prudent risk selection and proper pricing. Our insurance group believes that the key to this approach is adherence to uniform underwriting standards across all types of business. Our insurance group's senior management closely monitors the underwriting process.

- Focus on Providing Superior Claims Management. Our insurance group believes that claims handling is an integral component of credibility in the market for insurance products. Therefore, our insurance group believes that its ability to handle claims expeditiously and satisfactorily is a key to its success. Our insurance group

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employs experienced claims professionals and also utilizes experienced external claims managers (third party administrators) where appropriate.

Utilize a Brokerage Distribution System. Our insurance group believes that by utilizing a brokerage distribution system, consisting of select international, national and regional brokers, both wholesale and retail, it can efficiently access a broad customer base while maintaining underwriting control and discipline.

Our insurance group writes business on both an admitted and non-admitted basis. Our insurance group focuses on the following areas:

• Casualty. Our insurance group's casualty unit writes primary and excess casualty insurance coverages, including railroad and middle market energy business.

• Construction. Our insurance group's construction unit provides primary and excess casualty coverages to middle and large accounts in the construction industry.

• Executive Assurance. Our insurance group's executive assurance unit focuses on directors' and officers' liability insurance coverages for corporate, private equity, venture capital, real estate investment trust, limited partnership, financial institution and not-for-profit clients of all sizes. This unit also writes employment practices liability insurance, pension trust errors and omissions/fiduciary liability insurance, fidelity bonds, kidnap and ransom extortion insurance, representations and warranties insurance and various financial institution professional liability coverages.

• Healthcare. Our insurance group's healthcare unit provides medical professional and general liability insurance coverages for the healthcare industry, including excess professional liability programs for large, integrated hospital systems, outpatient facilities, clinics and long-term care facilities.

• Lenders products. Our insurance group's lenders products unit provides collateral protection, debt cancellation and service contract reimbursement products to banks, credit unions, automotive dealerships and original equipment manufacturers. The unit also underwrites other specialty programs that pertain to automotive lending and leasing.

• National Accounts. Our insurance group's national accounts unit provides a wide range of products for middle and large accounts and specializes in loss sensitive primary casualty insurance programs, including large deductible, self-insured retention and retrospectively rated programs.

• Professional Liability. Our insurance group's professional liability unit insures large law firms and accounting firms and professional programs, as well as miscellaneous professional liability, including coverages for consultants, network security, securities broker-dealers, wholesalers, captive agents and managing general agents. The professional liability unit also provides coverage for environmental and design professionals, including coverages for architectural and engineering firms and construction projects and pollution legal liability coverage for fixed sites.

• Programs. Our insurance group's programs unit targets program managers with unique expertise and niche products offering general liability, commercial automobile, inland marine and property business with minimal catastrophe exposure. This unit offers primarily package policies, underwriting workers' compensation and umbrella liability business in support of desirable package programs.

• Property, Energy, Marine and Aviation. Our insurance group's property unit provides primary and excess general property insurance coverages, including catastrophe-exposed property coverage, for commercial clients. The property unit also provides contractors all risk, erection all risk, aviation and stand alone terrorism insurance coverage for commercial clients.

• Surety. Our insurance group's surety unit provides contract and commercial surety coverages, including contract bonds (payment and performance bonds) primarily for medium and large contractors and commercial surety bonds for Fortune 1,000 companies and smaller transaction business programs. The surety unit also provides specialty contract bonds for homebuilders and developers.

• Travel and Accident. Our insurance group's travel and accident unit provides specialty travel and accident and related insurance products for individual and group travelers, as well as travel agents and suppliers.



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Other. Our insurance group also includes the following units: (i) alternative market risks, including captive insurance programs; (ii) contract binding, which provides property and casualty coverage through a network of appointed agents to small and medium risks where it is cost effective to use technology to access this niche market; (iii) accident and health, which provides accident, disability and medical plan insurance coverages for employer groups, medical plan members, students and other participant groups; and (iv) excess workers' compensation, which provides excess workers' compensation and employer's liability insurance coverages for qualified self-insured groups, associations and trusts in a wide range of businesses.

Underwriting Philosophy. Our insurance group's underwriting philosophy is to generate an underwriting profit (on both a gross and net basis) through prudent risk selection and proper pricing across all types of business. One key to this philosophy is the adherence to uniform underwriting standards across each product line that focuses on the following:

- risk selection;
- desired attachment point;
- limits and retention management;
- due diligence, including financial condition, claims history, management, and product, class and territorial exposure;
- underwriting authority and appropriate approvals; and
- collaborative decision making.

Premiums Written and Geographic Distribution. Set forth below is summary information regarding net premiums written for our insurance group:

INSURANCE SEGMENT	Year Ended December 31, 2013		2012		2011	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
Net premiums written						
Programs	\$419,673	22	\$340,130	19	\$290,378	17
Property, energy, marine and aviation	280,551	14	294,690	16	335,589	19
Professional liability	222,351	11	260,705	14	237,860	14
Executive assurance	213,727	11	250,904	14	231,405	13
Construction	161,877	8	130,201	7	120,405	7
Casualty	112,094	6	112,307	6	114,235	7
National accounts	109,233	6	80,929	4	80,973	5
Lenders products	101,576	5	99,724	5	94,301	5
Surety	64,911	3	53,271	3	42,475	2
Travel and accident	63,209	3	80,489	4	71,940	4
Healthcare	40,115	2	36,814	2	35,652	2
Other (1)	159,479	9	85,170	6	66,066	5
Total	\$1,948,796	100	\$1,825,334	100	\$1,721,279	100
Net premiums written by client location						
United States	\$1,526,156	78	\$1,314,577	72	\$1,208,007	70
Europe	226,254	12	271,278	15	273,578	16
Asia and Pacific	95,970	5	120,492	7	119,523	7
Other	100,416	5	118,987	6	120,171	7
Total	\$1,948,796	100	\$1,825,334	100	\$1,721,279	100
Net premiums written by underwriting location						
United States	\$1,478,930	76	\$1,254,623	69	\$1,153,834	67
Europe	389,763	20	472,132	26	463,855	27
Other	80,103	4	98,579	5	103,590	6

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Total	\$1,948,796	100	\$1,825,334	100	\$1,721,279	100
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(1) Includes alternative markets, contract binding, accident and health and excess workers' compensation business.

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**Marketing.** Our insurance group’s products are marketed principally through a group of licensed independent retail and wholesale brokers. Clients (insureds) are referred to our insurance group through a large number of international, national and regional brokers and captive managers who receive from the insured or insurer a set fee or brokerage commission usually equal to a percentage of gross premiums. In the past, our insurance group also entered into contingent commission arrangements with some brokers that provide for the payment of additional commissions based on volume or profitability of business. Currently, some of our contracts with brokers provide for additional commissions based on volume. We have also entered into service agreements with select international brokers that provide access to their proprietary industry analytics. In general, our insurance group has no implied or explicit commitments to accept business from any particular broker and neither brokers nor any other third parties have the authority to bind our insurance group, except in the case where underwriting authority may be delegated contractually to select program administrators. Such administrators are subject to a due diligence financial and operational review prior to any such delegation of authority and ongoing reviews and audits are carried out as deemed necessary by our insurance group to assure the continuing integrity of underwriting and related business operations. See “Risk Factors—Risks Relating to Our Company—We could be materially adversely affected to the extent that managing general agents, general agents and other producers exceed their underwriting authorities or if our agents, our insureds or other third parties commit fraud or otherwise breach obligations owed to us.” For information on major brokers, see note 14, “Commitments and Contingencies—Concentrations of Credit Risk,” of the notes accompanying our consolidated financial statements.

**Risk Management and Reinsurance.** In the normal course of business, our insurance group may cede a portion of its premium on a quota share or excess of loss basis through treaty or facultative reinsurance agreements. Reinsurance arrangements do not relieve our insurance group from its primary obligations to insureds. Reinsurance recoverables are recorded as assets, predicated on the reinsurers’ ability to meet their obligations under the reinsurance agreements. If the reinsurers are unable to satisfy their obligations under the agreements, our insurance subsidiaries would be liable for such defaulted amounts. Our principal insurance subsidiaries, with oversight by a group-wide reinsurance steering committee (“RSC”), are selective with regard to reinsurers, seeking to place reinsurance with only those reinsurers which meet and maintain specific standards of established criteria for financial strength. The RSC evaluates the financial viability of its reinsurers through financial analysis, research and review of rating agencies’ reports and also monitors reinsurance recoverables and collateral with unauthorized reinsurers. The financial analysis includes ongoing qualitative and quantitative assessments of reinsurers, including a review of the financial stability, appropriate licensing, reputation, claims paying ability and underwriting philosophy of each reinsurer. Our insurance group will continue to evaluate its reinsurance requirements. See note 4, “Reinsurance,” of the notes accompanying our consolidated financial statements.

For catastrophe-exposed insurance business, our insurance group seeks to limit the amount of exposure to catastrophic losses it assumes through a combination of managing aggregate limits, underwriting guidelines and reinsurance. For a discussion of our risk management policies, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies, Estimates and Recent Accounting Pronouncements—Ceded Reinsurance” and “Risk Factors—Risks Relating to Our Industry—The failure of any of the loss limitation methods we employ could have a material adverse effect on our financial condition or results of operations.”

**Claims Management.** Our insurance group’s claims management function is performed by claims professionals, as well as experienced external claims managers (third party administrators), where appropriate. In addition to investigating, evaluating and resolving claims, members of our insurance group’s claims departments work with underwriting professionals as functional teams in order to develop products and services desired by the group’s clients.

**Our Reinsurance Operations**

Our reinsurance operations are conducted on a worldwide basis through our reinsurance subsidiaries, Arch Re Bermuda, Arch Re U.S. and Arch Re Europe. Arch Re Bermuda is a registered Class 4 insurer and long-term insurer and is headquartered in Hamilton, Bermuda. Arch Re U.S. is licensed or is an accredited or otherwise approved reinsurer in 50 states and the District of Columbia and operates out of its office in Morristown, New Jersey. Our property facultative reinsurance operations are conducted primarily through Arch Re U.S. with certain executive functions conducted through Arch Re Facultative Underwriters Inc. located in Farmington, Connecticut. The property

facultative reinsurance operations have offices throughout the U.S., Canada and in Europe. Arch Re Europe, licensed and authorized as a non-life reinsurer and a life reinsurer, is headquartered in Dublin, Ireland with branch offices in Zurich and London. In 2011, we formed Arch MI Europe, which was authorized as a non-life insurer in Ireland in December 2011. Treaty operations in Canada were commenced in 2011 through the Canadian branch of Arch Insurance, but, from January 1, 2013, are conducted through Arch Insurance Canada. Mortgage insurance and reinsurance is underwritten in Europe through Arch MI Europe. Arch Risk

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Partners Ltd. (“Arch Risk Partners”), a U.K. based insurance intermediary authorized by the FSA in February 2012, acts on behalf of Arch MI Europe and Arch Re Bermuda in the arrangement of mortgage insurance and reinsurance. Our reinsurance operations acquired the credit and surety reinsurance operations of Ariel Re based in Zurich, Switzerland in April 2012. In the transaction, which was accounted for as a business combination under GAAP, we acquired approximately \$84.1 million of net unearned premiums along with other insurance balances.

As of February 24, 2014, our reinsurance group had approximately 240 employees.

**Strategy.** Our reinsurance group’s strategy is to capitalize on our financial capacity, experienced management and operational flexibility to offer multiple products through our operations. The reinsurance group’s operating principles are to:

**Actively Select and Manage Risks.** Our reinsurance group only underwrites business that meets certain profitability criteria, and it emphasizes disciplined underwriting over premium growth. To this end, our reinsurance group maintains centralized control over reinsurance underwriting guidelines and authorities.

**Maintain Flexibility and Respond to Changing Market Conditions.** Our reinsurance group’s organizational structure and philosophy allows it to take advantage of increases or changes in demand or favorable pricing trends. Our reinsurance group believes that its existing platforms in Bermuda, the U.S., Europe and Canada, broad underwriting expertise and substantial capital facilitates adjustments to its mix of business geographically and by line and type of coverage. Our reinsurance group believes that this flexibility allows it to participate in those market opportunities that provide the greatest potential for underwriting profitability.

**Maintain a Low Cost Structure.** Our reinsurance group believes that maintaining tight control over its staffing level and operating primarily as a broker market reinsurer permits it to maintain low operating costs relative to its capital and premiums.

Our reinsurance group writes business on both a proportional and non-proportional basis and writes both treaty and facultative business. In a proportional reinsurance arrangement (also known as pro rata reinsurance, quota share reinsurance or participating reinsurance), the reinsurer shares a proportional part of the original premiums and losses of the reinsured. The reinsurer pays the cedent a commission which is generally based on the cedent’s cost of acquiring the business being reinsured (including commissions, premium taxes, assessments and miscellaneous administrative expenses) and may also include a profit factor. Non-proportional (or excess of loss) reinsurance indemnifies the reinsured against all or a specified portion of losses on underlying insurance policies in excess of a specified amount, which is called a “retention.” Non-proportional business is written in layers and a reinsurer or group of reinsurers accepts a band of coverage up to a specified amount. The total coverage purchased by the cedent is referred to as a “program.” Any liability exceeding the upper limit of the program reverts to the cedent.

The reinsurance group’s treaty operations generally seek to write significant lines on less commoditized classes of coverage, such as specialty property and casualty reinsurance treaties. However, with respect to other classes of coverage, such as property catastrophe and casualty clash, the reinsurance group’s treaty operations participate in a relatively large number of treaties where they believe that they can underwrite and process the business efficiently. The reinsurance group’s property facultative operations write reinsurance on a facultative basis whereby they assume part of the risk under primarily single insurance contracts. Facultative reinsurance is typically purchased by ceding companies for individual risks not covered by their reinsurance treaties, for unusual risks or for amounts in excess of the limits on their reinsurance treaties.

Our reinsurance group focuses on the following areas:

**Casualty.** Our reinsurance group reinsures third party liability and workers’ compensation exposures from ceding company clients primarily on a treaty basis. The exposures that it reinsures include, among others, executive assurance, professional liability, workers’ compensation, excess and umbrella liability and healthcare business. Our reinsurance group writes this business on a proportional and non-proportional basis. On proportional and non-proportional “working casualty business,” which is treated separately from casualty clash business, our reinsurance group prefers to write treaties where there is a meaningful amount of actuarial data and where loss activity is more predictable.

**Marine and Aviation.** Our reinsurance group writes marine business, which includes coverages for energy, hull, cargo, specie, liability and transit, and aviation business, which includes coverages for airline and general



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aviation risks. Business written may also include space business, which includes coverages for satellite assembly, launch and operation for commercial space programs.

Other Specialty. Our reinsurance group writes other specialty lines, including U.K. motor primarily emanating from one significant client, surety, accident and health, private passenger auto, workers' compensation catastrophe, agriculture, trade credit and political risk.

Property Catastrophe. Our reinsurance group reinsures catastrophic perils for our reinsureds on a treaty basis. Treaties in this type of business provide protection for most catastrophic losses that are covered in the underlying policies written by our reinsureds. The primary perils in our reinsurance group's portfolio include hurricane, earthquake, flood, tornado, hail and fire. Our reinsurance group may also provide coverage for other perils on a case-by-case basis.

Property catastrophe reinsurance provides coverage on an excess of loss basis when aggregate losses and loss adjustment expense from a single occurrence of a covered peril exceed the retention specified in the contract. The multiple claimant nature of property catastrophe reinsurance requires careful monitoring and control of cumulative aggregate exposure.

Property Excluding Property Catastrophe. Our reinsurance group's treaty reinsurance operations reinsure individual property risks of a ceding company. Property per risk treaty and pro rata reinsurance contracts written by our treaty reinsurance group cover claims from individual insurance policies issued by reinsureds and include both personal lines and commercial property exposures (principally covering buildings, structures, equipment and contents). The primary perils in this business include fire, explosion, collapse, riot, vandalism, wind, tornado, flood and earthquake.

Our reinsurance group's property facultative operations focus on commercial property risks on an excess of loss basis. Other. Our reinsurance group writes mortgage reinsurance on both a proportional and non-proportional basis on a global basis and direct mortgage insurance in Europe along with life reinsurance business on both a proportional and non-proportional basis. Besides death risk, the portfolio may include short and long-term disability risk from accident or natural causes. In addition, our reinsurance group writes casualty clash business and, in limited instances, writes non-traditional business which is intended to provide insurers with risk management solutions that complement traditional reinsurance.

Underwriting Philosophy. Our reinsurance group employs a disciplined, analytical approach to underwriting reinsurance risks that is designed to specify an adequate premium for a given exposure commensurate with the amount of capital it anticipates placing at risk. A number of our reinsurance group's underwriters are also actuaries. It is our reinsurance group's belief that employing actuaries on the front-end of the underwriting process gives it an advantage in evaluating risks and constructing a high quality book of business.

As part of the underwriting process, our reinsurance group typically assesses a variety of factors, including:

- adequacy of underlying rates for a specific class of business and territory;
- the reputation of the proposed cedent and the likelihood of establishing a long-term relationship with the cedent, the geographic area in which the cedent does business, together with its catastrophe exposures, and our aggregate exposures in that area;
- historical loss data for the cedent and, where available, for the industry as a whole in the relevant regions, in order to compare the cedent's historical loss experience to industry averages;
- projections of future loss frequency and severity; and
- the perceived financial strength of the cedent.

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Premiums Written and Geographic Distribution. Set forth below is summary information regarding net premiums written for our reinsurance group:

REINSURANCE SEGMENT	Year Ended December 31, 2013		2012		2011	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
Net premiums written						
Other specialty (1)	\$417,865	30	\$308,104	25	\$219,632	23
Casualty (2)	306,304	22	205,925	17	173,344	18
Property excluding property catastrophe (3)	292,536	21	265,783	22	226,013	24
Property catastrophe	220,749	16	283,677	23	246,793	26
Marine and aviation	64,380	5	84,649	7	77,309	8
Other (4)	100,737	6	78,763	6	8,956	1
Total	\$1,402,571	100	\$1,226,901	100	\$952,047	100
Net premiums written by client location						
United States	\$770,080	55	\$629,614	51	\$512,319	54
Europe	327,172	23	341,674	28	250,809	26
Asia and Pacific	120,017	9	104,398	8	75,590	8
Bermuda	87,047	6	72,864	6	60,246	6
Other	98,255	7	78,351	7	53,083	6
Total	\$1,402,571	100	\$1,226,901	100	\$952,047	100
Net premiums written by underwriting location						
Bermuda	\$548,924	39	\$595,999	49	\$531,254	56
United States	507,183	36	379,239	31	323,731	34
Europe	309,242	22	225,491	18	84,919	9
Other	37,222	3	26,172	2	12,143	1
Total	\$1,402,571	100	\$1,226,901	100	\$952,047	100

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

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

(3) Includes facultative business.

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

Marketing. Our reinsurance group generally markets its reinsurance products through brokers, except our property facultative reinsurance group, which generally deals directly with the ceding companies. Brokers do not have the authority to bind our reinsurance group with respect to reinsurance agreements, nor does our reinsurance group commit in advance to accept any portion of the business that brokers submit to them. Our reinsurance group generally pays brokerage fees to brokers based on negotiated percentages of the premiums written through such brokers. For information on major brokers, see note 14, "Commitments and Contingencies—Concentrations of Credit Risk," of the notes accompanying our consolidated financial statements.

Risk Management and Retrocession. Our reinsurance group currently purchases a combination of per event excess of loss, per risk excess of loss and proportional retrocessional agreements. Such arrangements reduce the effect of individual or aggregate losses, and in certain cases may also increase the underwriting capacity of, our reinsurance group. Our reinsurance group will continue to evaluate its retrocessional requirements based on its net appetite for risk. See note 4, "Reinsurance," of the notes accompanying our consolidated financial statements.

For catastrophe exposed reinsurance business, our reinsurance group seeks to limit the amount of exposure it assumes from any one reinsured and the amount of the aggregate exposure to catastrophe losses from a single event in any one

geographic zone. For a discussion of our risk management policies, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies, Estimates and Recent Accounting Pronouncements—Ceded Reinsurance” and “Risk Factors—Risks Relating to Our Industry—The failure of any of the loss limitation methods we employ could have a material adverse effect on our financial condition or results of operations.” Claims Management. Claims management includes the receipt of initial loss reports, creation of claim files, determination of whether further investigation is required, establishment and adjustment of case reserves and payment of

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claims. Additionally, audits are conducted for both specific claims and overall claims procedures at the offices of selected ceding companies. Our reinsurance group makes use of outside consultants for claims work from time to time.

Employees

As of February 24, 2014, ACGL and its subsidiaries employed approximately 1,820 full-time employees, including approximately 300 employees in our U.S. mortgage operations following the closing of the Arch MI U.S. acquisition on January 30, 2014.

Reserves

Reserve estimates are derived after extensive consultation with individual underwriters, actuarial analysis of the loss reserve development and comparison with industry benchmarks. Our reserves are established and reviewed by experienced internal actuaries. Generally, reserves are established without regard to whether we may subsequently contest the claim. We do not currently discount our loss reserves except for excess workers' compensation and employers' liability loss reserves in our insurance operations.

Loss reserves represent estimates of what the insurer or reinsurer ultimately expects to pay on claims at a given time, based on facts and circumstances then known, and it is probable that the ultimate liability may exceed or be less than such estimates. Even actuarially sound methods can lead to subsequent adjustments to reserves that are both significant and irregular due to the nature of the risks written. Loss reserves are inherently subject to uncertainty. In establishing the reserves for losses and loss adjustment expenses, we have made various assumptions relating to the pricing of our reinsurance contracts and insurance policies and have also considered available historical industry experience and current industry conditions. The timing and amounts of actual claim payments related to recorded reserves vary based on many factors including large individual losses and changes in the legal environment, as well as general market conditions. The ultimate amount of the claim payments could differ materially from our estimated amounts. Certain lines of business written by us, such as excess casualty, have loss experience characterized as low frequency and high severity. This may result in significant variability in loss payment patterns and, therefore, may impact the related asset/liability investment management process in order to be in a position, if necessary, to make these payments. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies, Estimates and Recent Accounting Pronouncements—Reserves for Losses and Loss Adjustment Expenses."



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The table below represents the development of loss reserves as determined under accounting principles generally accepted in the United States of America (“GAAP”) for 2003 through 2013:

## Development of GAAP Reserves

## Cumulative Redundancy (Deficiency)

(U.S. dollars in millions)	Year Ended December 31,										
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Reserve for losses and loss adjustment expenses, net of reinsurance recoverables	\$1,543	\$2,875	\$4,063	\$4,911	\$5,483	\$5,938	\$6,214	\$6,395	\$6,638	\$7,104	\$7,076
Cumulative net paid losses as of:											
One year later	278	449	745	843	954	1,167	1,106	1,127	1,169	1,351	
Two years later	437	811	1,332	1,486	1,817	2,114	1,943	1,938	2,096		
Three years later	596	1,110	1,688	2,040	2,308	2,768	2,561	2,613			
Four years later	706	1,300	1,993	2,375	2,755	3,222	3,070				
Five years later	787	1,478	2,249	2,680	3,023	3,596					
Six years later	853	1,629	2,447	2,867	3,254						
Seven years later	930	1,740	2,603	3,005							
Eight years later	967	1,797	2,684								
Nine years later	993	1,829									
Ten years later	1,009										
Net re-estimated reserve as of:											
One year later	1,444	2,756	3,986	4,726	5,173	5,749	6,067	6,110	6,416	6,840	
Two years later	1,353	2,614	3,809	4,387	4,959	5,620	5,826	5,927	6,160		
Three years later	1,259	2,487	3,541	4,164	4,849	5,466	5,711	5,748			

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Four years later	1,237	2,353	3,381	4,107	4,740	5,403	5,570				
Five years later	1,187	2,305	3,359	4,026	4,680	5,308					
Six years later	1,183	2,291	3,301	3,989	4,604						
Seven years later	1,191	2,255	3,327	3,944							
Eight years later	1,177	2,271	3,280								
Nine years later	1,201	2,247									
Ten years later	1,198										
Cumulative net redundancy	\$345	\$628	\$783	\$967	\$879	\$630	\$644	\$647	\$478	\$264	
Cumulative net redundancy as a percentage of net reserves	22.4	%21.8	%19.3	%19.7	%16.0	%10.6	%10.4	%10.1	%7.2	%3.7	%
Gross reserve for losses and loss adjustment expenses	\$1,912	\$3,493	\$5,453	\$6,463	\$7,092	\$7,667	\$7,873	\$8,098	\$8,456	\$8,933	\$8,824
Reinsurance recoverable	(369 )	(618 )	(1,390 )	(1,552 )	(1,609 )	(1,729 )	(1,659 )	(1,703 )	(1,818 )	(1,829 )	(1,748 )
Net reserve for losses and loss adjustment expenses	\$1,543	\$2,875	\$4,063	\$4,911	\$5,483	\$5,938	\$6,214	\$6,395	\$6,638	\$7,104	\$7,076
Gross re-estimated reserve	\$1,453	\$2,704	\$4,568	\$5,242	\$5,977	\$6,754	\$6,999	\$7,193	\$7,739	\$8,633	
Re-estimated reinsurance recoverable	(255 )	(457 )	(1,288 )	(1,298 )	(1,373 )	(1,446 )	(1,429 )	(1,445 )	(1,579 )	(1,793 )	
Net re-estimated reserve	1,198	2,247	3,280	3,944	4,604	5,308	5,570	5,748	6,160	6,840	
Gross re-estimated	\$459	\$789	\$885	\$1,221	\$1,115	\$913	\$874	\$905	\$717	\$300	

redundancy

The preceding table does not present accident or policy year development data and, instead, presents an analysis of the claim development of gross and net balance sheet reserves existing at each calendar year-end in subsequent calendar years. The top line of the table shows the reserves, net of reinsurance recoverables, at the balance sheet date for each of the indicated years. This represents the estimated amounts of net losses and loss adjustment expenses arising in all prior years that are unpaid at the balance sheet date, including incurred but not reported (“IBNR”) reserves. The table also shows the re-estimated amount of the previously recorded reserves based on experience as of the end of each succeeding year. The estimate changes as more information becomes known about the frequency and severity of claims for individual years. The “cumulative redundancy (deficiency)” represents the aggregate change in the estimates over all prior years. The table also

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shows the cumulative amounts paid as of successive years with respect to that reserve liability. In addition, the table reflects the claim development of the gross balance sheet reserves for ending reserves at December 31, 2003 through December 31, 2012.

The following table represents an analysis of losses and loss adjustment expenses and a reconciliation of the beginning and ending reserve for losses and loss adjustment expenses. The reserves of acquired business relate to our purchase of the credit and surety reinsurance operations of Ariel Re in April 2012.

	Year Ended December 31,		
	2013	2012	2011
Reserve for losses and loss adjustment expenses at beginning of year	\$8,933,292	\$8,456,210	\$8,098,454
Unpaid losses and loss adjustment expenses recoverable	1,829,070	1,818,047	1,703,201
Net reserve for losses and loss adjustment expenses at beginning of year	7,104,222	6,638,163	6,395,253
Net incurred losses and loss adjustment expenses relating to losses occurring in:			
Current year	1,943,466	2,082,805	2,012,569
Prior years	(264,042 )	(221,528 )	(285,016 )
Total net incurred losses and loss adjustment expenses	1,679,424	1,861,277	1,727,553
Net losses and loss adjustment expense reserves of acquired business	—	31,977	—
Foreign exchange losses (gains)	1,617	38,184	(32,020 )
Net paid losses and loss adjustment expenses relating to losses occurring in:			
Current year	(288,114 )	(295,984 )	(325,273 )
Prior years	(1,420,703 )	(1,169,395 )	(1,127,350 )
Total net paid losses and loss adjustment expenses	(1,708,817 )	(1,465,379 )	(1,452,623 )
Net reserve for losses and loss adjustment expenses at end of year	7,076,446	7,104,222	6,638,163
Unpaid losses and loss adjustment expenses recoverable	1,748,250	1,829,070	1,818,047
Reserve for losses and loss adjustment expenses at end of year	\$8,824,696	\$8,933,292	\$8,456,210

Our initial reserving method to date has to a large extent been the expected loss method, which is commonly applied when limited loss experience exists. We select the initial expected loss and loss adjustment expense ratios based on information derived by our underwriters and actuaries during the initial pricing of the business, supplemented by industry data where appropriate. These ratios consider, among other things, rate changes and changes in terms and conditions that have been observed in the market. Any estimates and assumptions made as part of the reserving process could prove to be inaccurate due to several factors, including the fact that relatively limited historical information has been reported to us through December 31, 2013. We employ a number of different reserving methods depending on the segment, the line of business, the availability of historical loss experience and the stability of that loss experience. Over time, we have given additional weight to our historical loss experience in our reserving process due to the continuing maturation of our reserves, and the increased availability and credibility of the historical experience. For additional information regarding the key underlying movements in our losses and loss adjustment expenses by segment, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Results of Operations.”

Unpaid and paid losses and loss adjustment expenses recoverable were approximately \$1.75 billion at December 31, 2013. We are subject to credit risk with respect to our reinsurance and retrocessions because the ceding of risk to reinsurers and retrocessionaires does not relieve us of our liability to the clients or companies we insure or reinsure. Our failure to establish adequate reinsurance or retrocessional arrangements or the failure of our existing reinsurance or retrocessional arrangements to protect us from overly concentrated risk exposure could materially adversely affect

our financial condition and results of operations. Although we monitor the financial condition of our reinsurers and retrocessionaires and attempt to place coverages only with substantial, financially sound carriers, we may not be successful in doing so.

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## Investments

At December 31, 2013, consolidated cash and invested assets totaled approximately \$14.05 billion, as summarized in the table below. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Financial Condition, Liquidity and Capital Resources—Financial Condition—Investable Assets” and note 6, “Investment Information,” of the notes accompanying our financial statements.

The following table summarizes our invested assets:

	December 31, 2013		December 31, 2012	
	Amount	% of Total	Amount	% of Total
Fixed maturities available for sale, at fair value	\$9,571,776	68.1	\$9,839,988	75.4
Fixed maturities, at fair value (1)	448,254	3.2	363,541	2.8
Fixed maturities pledged under securities lending agreements, at fair value (2)	105,081	0.7	42,600	0.3
Total fixed maturities	10,125,111	72.1	10,246,129	78.5
Short-term investments available for sale, at fair value	1,478,367	10.5	722,121	5.5
Short-term investments pledged under securities lending agreements, at fair value (2)	—	—	8,248	0.1
Cash	434,057	3.1	371,041	2.8
Equity securities available for sale, at fair value	496,824	3.5	312,749	2.4
Equity securities, at fair value (1)	—	—	25,954	0.2
Other investments available for sale, at fair value	498,310	3.5	549,280	4.2
Other investments, at fair value (1)	773,280	5.5	527,971	4.0
Investments accounted for using the equity method (3)	244,339	1.7	307,105	2.4
Total cash and investments	14,050,288	100.0	13,070,598	100.2
Securities sold but not yet purchased (4)	—	—	(6,924 )	(0.1 )
Securities transactions entered into but not settled at the balance sheet date	(763 )	—	(18,540 )	(0.1 )
Total investable assets	\$14,049,525	100.0	\$13,045,134	100.0

Represents securities which are carried at fair value under the fair value option and reflected as “investments (1) accounted for using the fair value option” on our balance sheet. Changes in the carrying value of such securities are recorded in net realized gains or losses.

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

Changes in the carrying value of investment funds accounted for using the equity method are recorded as “equity in (3) net income (loss) of investments funds accounted for using the equity method” rather than as an unrealized gain or loss component of accumulated other comprehensive income.

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

Our current investment guidelines and approach stress preservation of capital, market liquidity and diversification of risk. Our investments are subject to market-wide risks and fluctuations, as well as to risks inherent in particular securities. While maintaining our emphasis on preservation of capital and liquidity, we expect our portfolio to become more diversified and, as a result, we may in the future expand into areas which are not part of our current investment strategy. At December 31, 2013, 92.6% of our fixed maturities and fixed maturities pledged under securities lending agreements were rated investment grade, compared to 93.2% at December 31, 2012. Our fixed maturities, fixed maturities pledged under securities lending agreements and short-term investments had an average credit quality

rating of “AA-” from S&P and “Aa2” from Moody’s Investors Service (“Moody’s”) at December 31, 2013, compared to “AA-” from S&P and “Aa2” from Moody’s at December 31, 2012. Our investment portfolio had an average effective duration of approximately 2.62 years and 3.06 years at December 31, 2013 and 2012, respectively.

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The credit quality distribution of our fixed maturities and fixed maturities pledged under securities lending agreements are shown below:

Rating (1)	December 31, 2013		December 31, 2012	
	Fair Value	% of Total	Fair Value	% of Total
U.S. government and government agencies (2)	\$2,284,053	22.6	\$2,523,212	24.6
AAA	3,709,872	36.6	3,413,431	33.3
AA	1,720,605	17.0	1,563,846	15.3
A	1,359,193	13.4	1,501,156	14.7
BBB	304,543	3.0	538,140	5.3
BB	180,125	1.8	174,527	1.7
B	188,119	1.9	220,772	2.2
Lower than B	241,463	2.4	175,866	1.7
Not rated	137,138	1.3	135,179	1.2
Total	\$10,125,111	100.0	\$10,246,129	100.0

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

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

For 2013, 2012 and 2011, set forth below is the pre-tax total return (before investment expenses) of our investment portfolio (including fixed maturities, short-term investments and fixed maturities and short-term investments pledged under securities lending agreements) compared to the benchmark return against which we measured our portfolio during the year. 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 (see "Management's Discussion and Analysis of Financial Condition and Results of Operations—General—Financial Measures—Total Return on Investments").

	Arch Portfolio (1)	Benchmark Return	
Pre-tax total return (before investment expenses):			
Year ended December 31, 2013	1.28	% 0.85	%
Year ended December 31, 2012	5.88	% 4.90	%
Year ended December 31, 2011	3.81	% 4.80	%

(1) Our investment expenses were approximately 0.26%, 0.22% and 0.22%, respectively, of average invested assets in 2013, 2012 and 2011.

### Ratings

Our ability to underwrite business is dependent upon the quality of our claims paying ability and financial strength ratings as evaluated by independent agencies. Such ratings from third party internationally recognized statistical rating organizations or agencies are instrumental in establishing the competitive positions of companies in our industry. We believe that the primary users of such ratings include commercial and investment banks, policyholders, brokers, ceding companies and investors. Insurance ratings are also used by insurance and reinsurance intermediaries as an important means of assessing the financial strength and quality of insurers and reinsurers, and have become an increasingly important factor in establishing the competitive position of insurance and reinsurance companies. These ratings are often an important factor in the decision by an insured or intermediary of whether to place business with a particular insurance or reinsurance provider. Periodically, rating agencies evaluate us to confirm that we continue to meet their criteria for the ratings assigned to us by them. A.M. Best Company ("A.M. Best") maintains a letter scale rating system ranging from "A++" (Superior) to "F" (In Liquidation). Moody's maintains a letter scale rating from "Aaa" (Exceptional) to "NP" (Not Prime). S&P maintains a letter scale rating system ranging from "AAA" (Extremely Strong) to



“R” (Under Regulatory Supervision). Fitch Ratings (“Fitch”) maintains a letter scale rating system ranging from “AAA” (Exceptionally Strong) to “C” (Distressed).

Our reinsurance subsidiaries, Arch Re U.S., Arch Re Bermuda, Arch Re Europe (S&P and Fitch only) and Arch MI Europe (S&P only), and our principal insurance subsidiaries, Arch Insurance, Arch E&S, Arch Specialty, Arch Insurance

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Company Europe and Arch Insurance Canada (S&P and A.M. Best only), each currently has a financial strength rating of “A+” (the second highest out of fifteen rating levels) with a stable outlook from A.M. Best, “A1” (the fifth highest out of 21 rating levels) with a stable outlook from Moody’s, “A+” (the fifth highest out of 21 rating levels) with a stable outlook from S&P, and “A+” (the fifth highest out of 24 rating levels) with a stable outlook from Fitch. A.M. Best has assigned a financial strength rating of “NR-3” (Rating Procedure Inapplicable) to Arch Indemnity, which is not writing business currently. Lloyd’s has financial strength ratings of “A” (the third highest out of fifteen rating levels) with a stable outlook from A.M. Best, “A+” with a stable outlook from S&P and “A+” with a stable outlook from Fitch. Our U.S. mortgage insurance subsidiary, Arch MI U.S., is rated “BBB+” (the eighth highest out of 21 rating levels) with a stable outlook by S&P.

ACGL has received counterparty (issuer) credit ratings of “A-” (seventh highest out of 21 rating levels) with a stable outlook from S&P, “A3” (seventh highest out of 21 rating levels) with a stable outlook from Moody’s and “A” long term issuer rating (sixth highest out of 23 rating levels) with a stable outlook from Fitch. A counterparty credit rating provides an opinion on an issuer’s overall capacity and willingness to meet its financial commitments as they become due, but is not specific to a particular financial obligation.

The financial strength ratings assigned by rating agencies to insurance and reinsurance companies represent independent opinions of financial strength and ability to meet policyholder obligations and are not directed toward the protection of investors, nor are they recommendations to buy, hold or sell any securities. We can offer no assurances that our ratings will remain at their current levels, or that our security will be accepted by brokers and our insureds and reinsureds. A ratings downgrade or the potential for such a downgrade, or failure to obtain a necessary rating, could adversely affect both our relationships with agents, brokers, wholesalers and other distributors of our existing products and services and new sales of our products and services. In addition, under certain of the reinsurance agreements assumed by our reinsurance operations, upon the occurrence of a ratings downgrade or other specified triggering event with respect to our reinsurance operations, such as a reduction in surplus by specified amounts during specified periods, our ceding company clients may be provided with certain rights, including, among other things, the right to terminate the subject reinsurance agreement and/or to require that our reinsurance operations post additional collateral. In the event of a ratings downgrade or other triggering event, the exercise of such contract rights by our clients could have a material adverse effect on our financial condition and results of operations, as well as our ongoing business and operations. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Financial Condition, Liquidity and Capital Resources—Liquidity and Capital Resources.”

### Competition

The worldwide reinsurance and insurance businesses are highly competitive. We compete, and will continue to compete, with major U.S. and non-U.S. insurers and reinsurers, some of which have greater financial, marketing and management resources than we have and have had longer-term relationships with insureds and brokers than us. We compete with other insurers and reinsurers primarily on the basis of overall financial strength, ratings assigned by independent rating agencies, geographic scope of business, strength of client relationships, premiums charged, contract terms and conditions, products and services offered, speed of claims payment, reputation, employee experience, and qualifications and local presence.

In our insurance business, we compete with insurers that provide specialty property and casualty lines of insurance, including: ACE Limited, Alleghany Corporation, Allied World Assurance Company, Ltd., American International Group, Inc., AXIS Capital Holdings Limited, Berkshire Hathaway, Inc., Chubb Corporation, CNA, Endurance Specialty Holdings Ltd., The Hartford Financial Services Group, Inc., HCC Insurance Holdings, Inc., Ironshore Inc., Liberty Mutual Insurance, Lloyd’s, Markel Insurance Company, RLI Corp., The Travelers Companies, W.R. Berkley Corp., XL Group plc and Zurich Insurance Group. In our reinsurance business, we compete with reinsurers that provide property and casualty lines of reinsurance, including ACE Limited, Alleghany Corporation, Argo International Holdings, Ltd., AXIS Capital Holdings Limited, Berkshire Hathaway, Inc., Endurance Specialty Holdings Ltd., Everest Re Group Ltd., Hannover Rückversicherung AG, Lloyd’s, Markel Global Reinsurance, Montpelier Re Holdings Ltd., Munich Re Group, PartnerRe Ltd., Platinum Underwriters Holdings, Ltd., RenaissanceRe Holdings Ltd., Swiss Reinsurance Company, Third Point Reinsurance Ltd., Validus Holdings Ltd and XL Group plc. We do not believe that we have a significant market share in any of our markets.



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### Enterprise Risk Management

Enterprise Risk Management (“ERM”) is a key element in our philosophy, strategy and culture. We employ an ERM framework that includes underwriting, reserving, investment, credit and operational risks. Risk appetite and exposure limits are set by our executive management team, reviewed with our board of directors and board level committees and routinely discussed with business unit management. These limits are integrated into our operating guidelines and the exposures are aggregated and monitored periodically by our corporate risk management team. The reporting, review and approval of risk management information is integrated into our annual planning process, capital modeling and allocation, reinsurance purchasing strategy and reviewed at insurance business reviews, reinsurance underwriting meetings and board level committees. For a discussion of our risk management policies, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies, Estimates and Recent Accounting Pronouncements—Ceded Reinsurance” and “Risk Factors—Risks Relating to Our Industry—The failure of any of the loss limitation methods we employ could have a material adverse effect on our financial condition or results of operations.”

### Regulation

#### Bermuda Insurance Regulation

The Insurance Act 1978 of Bermuda and Related Regulations (“Insurance Act”). Arch Re Bermuda is subject to the Insurance Act, which provides that no person shall carry on any insurance business in or from within Bermuda unless registered as an insurer under the Insurance Act by the Bermuda Monetary Authority (the “BMA”), which is responsible for the day-to-day supervision of insurers. Under the Insurance Act, insurance business includes reinsurance business. We believe that we are in compliance with all applicable regulations under the Insurance Act.

The Insurance Act imposes solvency and liquidity standards and auditing and reporting requirements on Bermuda insurance companies and grants to the BMA powers to supervise, investigate and intervene in the affairs of insurance companies. Certain significant aspects of the Bermuda insurance regulatory framework are set forth below.

**Classification of Insurers.** The Insurance Act distinguishes between insurers carrying on long-term business, insurers carrying on general business and insurers carrying on special purpose business. There are six general business classifications (Classes 1, 2, 3, 3A, 3B and 4), five long-term business classifications (Classes A, B, C, D and E) and one classification of special purpose insurer.

As Arch Re Bermuda carries on both long-term and general business, it is required to be registered as both a long-term and as a general business insurer under the Insurance Act. Accordingly, Arch Re Bermuda is registered as a Class 4 general business insurer and as a Class C long-term insurer. Class 4 insurers are regarded as large commercial underwriters and are subject to the strictest regulation. Class C insurers are regarded as small commercial underwriters and are subject to less stringent regulation.

**Minimum Paid-Up Share Capital.** Arch Re Bermuda is required to maintain fully paid-up share capital of \$1.25 million.

**Principal Representative and Principal Office.** An insurer is required to maintain a principal office and to appoint and maintain a principal representative in Bermuda. It is the duty of the principal representative upon reaching the view that there is a likelihood of the insurer for which the principal representative acts becoming insolvent or that a reportable “event” has, to the principal representative’s knowledge, occurred or is believed to have occurred, to immediately notify the BMA and to make a report in writing to the BMA within 14 days of the prior notification setting out all the particulars of the case that are available to the principal representative.

Where there has been a significant loss which is reasonably likely to cause the insurer to fail to comply with its enhanced capital requirement (in respect of its general business, as described in more detail below), the principal representative must also furnish the BMA with a capital and solvency return reflecting an enhanced capital requirement prepared using post-loss data. The principal representative must provide this within 45 days of notifying the BMA regarding the loss.

Furthermore, where a notification has been made to the BMA regarding a material change to an insurer’s business or structure (including a merger or amalgamation), the principal representative has 30 days from the date of such notification



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to furnish the BMA with unaudited interim statutory financial statements in relation to such period if so requested by the BMA, together with a general business solvency certificate in respect of those statements.

Approved Independent Auditor. All insurers must appoint an independent auditor who annually audits and reports on the insurer's financial statements prepared under generally accepted accounting principles ("GAAP") or international financial reporting standards ("IFRS") and statutory financial statements and the statutory financial return of the insurer, all of which, in the case of Arch Re Bermuda, are required to be filed annually with the BMA. The independent auditor must be approved by the BMA.

Approved Actuary. As a Class C insurer, Arch Re Bermuda is required to submit an annual actuary's certificate when filing its statutory financial returns. The actuary, who is normally a qualified life actuary, must be approved by the BMA.

Approved Loss Reserve Specialist. As a Class 4 insurer, Arch Re Bermuda is required to submit an opinion of its approved loss reserve specialist with its statutory financial return in respect of its loss and loss expense provisions. The loss reserve specialist, who will normally be a qualified casualty actuary, must be approved by the BMA.

Annual Financial Statements, Annual Statutory Financial Return and Annual Capital and Solvency Return. Arch Re Bermuda must prepare annual statutory financial statements as prescribed in the Insurance Act with respect to both its general business and its long-term business. The statutory financial statements are distinct from the annual GAAP basis financial statements referred to below. The statutory financial return for a Class 4 insurer shall include a report of the approved independent auditor on the statutory financial statement of such insurer, solvency certificates, the statutory financial statements for the general business, the opinion of the loss reserve specialist and a schedule of reinsurance ceded. The statutory financial return for a Class C insurer shall include a report of the approved independent auditor on the statutory financial statements of such insurer, the statutory financial statements related to the long-term business, a declaration of the statutory ratios, the long-term business solvency certificate and a certificate from the approved actuary. Arch Re Bermuda is also required to file audited GAAP basis annual financial statements, which must be available to the public. In addition, Arch Re Bermuda is required to file a capital and solvency return in respect of its general business and long-term business. The capital and solvency return includes its relevant regulatory risk-based capital model, a schedule of fixed income investments by ratings categories, a schedule of net reserves for losses and loss expense provisions by line of business, a schedule of premiums written by line of business, a schedule of risk management and a schedule of fixed income securities, a schedule of commercial insurer's solvency self assessment, a schedule of catastrophe risk return, a schedule of loss triangles or reconciliation of net loss reserves and a schedule of eligible capital.

Minimum Solvency Margins. Arch Re Bermuda, as a Class 4 insurer, must ensure that the value of its general business assets exceeds the amount of its general business liabilities by an amount greater than the prescribed minimum solvency margin ( and enhanced capital requirement pertaining to its general business. Accordingly, Arch Re Bermuda is required, with respect to its general business, to maintain a minimum solvency margin equal to the greatest of (i) \$100 million, (ii) 50% of net premiums written (being gross premiums written less any premiums ceded by Arch Re Bermuda, but Arch Re Bermuda may not deduct more than 25% of gross premiums when computing net premiums written), (iii) 15% of net discounted aggregate losses and loss expense provisions and other insurance reserves and (iv) 25% of its enhanced capital requirement. As a long-term insurer, Arch Re Bermuda is also required, with respect to its long-term business, to maintain a minimum solvency margin equal to the greater of \$500,000 or 1.5% of its assets. For the purpose of this calculation, assets are defined as the total assets pertaining to its long-term business reported on the balance sheet in the relevant year less the amounts held in a segregated account.

Enhanced Capital Requirement. As a Class 4 insurer, Arch Re Bermuda is required to maintain available statutory capital and surplus pertaining to its general business at a level equal to or in excess of its enhanced capital requirement which is established by reference to either the Bermuda Solvency Capital Requirement model ("BSCR") or an approved internal capital model. The BSCR is a risk-based capital model which provides a method for determining an insurer's capital requirements (statutory capital and surplus) by taking into account the risk characteristics of different aspects of the insurer's business. The BSCR model is a risk-based capital model which provides a method for determining an insurer's capital requirements (statutory capital and surplus) by taking into account the risk characteristics of different aspects of the insurer's business. While not specifically referred to in the Insurance Act, the BMA has also established

a target capital level for each Class 4 insurer equal to 120% of its enhanced capital requirement. While a Class 4 insurer is not currently required to maintain its statutory capital and surplus at this level, the target capital level serves as an early warning tool for the BMA, and failure to maintain statutory capital at least equal to the target capital level will likely result in increased regulatory oversight. As a Class C insurer, Arch Re Bermuda is also required to maintain available statutory capital and

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surplus in respect of its long-term business at a level equal to or in excess of its long-term enhanced capital requirement which is established by reference to either the Class C BSCR model or an approved internal capital model. The long-term enhanced capital requirement is being phased in and shall be 50%, 75% and 100% of the calculated amount determined by the long-term BSCR model for financial years 2013, 2014 and 2015, respectively.

**Eligible Capital.** To enable the BMA to better assess the quality of the insurer's capital resources, as a Class 4 insurer, Arch Re Bermuda is required to disclose the makeup of its capital in accordance with a 3-tiered capital system. Under this system, all of the insurer's capital instruments will be classified as either basic or ancillary capital, which in turn will be classified into one of three tiers based on their "loss absorbency" characteristics. Highest quality capital will be classified Tier 1 Capital, lesser quality capital will be classified as either Tier 2 Capital or Tier 3 Capital. A minimum threshold of Tier 1 and maximum thresholds of Tier 2 and Tier 3 Capital used to support Arch Re Bermuda's minimum solvency margin and enhanced capital requirement are specified under the rules. Tier 1, Tier 2 and Tier 3 Capital may, until January 1, 2024, include capital instruments that do not satisfy the requirement that the instrument be non-redeemable or settled only with the issuance of an instrument of equal or higher quality upon a breach, or if it would cause a breach, of the enhanced capital requirement. Where the BMA approved the use of certain instruments for capital purposes prior to the implementation of the eligible capital rules, the BMA's consent must be obtained if such instruments are to remain eligible for use in satisfying the minimum solvency margin pertaining to its general business and its enhanced capital requirement.

**Minimum Liquidity Ratio.** Arch Re Bermuda is required to maintain a minimum liquidity ratio for general business equal to the value of its relevant assets at not less than 75% of the amount of its relevant liabilities. Relevant assets include cash and time deposits, quoted investments, unquoted bonds and debentures, first liens on real estate, investment income due and accrued, accounts and premiums receivable and reinsurance balances receivable. The relevant liabilities are total general business insurance reserves and total other liabilities less deferred income tax and sundry liabilities (by interpretation, those not specifically defined).

**Restrictions on Dividends and Distributions.** Arch Re Bermuda is prohibited from declaring or paying any dividends during any financial year if it is in breach of its enhanced capital requirement or its general business or long-term solvency margins or its minimum liquidity ratio or if the declaration or payment of such dividends would cause such a breach. If it has failed to meet its minimum solvency margins or minimum liquidity ratio on the last day of any financial year, Arch Re Bermuda will be prohibited, without the approval of the BMA, from declaring or paying any dividends during the next financial year. In addition, Arch Re Bermuda is prohibited from declaring or paying in any financial year dividends of more than 25% of its total statutory capital and surplus (as shown on its previous financial year's statutory balance sheet) unless it files (at least seven days before payment of such dividends) with the BMA an affidavit stating that it will continue to meet the required margins.

**Reduction of Capital.** Without the approval of the BMA, Arch Re Bermuda is prohibited from reducing by 15% or more its total statutory capital as set out in its previous year's financial statements and any application for such approval must include an affidavit stating that it will continue to meet the required margins.

**Long-Term Business Fund.** An insurer carrying on long-term business is required to keep its accounts in respect of its long-term business separate from any accounts kept in respect of any other business. All receipts of its long-term business form part of its long-term business fund. No payment may be made directly or indirectly from an insurer's long-term business fund for any purpose other than a purpose related to the insurer's long-term business, unless such payment can be made out of any surplus certified by the insurer's approved actuary to be available for distribution otherwise than to policyholders. Arch Re Bermuda may not declare or pay a dividend to any person other than a policyholder unless the value of the assets in its long-term business fund, as certified by its approved actuary, exceeds the extent (as so certified) of the liabilities of the insurer's long-term business. In addition, the amount of such dividend shall not exceed the aggregate of that excess and any other funds properly available for payment of dividends, being funds arising out of business of the insurer other than its long-term business.

**Restrictions on Transfer of Business and Winding-Up.** As a long-term insurer, Arch Re Bermuda may only transfer long-term business, other than long-term business that is reinsurance business, with the sanction of the applicable Bermuda court. A long-term insurer may only be wound-up or liquidated by order of the applicable Bermuda court.



Fit and Proper Controllers. The BMA maintains supervision over the controllers of all registered insurers in Bermuda. A controller includes: (i) the managing director of the registered insurer or its parent company; (ii) the chief executive of the registered insurer or of its parent company; (iii) a shareholder controller; and (iv) any person in accordance with whose

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directions or instructions the directors of the registered insurer or of its parent company are accustomed to act. The definition of shareholder controller is set out in the Insurance Act, but generally refers to (i) a shareholder who holds 10% or more of the shares carrying rights to vote at a shareholders' meeting of the registered insurer or its parent company, or (ii) a shareholder who is entitled to exercise 10% or more of the voting power at any shareholders' meeting of such registered insurer or its parent company, or (iii) a shareholder who is able to exercise significant influence over the management of the registered insurer or its parent company by virtue of its shareholding or its entitlement to exercise, or control the exercise of, the voting power at any shareholders' meeting. A shareholder controller that owns 10% or more but less than 20% of the shares as described above is defined as a 10% shareholder controller; a shareholder controller that owns 20% or more but less than 33% of the shares as described above is defined as a 20% shareholder controller; a shareholder controller that owns 33% or more but less than 50% of the shares as described above is defined as a 33% shareholder controller; and a shareholder controller that owns 50% or more of the shares as described above is defined as a 50% shareholder controller.

Where the shares of the shareholder of a registered insurer, or the shares of its parent company, are traded on a recognized stock exchange, and such shareholder becomes a 10%, 20%, 33% or 50% shareholder controller of the insurer, that shareholder shall, within 45 days, notify the BMA in writing that such shareholder has become such a controller. Any person or entity who contravenes the Insurance Act by failing to give notice or knowingly becoming a shareholder controller before the required 45 days has elapsed is guilty of an offense and liable to a fine.

The BMA may file a notice of objection to any shareholder who has become a controller of any description where it appears that such shareholder is, or is no longer, a fit and proper shareholder to be a controller of the registered insurer. Any person who continues to be a controller of any description after having received a notice of objection shall be guilty of an offense.

**Notification by Registered Person of Change of Controllers and Officers.** All registered insurers are required to give written notice to the BMA of the fact that a person has become, or ceased to be, a controller or officer of the registered insurer within 45 days of becoming aware of such fact. An officer in relation to a registered insurer means a director, chief executive or senior executive performing duties of underwriting, actuarial, risk management, compliance, internal audit, finance or investment matters.

**Notification of Material Changes.** All registered insurers are required to give notice to the BMA of their intention to effect a material change within the meaning of the Insurance Act. For the purposes of the Insurance Act, the following changes are material: (i) the transfer or acquisition of insurance business being part of a scheme falling under section 25 of the Insurance Act or section 99 of the Companies Act; (ii) the amalgamation with or acquisition of another firm; (iii) engaging in unrelated business that is retail business, (iv) the acquisition of a controlling interest in an undertaking that is engaged in non-insurance business which offers services and products to persons who are not affiliates of the insurer, (v) outsourcing all or substantially all of the company's actuarial, risk management and internal audit functions, (vi) outsourcing all or a material part of an insurer's underwriting activity, (vii) the transfer other than by way of reinsurance of all or substantially all of a line of business, and (viii) the expansion into a material new line of business.

No registered insurer shall take any steps to give effect to a material change unless it has first served notice on the BMA that it intends to effect such material change and before the end of 14 days, either the BMA has notified such company in writing that it has no objection to such change or that period has lapsed without the BMA having issued a notice of objection. Any insurer who fails to give the required notice or which effects a material change, or allows such material change to be effected, before the prescribed period has elapsed or after having received a notice of objection from the BMA shall be guilty of an offense.

**Insurance Code of Conduct.** Arch Re Bermuda is subject to the Insurance Code of Conduct (the "Insurance Code"), which establishes duties and standards which must be complied with to ensure it implements sound corporate governance, risk management and internal controls. Failure to comply with the requirements under the Insurance Code will be a factor taken into account by the BMA in determining whether an insurer is conducting its business in a sound and prudent manner as prescribed by the Insurance Act. Failure to comply with the requirements of the Insurance Code could result in the BMA exercising its powers of intervention and will be a factor in calculating the operational risk charge applicable in accordance with that insurer's risk based capital model.



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**Cancellation of Insurer's Registration.** An insurer's registration may be canceled by the BMA on certain grounds specified in the Insurance Act, including failure of the insurer to comply with its obligations under the Insurance Act or if, in the opinion of the BMA, the insurer has not been carrying on business in accordance with sound insurance principles.

**Group Supervision.** The BMA acts as group supervisor of our group of insurance and reinsurance companies ("Group") and has designated Arch Re Bermuda as the designated insurer ("Designated Insurer"). Pursuant to its powers under the Insurance Act, the BMA maintains a register of particulars for the Group detailing, among other things, the names and addresses of the Designated Insurer; each member company of the Group falling within the scope of supervision; the principal representative of the Group in Bermuda; other competent authorities supervising other member companies of the Group; and the Group auditors. The Designated Insurer must notify the BMA of any changes to the above details entered on the register of the Group.

As Group supervisor, the BMA performs a number of supervisory functions including (i) coordinating the gathering and dissemination of information which is of importance for the supervisory task of other competent authorities; (ii) carrying out a supervisory review and assessment of the Group; (iii) carrying out an assessment of the Group's compliance with the rules on solvency, risk concentration, intra-Group transactions and good governance procedures; (iv) planning and coordinating, with other competent authorities, supervisory activities in respect of the Group, both as a going concern and in emergency situations; (v) coordinating any enforcement action that may need to be taken against the Group or any of its members; and (vi) planning and coordinating meetings of colleges of supervisors (consisting of insurance regulators) in order to facilitate the carrying out of the functions described above.

In carrying out its functions, the BMA makes rules for (i) assessing the financial situation and the solvency position of the Group and/or its members and (ii) regulating intra-Group transactions, risk concentration, governance procedures, risk management and regulatory reporting and disclosure.

**Group Solvency and Group Supervision.** The current supervision and solvency rules (together, "Group Rules") apply to our Group so long as the BMA remains our group supervisor. The BMA has implemented and imposed many of the additional requirements described in this section as part of its efforts to gain equivalence under Solvency II. Due to the delays in the implementation of Solvency II in Europe, it is not expected that the European Commission will take a final decision on whether or not it will recognize the regime in Bermuda to be equivalent to that laid down in Solvency II until the latter part of 2014, at the earliest. If the European Commission does not recognize the regime in Bermuda, this could mean that Arch Re Bermuda and its European Union-regulated affiliates may be subject to group supervision in Bermuda and the European Union, respectively. In addition, through the Group Rules, the BMA may take action which affects ACGL. A summary of the Group Rules is set forth below.

**Annual Group Financial Statements.** The Group is required to prepare and submit, on an annual basis, financial statements prepared in accordance with either IFRS or GAAP, together with statutory financial statements. The financial statements must be audited annually by the Group's approved auditor who is required to prepare an auditor's report thereon in accordance with generally accepted auditing standards. In addition, the Group must prepare statutory financial statements (which include, in statutory form, a balance sheet, an income statement, a statement of capital and surplus, and notes thereto). The Designated Insurer is required to file with the BMA the statutory financial statements and the audited GAAP financial statements for the Group with the BMA within five months from the end of the relevant financial year (unless specifically extended).

**Annual Group Statutory Financial Return and Annual Capital and Solvency Return.** The Group is required to prepare an annual statutory financial return which shall include, among other things, a report of the approved auditor (for the GAAP financial statements only), a business solvency certificate, the opinion of an actuary (exempt for 2013 filing), a capital and solvency certificate (and a declaration signed by two directors of the parent company, one of which may be the chief executive) and either the chief risk or chief financial officer of the parent company declaring that the return fairly represents the financial condition of the Group in all material respects). Both the annual statutory financial return and the capital and solvency return must be submitted to the BMA by the Designated Insurer within five months after its financial year end (unless specifically extended).

**Quarterly Group Financial Statements.** The Designated Insurer is required to file quarterly financial returns for the Group with the BMA on or before the last day of the months May, August and November of each year. The quarterly

Group financial returns consist of (i) quarterly unaudited (consolidated) financial statements for each financial quarter (which must minimally include a balance sheet and income statement and must also be recent and not reflect a financial position

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that exceeds two months) and (ii) a list and details of material intra-Group transactions and risk concentrations, details surrounding all intra-Group reinsurance and retrocession arrangements and details of the top ten counterparties and any other counterparty exposures exceeding 10% of Group’s statutory capital and surplus.

Group Solvency Self Assessment (“GSSA”). The Group Rules require the board of directors of the parent company of the insurance group (the “Parent Board”) to establish solvency self assessment procedures for the group that factors in all the foreseeable reasonably material risks. Such procedures should be carried out at least annually and assess the quality and quantity of the capital required to adequately cover the risks to which the insurance group is exposed. Such procedures must also be an integral part of the group’s risk management framework and be reviewed and evaluated on a regular basis by the Parent Board. In particular, the GSSA should, among other things, demonstrate consideration of the relationship between risk management, the quality and quantity of capital resources, the impact of risk mitigation techniques and diversification and correlation effects between material risks; a description of the group’s risk appetite; be forward-looking; include appropriate stress and scenario testing and appropriately reflect all assets and liabilities, material off-balance sheet arrangements, material intra group transactions, relevant managerial practices, systems and controls and a valuation basis that is aligned with the risk characteristics and business model of the group.

Group Minimum Solvency Margin (“Group MSM”) and Group Enhanced Capital Requirement (“Group ECR”). Effective January 1, 2013, the Designated Insurer must ensure that the value of the Group’s assets exceeds the amount of the Group’s liabilities by the aggregate minimum margin of solvency of each qualifying member of the Group. A member is a qualifying member of the Group if it is subject to solvency requirements in the jurisdiction in which it is registered. Where the parent company exercises control in relation to any member of the group, the minimum margin of solvency of such member shall be its individual minimum solvency margin. Where the parent company exercises significant influence on any member of the Group, the minimum margin of solvency applicable to that member for purposes of calculating the Group MSM shall be an amount equal to the parent company’s percentage shareholding in the member multiplied by that member’s minimum margin of solvency. “Control” and “significant influence” shall be determined in accordance with either the IFRS or GAAP used to prepare the Group’s IFRS or GAAP financial statements. The Group is required to maintain available group capital and surplus at a level equal to 50% of the Group ECR and this requirement will increase by increments of 10% in each of the following five years until 100% is required in 2018. This phasing in schedule is conditioned upon the BMA making further adjustments that would be either needed or appropriate once the effective date of Solvency II capital requirements is finalized.

Group Eligible Capital. To enable the BMA to better assess the quality of the group’s capital resources, the Designated Insurer is required to disclose the makeup of the Group’s capital in accordance with a 3-tiered capital system. Under the eligible capital requirements, all of the Group’s capital instruments will be classified as either basic or ancillary capital which in turn will be classified into one of 3 tiers based on their “loss absorbency” characteristics. Highest quality capital will be classified Tier 1 Capital, lesser quality capital will be classified as either Tier 2 Capital or Tier 3 Capital. A minimum threshold of Tier 1 and maximum thresholds of Tier 2 and Tier 3 Capital used to satisfy the Group MSM and Group ECR requirements are specified under the rules. Tier 1, Tier 2 and Tier 3 Capital may, until January 1 2024, include capital instruments that do not satisfy the requirement that the instrument be non-redeemable or settled only with the issuance of an instrument of equal or higher quality upon a breach, or if redemption would cause a breach, of the Group ECR.

Group Governance. The Group Rules require the Parent Board to establish and effectively implement corporate governance policies and procedures, which it must be periodically review to ensure they continue to support the overall organizational strategy of the group. In particular, the Parent Board must:

- ensure that operational and oversight responsibilities of the group are clearly defined and documented and that the reporting of material deficiencies and fraudulent activities are transparent and devoid of conflicts of interest;
- establish systems for identifying on a risk sensitive basis those policies and procedures that must be reviewed annually and those policies and procedures that must be reviewed at other regular intervals;
- establish a risk management and internal controls framework and ensure that it is assessed regularly and such assessment is reported to the Parent Board and the chief and senior executives;
- establish and maintain sound accounting and financial reporting procedures and practices for the group; and

establish and keep under review group functions relating to actuarial, compliance, internal audit and risk management functions which must address certain specific requirements as set out in the Group Rules.

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Designated Insurer Notification Obligations. The Designated Insurer must notify the BMA upon reaching a view that there is a likelihood of the Group or any member of the Group becoming insolvent or that a reportable “event” has, to the Designated Insurer’s knowledge, occurred or is believed to have occurred. Examples of a reportable “event” include a failure by the Group or any member of the Group to comply substantially with a requirement imposed upon it under the Group Rules relating to its solvency position, governance and risk management or supervisory reporting and disclosures; failure by the Designated Insurer to comply with a direction given to it under the Insurance Act in respect of the group or any of its members; a criminal conviction imposed upon any member of the Group whether in Bermuda or abroad; material breaches of any statutory requirements by any member of the Group located outside of Bermuda that could lead to supervisory or enforcement action by a competent authority; or a significant loss that is reasonably likely to cause the Group to be unable to comply with its Group ECR. Within 30 days of such notification to the BMA, the Designated Insurer must furnish the BMA with a written report setting out all the particulars of the case that are available to it and within 45 days it must furnish a Group capital and solvency return that reflects the Group ECR that has been prepared using post-loss data and unaudited financial statements for such period as the BMA shall require together with a declaration of solvency in respect thereof. The Designated Insurer must also notify the BMA in writing within 14 days of becoming aware that a requirement of the Group Rules conflicts with the laws of another jurisdiction where a member of the Group operates.

The following events constitute material changes that must be notified to the BMA: (i) the amalgamation with or acquisition of another firm, (ii) engaging in unrelated business that is retail business, (iii) the acquisition of a controlling interest in an undertaking that is engaged in non-insurance business which offers services and products to persons who are not affiliates, (iv) outsourcing all or substantially all of the actuarial, risk management and internal audit functions, (v) outsourcing all or a material part of underwriting activities, (vi) the transfer other than by way of reinsurance of all or substantially all of a line of business, and (vii) the expansion into a material new line of business. The Designated Insurer is required to give written notice to the BMA of the fact that a person has become, or ceased to be, a controller or officer of the parent company of the Group within 45 days of becoming aware of such fact. An officer in relation to the parent company of the Group means a director, chief executive or senior executive performing duties of underwriting, actuarial, risk management, compliance, internal audit, finance or investment matters.

If it appears to the BMA that the Designated Insurer is in breach of any provision of the Insurance Act or the Group Rules, the BMA may give the Designated Insurer such directions as appear to the BMA to be desirable for safeguarding the interests of policyholders and potential policyholders of the Group.

BMA’s Powers of Intervention, Obtaining Information, Reports and Documents and Providing Information to other Regulatory Authorities. The BMA may, by notice in writing served on a registered person or a Designated Insurer, require the registered person or a Designated Insurer to provide such information and/or documentation as the BMA may reasonably require with respect to matters that are likely to be material to the performance of its supervisory functions under the Insurance Act. In addition, it may require such person’s auditor, underwriter, accountant or any other person with relevant professional skill to prepare a report on any aspect pertaining thereto. In the case of a report, the person so appointed shall immediately give the BMA written notice of any fact or matter of which he becomes aware or which indicates to him that any condition attaching to his registration under the Insurance Act is not or has not or may not be or may not have been fulfilled and that such matters are likely to be material to the performance of its functions under the Insurance Act. If it appears to the BMA to be desirable in the interests of the clients of a registered person or relevant insurance group, the BMA may also exercise these powers in relation to subsidiaries, parent companies and other affiliates of the registered person or designated insurer.

If the BMA deems it necessary to protect the interests of the policyholders or potential policyholders of an insurer or insurance group, it may appoint one or more competent persons to investigate and report on the nature, conduct or state of the insurer’s or the insurance group’s business, or any aspect thereof, or the ownership or control of the insurer or insurance group. If the person so appointed thinks it necessary for the purposes of his investigation, he may also investigate the business of any person who is or has been at any relevant time, a member of the insurance group or of a partnership of which the person being investigated is a member. In this regard, it shall be the duty of every person who is or was a controller, officer, employee, agent, banker, auditor, accountant, barrister and attorney or insurance



manager to produce to the person appointed such documentation as he may reasonably require for purposes of his investigation, and to attend and answer questions relevant to the investigation and to otherwise provide such assistance as may be necessary in connection therewith.

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Where the BMA suspects that a person has failed to properly register under the Insurance Act or that a registered person or designated insurer has failed to comply with a requirement of the Insurance Act or that a person is not, or is no longer, a fit and proper person to perform functions in relation to a regulated activity, it may, by notice in writing, carry out an investigation into such person (or any other person connected thereto). In connection therewith, the BMA may require every person who is or was a controller, officer, employee, agent, banker, auditor, accountant, barrister and attorney or insurance manager to make a report and produce such documents in his care, custody and control and to attend before the BMA to answer questions relevant to the BMA's investigation and to take such actions as the BMA may direct. The BMA may also enter any premises for the purposes of carrying out its investigation and may petition the court for a warrant if it believes a person has failed to comply with a notice served on him or there are reasonable grounds for suspecting the completeness of any information or documentation produced in response to such notice or that its directions will not be complied with or that any relevant documents would be removed, tampered with or destroyed.

The BMA has the power to assist other regulatory authorities, including foreign insurance regulatory authorities, with their investigations involving insurance and reinsurance companies in Bermuda if it is satisfied that the assistance being requested is in connection with the discharge of regulatory responsibilities and that such cooperation is in the public interest. The grounds for disclosure by the BMA to a foreign regulatory authority without consent of the insurer are limited and the Insurance Act provides for sanctions for breach of the statutory duty of confidentiality.

### Certain Other Bermuda Law Considerations

ACGL and Arch Re Bermuda are incorporated in Bermuda as "exempted companies." As a result, they are exempt from Bermuda laws restricting the percentage of share capital that may be held by non-Bermudians, but they may not participate in certain business transactions, including (i) the acquisition or holding of land in Bermuda (except that required for their business and held by way of lease or tenancy for terms of not more than 50 years) without the express authorization of the Bermuda legislature, (ii) the taking of mortgages on land in Bermuda to secure an amount in excess of \$50,000 without the consent of the Minister of Finance, (iii) the acquisition of any bonds or debentures secured by any land in Bermuda, other than certain types of Bermuda government securities or (iv) the carrying on of business of any kind in Bermuda, except in furtherance of their business carried on outside Bermuda or under license granted by the Minister of Finance. While an insurer is permitted to reinsure risks undertaken by any company incorporated in Bermuda and permitted to engage in the insurance and reinsurance business, generally it is not permitted without a special license granted by the Minister of Finance to insure Bermuda domestic risks or risks of persons of, in or based in Bermuda.

ACGL and Arch Re Bermuda also need to comply with the provisions of The Bermuda Companies Act 1981, as amended (the "Companies Act") regulating the payment of dividends and making distributions from contributed surplus. A company shall not declare or pay a dividend, or make a distribution out of contributed surplus, if there are reasonable grounds for believing that: (i) the company is, or would after the payment be, unable to pay its liabilities as they become due; or (ii) the realizable value of the company's assets would thereby be less than its liabilities. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Financial Condition, Liquidity and Capital Resources—Liquidity and Capital Resources" and note 20, "Statutory Information," of the notes accompanying our financial statements.

Under Bermuda law, only persons who are Bermudians, spouses of Bermudians, holders of a permanent resident's certificate, holders of a working resident's certificate or persons who are exempt pursuant to the Incentives for Job Makers Act 2011, as amended ("exempted persons") may engage in gainful occupation in Bermuda without an appropriate governmental work permit. Our success may depend in part upon the continued services of key employees in Bermuda. Certain of our current key employees are not exempted persons and, as such, require specific approval to work for us in Bermuda. A work permit may be granted or extended upon showing that, after proper public advertisement, no exempted person is available who meets the minimum standards reasonably required by the employer.

### U.S. Insurance Regulation

General. In common with other insurers, our U.S. based subsidiaries are subject to extensive governmental regulation and supervision in the various states and jurisdictions in which they are domiciled and licensed and/or approved to

conduct business. The laws and regulations of the state of domicile have the most significant impact on operations. This regulation and supervision is designed to protect policyholders rather than investors. Generally, regulatory authorities have broad regulatory powers over such matters as licenses, standards of solvency, premium rates, policy forms, marketing practices, claims practices, investments, security deposits, methods of accounting, form and content of financial statements, reserves

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and provisions for unearned premiums, unpaid losses and loss adjustment expenses, reinsurance, minimum capital and surplus requirements, dividends and other distributions to shareholders, periodic examinations and annual and other report filings. In addition, transactions among affiliates, including reinsurance agreements or arrangements, as well as certain third party transactions, require prior regulatory approval from, or prior notice to and no disapproval by, the applicable regulator under certain circumstances. Certain insurance regulatory requirements are highlighted below. In addition, regulatory authorities conduct periodic financial, claims and market conduct examinations. Arch Insurance Company Europe is also subject to certain governmental regulation and supervision in the states where it writes excess and surplus lines insurance.

In addition to regulation applicable generally to U.S. insurance and reinsurance companies, our U.S. mortgage insurance operations are affected by federal and state regulation relating to mortgage insurers, mortgage lenders, and the origination, purchase and sale of residential mortgages. The private mortgage insurance industry is, and likely will continue to be, subject to substantial federal and state regulation, which has increased in recent years as a result of the deterioration of the housing and mortgage markets in the U.S. Increased federal or state regulatory scrutiny could lead to new legal precedents, new regulations, new practices, or regulatory actions or investigations, which could adversely affect our financial condition and operating results.

**Credit for Reinsurance.** Arch Re U.S. is subject to insurance regulation and supervision that is similar to the regulation of licensed primary insurers. However, except for certain mandated provisions that must be included in order for a ceding company to obtain credit for reinsurance ceded, the terms and conditions of reinsurance agreements generally are not subject to regulation by any governmental authority. This contrasts with admitted primary insurance policies and agreements, the rates and terms of which generally are regulated by state insurance regulators. As a practical matter, however, the rates charged by primary insurers do have an effect on the rates that can be charged by reinsurers. Certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), which became effective on July 21, 2011, provide that only the state in which a primary insurer is domiciled may regulate the financial statement credit for reinsurance taken by that primary insurer; other states will no longer be able to impose their own credit for reinsurance laws on primary insurers that are only licensed in such other states. A primary insurer ordinarily will enter into a reinsurance agreement only if it can obtain credit for the reinsurance ceded on its U.S. statutory-basis financial statements. In general, credit for reinsurance is allowed in the following circumstances:

- if the reinsurer is licensed in the state in which the primary insurer is domiciled;
- if the reinsurer is an “accredited” or otherwise approved reinsurer in the state in which the primary insurer is domiciled; in some instances, if the reinsurer (a) is domiciled in a state that is deemed to have substantially similar credit for reinsurance standards as the state in which the primary insurer is domiciled and (b) meets certain financial requirements; or
- if none of the above applies, to the extent that the reinsurance obligations of the reinsurer are collateralized appropriately, typically through the posting of a letter of credit for the benefit of the primary insurer or the deposit of assets into a trust fund established for the benefit of the primary insurer.

Some states have adopted provisions of the National Association of Insurance Commissioners (“NAIC”) adopted amendments to its Credit for Reinsurance Model Law and Regulation (the “NAIC Credit for Reinsurance Model Act”) that allow full credit to U.S. ceding insurers for reinsurance ceded to qualified non-U.S. reinsurers (called “certified reinsurers”) based upon less than 100% collateralization. Under those provisions, collateral requirements may be reduced for international reinsurers meeting certain criteria as to financial strength and reliability that are domiciled in countries that are found to have strong systems of domestic insurance regulation. Applicants for “certified reinsurer” designation must agree to certain financial reporting, consent to jurisdiction and consent to provide collateral for the full amount of their assumed liabilities in specified circumstances. Arch Re Bermuda is approved in Florida and New York to post reduced collateral and may apply to be designated as a “certified reinsurer” in other U.S. states.

As a result of the requirements relating to the provision of credit for reinsurance, Arch Re U.S. and Arch Re Bermuda are indirectly subject to certain regulatory requirements imposed by jurisdictions in which ceding companies are domiciled.

Arch Re U.S. is licensed or is an accredited or otherwise approved reinsurer in 50 states and the District of Columbia. Arch Insurance is licensed as an insurer in 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands and

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Guam with a branch office in Canada (authorized to underwrite until December 31, 2012). Arch Specialty is licensed in one state and approved as an excess and surplus lines insurer in 49 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands. Arch E&S is licensed in one state and approved as an excess and surplus lines insurer in 47 states and the District of Columbia. Arch Indemnity is licensed as an insurer in 49 states and the District of Columbia. Arch Insurance Company Europe is eligible to write excess and surplus lines insurance in 50 states, the District of Columbia, the U.S. Virgin Islands, Guam, the Northern Mariana Islands and American Samoa by virtue of its listing on the NAIC International Insurers Department's Quarterly Listing of Alien Insurers pursuant to the Nonadmitted and Reinsurance Reform Act of 2010. Neither Arch Re Bermuda nor Arch Re Europe expects to become licensed, accredited or so approved in any U.S. jurisdiction.

Certain state regulatory agencies as well are conducting investigations of insurance and reinsurance companies' compliance with various federal and state laws. On June 25, 2013, the New York Department of Financial Services sent a letter to non-U.S. reinsurers approved to post reduced collateral (see "Regulation-U.S. Insurance Regulation-Credit for Reinsurance"), including Arch Re Bermuda, seeking information concerning such reinsurers' compliance with the Iran Freedom and Counter-Proliferation Act of 2012. We cannot predict the effect or outcome of these investigations on the insurance or reinsurance industry, the regulatory framework, or our business, financial condition and results of operations.

**Holding Company Acts.** All states have enacted legislation that regulates insurance holding company systems. These regulations generally provide that each insurance company in the system is required to register with the insurance department of its state of domicile and furnish information concerning the operations of companies within the holding company system which may materially affect the operations, management or financial condition of the insurers within the system. All transactions within a holding company system affecting insurers must be fair and reasonable. Notice to the state insurance departments is required prior to the consummation of certain material transactions between an insurer and any entity in its holding company system. In addition, certain of such transactions cannot be consummated without the applicable insurance department's prior approval, or its failure to disapprove after receiving notice. The holding company acts also prohibit any person from directly or indirectly acquiring control of a U.S. insurance company unless that person has filed an application with specified information with the insurance company's domiciliary commissioner and has obtained the commissioner's prior approval. Under most states' statutes, including Missouri and Nebraska, acquiring 10% or more of the voting securities of an insurance company or its parent company is presumptively considered an acquisition of control of the insurance company, although such presumption may be rebutted. Accordingly, any person or entity that acquires, directly or indirectly, 10% or more of the voting securities of ACGL without the prior approval of the commissioner will be in violation of these laws and may be subject to injunctive action requiring the disposition or seizure of those securities by the commissioner or prohibiting the voting of those securities, or to other actions that may be taken by the commissioner. In 2010, the NAIC adopted amendments to the Insurance Holding Company System Regulatory Act and Regulation, which, among other changes, introduce the concept of "enterprise risk" within an insurance holding company system. If and when the amendments are adopted by a particular state, the amended Insurance Holding Company System Regulatory Act and Regulation would impose more extensive informational requirements on parents and other affiliates of licensed insurers or reinsurers with the purpose of protecting them from enterprise risk, including requiring an annual enterprise risk report by the ultimate controlling person identifying the material risks within the insurance holding company system that could pose enterprise risk to the licensed companies. The amended Insurance Holding Company System Regulatory Act also requires any controlling person of a U.S. insurance company seeking to divest its controlling interest in the insurance company to file with the commissioner a confidential notice of the proposed divestiture at least 30 days prior to the cessation of control; after receipt of the notice, the commissioner shall determine those instances in which the parties seeking to divest or to acquire a controlling interest will be required to file for or obtain approval of the transaction. The amended Insurance Holding Company System Regulatory Act and Regulation must be adopted by the individual states for the new requirements to apply to U.S. domestic insurers and reinsurers. To date, only 24 states, including states in which our U.S.-based insurance subsidiaries are domiciled or licensed, have enacted legislation adopting the amended Insurance Holding Company System Regulatory Act in some form.

Enterprise Risk. The NAIC has increased its focus on risks within an insurer's holding company system that may pose enterprise risk to the insurer. "Enterprise risk" is defined as any activity, circumstance, event or series of events involving one or more affiliates of an insurer that, if not remedied promptly, is likely to have a material adverse effect upon the financial condition or the liquidity of the insurer or its insurance holding company system as a whole. As noted above, the NAIC recently adopted amendments to its Model Insurance Holding Company System Regulatory Act and Regulation, which include, among other amendments, a requirement for the ultimate controlling person to file an enterprise risk report. In 2012, the NAIC adopted the Risk Management and Own Risk and Solvency Assessment ("ORSA") Model Act, which requires domestic insurers to maintain a risk management framework and establishes a legal requirement for domestic

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insurers to conduct an ORSA in accordance with the NAIC's ORSA Guidance Manual. The ORSA Model Act provides that domestic insurers, or their insurance group, must regularly conduct an ORSA consistent with a process comparable to the ORSA Guidance Manual process. The ORSA Model Act also provides that, no more than once a year, an insurer's domiciliary regulator may request that an insurer submit an ORSA summary report, or any combination of reports that together contain the information described in the ORSA Guidance Manual, with respect to the insurer and/or the insurance group of which it is a member. If and when the ORSA Model Act is adopted by a particular state, the ORSA Model Act would impose more extensive filing requirements on parents and other affiliates of domestic insurers.

**Regulation of Dividends and Other Payments from Insurance Subsidiaries.** The ability of an insurer to pay dividends or make other distributions is subject to insurance regulatory limitations of the insurance company's state of domicile. Generally, such laws limit the payment of dividends or other distributions above a specified level. Dividends or other distributions in excess of such thresholds are "extraordinary" and are subject to prior regulatory approval. Such dividends or distributions may be subject to applicable withholding or other taxes. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Financial Condition, Liquidity and Capital Resources—Liquidity and Capital Resources" and note 20, "Statutory Information," of the notes accompanying our financial statements.

**Insurance Regulatory Information System Ratios.** The NAIC Insurance Regulatory Information System ("IRIS") was developed by a committee of state insurance regulators and is intended primarily to assist state insurance departments in executing their statutory mandates to oversee the financial condition of insurance companies operating in their respective states. IRIS identifies 13 industry ratios (referred to as "IRIS ratios") and specifies "usual values" for each ratio. Departure from the usual values of the IRIS ratios can lead to inquiries from individual state insurance commissioners as to certain aspects of an insurer's business. Certain of our U.S.-based subsidiaries generate IRIS ratios that are outside of the usual values. To date, none of these subsidiaries has received any notice of regulatory review regarding the IRIS ratios but there is no assurance that we may not be notified in the future.

**Accreditation.** The NAIC has instituted its Financial Regulation Accreditation Standards Program ("FRASP") in response to federal initiatives to regulate the business of insurance. FRASP provides a set of standards designed to establish effective state regulation of the financial condition of insurance companies. Under FRASP, a state must adopt certain laws and regulations, institute required regulatory practices and procedures, and have adequate personnel to enforce such items in order to become an "accredited" state. If a state is not accredited, other states may not accept certain financial examination reports of insurers prepared solely by the regulatory agency in such unaccredited state. The respective states in which our insurance and reinsurance subsidiaries are domiciled are accredited states.

**Risk-Based Capital Requirements.** In order to enhance the regulation of insurer solvency, the NAIC adopted in December 1993 a formula and model law to implement risk-based capital requirements for property and casualty insurance companies. These risk-based capital requirements are designed to assess capital adequacy and to raise the level of protection that statutory surplus provides for policyholder obligations. The risk-based capital model for property and casualty insurance companies measures three major areas of risk facing property and casualty insurers:

- underwriting, which encompasses the risk of adverse loss developments and inadequate pricing;
- declines in asset values arising from credit risk; and
- declines in asset values arising from investment risks.

An insurer will be subject to varying degrees of regulatory action depending on how its statutory surplus compares to its risk-based capital calculation. For equity investments in an insurance company affiliate, the risk-based capital requirements for the equity securities of such affiliate would generally be our U.S.-based subsidiaries' proportionate share of the affiliate's risk-based capital requirement.

Under the approved formula, an insurer's total adjusted capital is compared to its authorized control level risk-based capital. If this ratio is above a minimum threshold, no company or regulatory action is necessary. Below this threshold are four distinct action levels at which a regulator can intervene with increasing degrees of authority over an insurer as the ratio of surplus to risk-based capital requirement decreases. The four action levels include:

- insurer is required to submit a plan for corrective action;
- insurer is subject to examination, analysis and specific corrective action;





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regulators may place insurer under regulatory control; and

regulators are required to place insurer under regulatory control.

Each of our U.S. subsidiaries' surplus (as calculated for statutory purposes) is above the risk-based capital thresholds that would require either company or regulatory action.

Guaranty Funds and Assigned Risk Plans. Most states require all admitted insurance companies to participate in their respective guaranty funds which cover certain claims against insolvent insurers. Solvent insurers licensed in these states are required to cover the losses paid on behalf of insolvent insurers by the guaranty funds and are generally subject to annual assessments in the states by the guaranty funds to cover these losses. Participation in state-assigned risk plans may take the form of reinsuring a portion of a pool of policies or the direct issuance of policies to insureds. The calculation of an insurer's participation in these plans is usually based on the amount of premium for that type of coverage that was written by the insurer on a voluntary basis. Assigned risk pools tend to produce losses which result in assessments to insurers writing the same lines on a voluntary basis.

Federal Regulation. Although state regulation is the dominant form of regulation for insurance and reinsurance business, the federal government in recent years has shown some concern over the adequacy of state regulation. It is not possible to predict the future impact of any potential federal regulations or other possible laws or regulations on our U.S. based subsidiaries' capital and operations, and such laws or regulations could materially adversely affect their business. In addition, a number of federal laws affect and apply to the insurance industry, including various privacy laws and the economic and trade sanctions implemented by the Office of Foreign Assets Control ("OFAC"). OFAC maintains and enforces economic sanctions against certain foreign countries and groups and prohibits U.S. persons from engaging in certain transactions with certain persons or entities. OFAC has imposed civil penalties on persons, including insurance and reinsurance companies, arising from violations of its economic sanctions program.

Certain federal laws, such as the Real Estate Settlement Procedures Act of 1974 ("RESPA") and the Homeowners Protection Act of 1998 ("HOPA"), directly impact mortgage insurers. Other federal law and regulation relating to mortgage lenders and servicers, the GSEs, the Federal Housing Administration ("FHA") and the U.S. Department of Veterans Affairs ("VA") may also affect mortgage insurers and the demand for private mortgage insurance. Such laws include the Equal Credit Opportunity Act, the Fair Housing Act, the Truth In Lending Act ("TILA"), the Fair Credit Reporting Act of 1970 ("FCRA"), and the Fair Debt Collection Practices Act. Among other things, these laws and their implementing regulations prohibit payments for referrals of settlement service business, require fairness and non-discrimination in granting or facilitating the granting of credit, govern the circumstances under which companies may obtain and use consumer credit information, define the manner in which companies may pursue collection activities, and require disclosures of the cost of credit and provide for other consumer protections.

The Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act created the Federal Insurance Office ("FIO") within the Department of Treasury, which is not a federal regulator or supervisor of insurance, but monitors the insurance industry for systemic risk, administers the Terrorism Risk Insurance Program Reauthorization Act of 2007 ("TRIPRA"), consults with the states regarding insurance matters and develops federal policy on aspects of international insurance matters. In 2013, the FIO issued two reports relating to the insurance industry, one on modernization of the insurance regulatory system and one on the impact of Part II of the Nonadmitted and Reinsurance Reform Act of 2010. In its December 2013 report on modernization of the insurance regulatory system, the FIO recommended that federal standards and oversight for mortgage insurers be developed and implemented. The FIO has sought comment from the insurance industry in connection with a further report on the global reinsurance market and the regulation of reinsurance, which has not yet been released. The impact that these reports will have on the regulation of insurance, if any, is yet to be determined. The Dodd-Frank Act also created a uniform system for non-admitted insurance premium tax payments based on the home state of the policyholder and provides for single state regulation for financial solvency and credit for reinsurance as discussed above.

The Dodd-Frank Act established the Consumer Finance Protection Bureau ("CFPB") to regulate the offering and provision of consumer financial products and services under federal law, including residential mortgages. Pursuant to the Dodd-Frank Act, the CFPB is charged with rulemaking and enforcement with respect to enumerated consumer laws, including RESPA, TILA, HOPA, the SAFE Act and FCRA. The Dodd-Frank Act also granted to the CFPB certain supervisory powers with respect to "covered persons" and "service providers," as defined by the Act. The CFPB

recently published residential mortgage servicing rules pursuant to TILA and RESPA. The CFPB has issued Civil Investigative

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Demands to several other mortgage insurers and in 2013 the United States District Court for the Southern District of Florida approved consent orders issued by the CFPB against four other mortgage insurers relating to captive reinsurers.

Under the Dodd-Frank Act, the CFPB is authorized to issue regulations governing a loan originator's determination that, at the time a loan is originated, the consumer has a reasonable ability to repay the loan ("ATR"). The CFPB issued final ATR regulations in 2013 containing detailed requirements on how lenders must verify a borrower's ability to repay a covered mortgage loan. The ATR rule became effective in January 2014. The Dodd-Frank Act provides for a statutory presumption that a borrower will have the ability to repay a loan if the loan has characteristics satisfying the definition of "qualified mortgage," or QM, as contained in the CFPB's ATR regulations. Creditors who violate the ATR rule can be liable for interest and fees paid by the borrower as well as actual and statutory damages. A borrower may assert such a violation as a defense by recoupment or set off in a foreclosure action.

Under the CFPB's ATR rule, a loan is deemed to be a QM if it meets certain requirements, including:

- the term of the mortgage is 30 years or less;
- there is no negative amortization, interest only or balloon features;
- the lender documents the loan in accordance with requirements;
- the total "points and fees" do not exceed certain thresholds, generally 3%; and
- the total debt-to-income ratio does not exceed 43%.

The QM definition provides a "safe harbor" for QM loans with annual percentage rates, or APRs, below the threshold of 150 basis points over the Average Prime Offer Rate and a "rebuttable presumption" of compliance with ATR requirements for QM loans with an APR above that threshold.

The ATR rule also provides for a second, temporary category that allows for more flexible underwriting requirements. To qualify under the temporary QM definition, a mortgage must meet the general product feature requirements and be eligible to be purchased or guaranteed by the GSEs while they remain under conservatorship, FHA, VA, the Department of Agriculture or the Rural Housing Service. This temporary QM category expires on January 10, 2021, or earlier to the extent that the conservatorship of the Federal Housing Finance Agency ("FHFA") ends or federal agencies issue their own qualified mortgage rules. In May 2013, the FHFA directed the GSEs to limit purchases after January 10, 2014 to loans that meet certain QM criteria. On September 30, 2013, HUD proposed a separate definition of a qualified mortgage for loans insured by the FHA. To the extent that government agencies adopt their own definitions of a qualified mortgage and those definitions are more favorable to lenders than those applicable to the market in which private mortgage insurers participate, our business may be adversely affected.

Under the QM Rule, mortgage insurance premiums that are payable by the consumer at or prior to consummation of the loan are includible in the calculation of points and fees unless, and to the extent that, they are less than or equal to those charged by FHA and are automatically refundable on a pro rata basis upon satisfaction of the loan.

Borrower-paid single premium products, both refundable and non-refundable, may be included within the points and fees calculation under the QM Rule. Because inclusion of mortgage insurance premiums in the calculation of points and fees will reduce the capacity for other points and fees in order for lenders to comply with the QM Rule, mortgage originators may be less likely to use those mortgage insurance products. The treatment of mortgage insurance premiums as a component of the points and fees calculation, or the potential indirect impact of mortgage insurance premiums on the total points and fees, may be factors as to whether a loan is in the safe harbor, receives a rebuttable presumption of ability to repay, or receives no presumption.

Because of the QM evidentiary standard that gives presumption of compliance, we anticipate that most newly-originated mortgages will be QMs. As a result, we believe that the QM regulations will have an impact on the size of the residential mortgage market. Our operating results could be adversely impacted if the QM regulations reduce the size of the origination market, reduce the willingness of lenders to extend low down payment credit, favor alternatives to private mortgage insurance such as government mortgage insurance programs, or change the mix of mortgage insurance business in ways that may be unfavorable to us.

The Dodd-Frank Act generally requires an issuer of an asset-backed security or initiator of an asset-backed transaction (a "securitizer") to retain at least 5% of the risk associated with securitized mortgage loans, although in some cases the retained risk may be allocated between the securitizer and the mortgage originator. This risk-retention requirement

does not

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apply to a mortgage loan that is a "qualified residential mortgage," or "QRM," or that is insured or guaranteed by FHA or certain other federal agencies. In March 2011, federal regulators issued a proposed risk-retention rule that included a definition of QRM and an alternative definition. In August 2013, federal regulators made public a revised proposed risk retention rule and QRM definition (the "Revised Proposal"). The Revised Proposal generally defines QRM as a mortgage meeting the requirements of a QM. In addition, an alternative QRM definition, "QM-plus," that was considered but ultimately not selected as the preferred approach, was also proposed for comment. In addition to adopting certain QM criteria, QM-plus incorporates a maximum LTV standard of 70% and other restrictions to reduce the risk of default. Under the QM-plus alternative, significantly fewer loans likely would qualify as a QRM and, therefore, be exempt from risk retention.

Under the original and the Revised Proposal, lenders that originate loans that are sold to the GSEs while they are in conservatorship will not be required to retain risk associated with those loans. Changes in the conservatorship status of the GSEs or capital support provided to the GSEs by the U.S. government could impact the manner in which the credit risk retention rules apply to the GSEs.

If the final rules treat all QM loans as QRMs, low down payment loans with private mortgage insurance that do not meet the requirements of the QM rule can only be securitized with a risk retention requirement, which may further deter their origination and adversely affect our business. If the final definition includes a substantial down payment requirement, as in QM-plus, without recognition of private mortgage insurance to meet the definition, loans with LTVs in excess of the final requirement that are not guaranteed by the GSEs cannot be securitized without risk retention, which may deter their origination and adversely affect our business. Neither definition of QRM in the Revised Proposal incorporates the use of private mortgage insurance. The final timing of the adoption of any risk retention regulation and the definition of QRM remains uncertain.

The Dodd-Frank Act amended and expanded mortgage servicing requirements under TILA and RESPA. The CFPB published final regulations implementing these mortgage servicing requirements which became effective in January 2014. New loss mitigation procedures include the prohibition of commencement of foreclosure by the loan holder or servicer until 120 days after the borrower's delinquency. This and other loss mitigation requirements could cause delays in default servicing, cause the servicing of mortgage loans to become more costly, and could have an adverse impact on the timely resolution of mortgage insurance claims.

The Homeowners Protection Act of 1998. HOPA provides for the automatic termination, or cancellation upon a borrower's request, of private mortgage insurance upon satisfaction of certain conditions. HOPA requires that lenders give borrowers certain notices with regard to the automatic termination or cancellation of mortgage insurance. These provisions apply to borrower-paid mortgage insurance for purchase money, refinance and construction loans secured by the borrower's principal dwelling. FHA and VA loans are not covered by HOPA. Under HOPA, automatic termination of mortgage insurance generally occurs when the mortgage is first scheduled to reach an LTV of 78% of the home's original value, assuming that the borrower is current on the required mortgage payments. A borrower who has a "good payment history," as defined by HOPA, may generally request cancellation of mortgage insurance when the LTV is first scheduled to reach 80% of the home's original value or when actual payments reduce the loan balance to 80% of the home's original value.

Real Estate Settlement Procedures Act of 1974. Subject to limited exceptions, RESPA prohibits persons from giving or accepting anything of value in connection with the referral of a settlement service. Mortgage insurance generally has been considered to be a "settlement service" for purposes of RESPA. RESPA authorizes the CFPB, the Department of Justice, state attorneys general and state insurance commissioners to bring civil enforcement actions, and also provides for criminal penalties and private rights of action. In the past, a number of lawsuits have challenged the actions of private mortgage insurers under RESPA, alleging that the insurers violated the referral fee prohibition by entering into captive reinsurance arrangements or providing products or services to mortgage lenders at improperly reduced prices in return for the referral of mortgage insurance, including the provision of contract underwriting services. In addition to these private lawsuits, in April 2013, the United States District Court for the Southern District of Florida approved consent orders issued by the CFPB against four other private mortgage insurers relating to captive reinsurance. Under the settlements, the mortgage insurers will end the challenged practices, pay monetary penalties, and be subject to monitoring by the CFPB and required to make reports to the CFPB in order to ensure their

compliance with the provisions of the orders.

Home Mortgage Disclosure Act of 1975. The Home Mortgage Disclosure Act of 1975 (“HMDA”) requires most mortgage originators to collect and report to the CFPB data relating to a mortgage loan applicant's race, nationality, gender, marital status, and census tract. Mortgage insurers are not required pursuant to law or regulation to report HMDA data,

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although, under the laws of several states, mortgage insurers are currently prohibited from discriminating on the basis of certain classifications. Mortgage insurers have, through an industry trade group, voluntarily reported the same data on loans submitted for insurance as is required for most mortgage lenders under HMDA.

Secure and Fair Enforcement for Mortgage Licensing Act. The Secure and Fair Enforcement for Mortgage Licensing Act ("SAFE Act") requires mortgage loan originators to be licensed or registered with the Nationwide Mortgage Licensing System and Registry, a database established by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators. We do not believe that the SAFE Act applies to Arch MI U.S. employees or contractors who review loan files in connection with underwriting mortgage insurance applications for the purpose of making mortgage insurance decisions. If the SAFE Act is interpreted to apply to our underwriters or other employees or contractors, we would take steps to comply with the Act, which could increase our costs.

Fair Credit Reporting Act. The Fair Credit Reporting Act ("FCRA") imposes restrictions on the permissible use of credit report information. FCRA has been interpreted by some FTC staff and federal courts to require mortgage insurance companies to provide "adverse action" notices to consumers in the event an application for mortgage insurance is declined or offered at less than the best available rate for the loan program applied for on the basis of a review of the consumer's credit. Arch MI U.S. provides notices as required. Although Arch MI U.S. has not been involved, there has been class action litigation over FCRA adverse action notices involving the mortgage industry, including court-approved settlements.

Terrorism Risk Insurance Program Reauthorization Act of 2007. The Terrorism Risk Insurance Act of 2002 was amended and extended by the Terrorism Risk Insurance Extension Act of 2005 and amended and extended again by TRIPRA through December 31, 2014. TRIPRA provides a federal backstop for insurance related losses resulting from any act of terrorism on U.S. soil or against certain U.S. air carriers, vessels or foreign missions. Under TRIPRA, all U.S. based property and casualty insurers are required to make terrorism insurance coverage available in specified commercial property and casualty insurance lines. Under TRIPRA, the federal government will pay 85% of covered losses after an insurer's losses exceed a deductible determined by a statutorily prescribed formula, up to a combined annual aggregate limit for the federal government and all insurers of \$100 billion. If an act (or acts) of terrorism result in covered losses exceeding the \$100 billion annual limit, insurers with losses exceeding their deductibles will not be responsible for additional losses. An insurer's deductible for each year is based on the insurer's direct commercial earned premiums for property and casualty insurance, excluding certain lines of business such as commercial auto, surety, professional liability and earthquake lines of business, for the prior calendar year multiplied by a specified percentage. The specified percentages for prior periods were 15% for 2005, 17.5% for 2006 and 20% for 2007 through 2013 and will be 20% for 2014.

Our U.S.-based property and casualty insurers, Arch Insurance, Arch Specialty, Arch E&S and Arch Indemnity, are subject to TRIPRA. TRIPRA specifically excludes reinsurance business and, accordingly, does not apply to our reinsurance operations. Our insurance group's deductible for 2013 was approximately \$239 million (i.e., 20.0% of direct earned premiums). Based on 2013 direct commercial earned premiums, our insurance group's deductible for 2014 will be approximately \$258 million (i.e., 20.0% of such direct earned premiums). It is possible that TRIPRA, which is currently scheduled to expire on December 31, 2014, will not be removed, or that coverage currently provided under TRIPRA will be significantly different after 2014.

The Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Act of 1999 ("GLBA"), which implements fundamental changes in the regulation of the financial services industry in the United States, was enacted on November 12, 1999. The GLBA permits mergers that combine commercial banks, insurers and securities firms under one holding company, a "financial holding company." Bank holding companies and other entities that qualify and elect to be treated as financial holding companies may engage in activities, and acquire companies engaged in activities, that are "financial" in nature or "incidental" or "complementary" to such financial activities. Such financial activities include acting as principal, agent or broker in the underwriting and sale of life, property, casualty and other forms of insurance and annuities.

Until the passage of the GLBA, the Glass-Steagall Act of 1933 had limited the ability of banks to engage in securities-related businesses, and the Bank Holding Company Act of 1956 had restricted banks from being affiliated with insurers. Since passage of the GLBA, among other things, bank holding companies may acquire insurers, and



insurance holding companies may acquire banks. The ability of banks to affiliate with insurers may affect our U.S. subsidiaries' product lines by substantially increasing the number, size and financial strength of potential competitors. The GLBA also imposes privacy requirements on financial institutions, including obligations to protect and safeguard consumers' nonpublic personal information and records, and limitations on the re-use of such information. Federal

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regulatory agencies have issued Interagency Guidelines Establishing Information Security Standards, or "Security Guidelines," and interagency regulations regarding financial privacy, or "Privacy Rule," implementing sections of GLBA. The Security Guidelines establish standards relating to administrative, technical, and physical safeguards to ensure the security, confidentiality, integrity, and the proper disposal of consumer information. The Privacy Rule limits a financial institution's disclosure of nonpublic personal information to unaffiliated third parties unless certain notice requirements are met and the consumer does not elect to prevent or "opt out" of the disclosure. The Privacy Rule also requires that privacy notices provided to customers and consumers describe the financial institutions' policies and practices to protect the confidentiality and security of the information. With respect to mortgage insurers, GLBA is enforced by the U.S. Federal Trade Commission, or FTC, and state insurance regulators. Many states have enacted legislation implementing GLBA and establishing information security regulation. Many states have enacted privacy and data security laws which impose compliance obligations beyond GLBA, including obligations to protect social security numbers and provide notification in the event that a security breach results in a reasonable belief that unauthorized persons may have obtained access to consumer nonpublic information.

GSE Qualified Mortgage Insurer Requirements. Pursuant to their charters, the GSEs purchase low down payment loans insured by MIs that they determine to be qualified. Fannie Mae and Freddie Mac have each published comprehensive requirements to become and remain a qualified mortgage insurer (the "Eligibility Requirements"). Both Fannie Mae and Freddie Mac are in the process of revising their Eligibility Requirements and issued new draft eligibility requirements in 2010. Freddie Mac issued further draft requirements in 2011. FHFA, regulator and conservator of the GSEs, has announced its intention to complete the revision process. We expect new requirements to include a substantially revised capital adequacy framework with minimum capital requirements.

Arch MI U.S. is currently approved by the GSEs as an eligible mortgage insurer. In addition to the Eligibility Requirements, the GSEs imposed conditions in connection with their approvals of Arch MI U.S. as a qualified mortgage insurer. These conditions require, among other things, that Arch MI U.S.:

- maintain, through December 31, 2016, minimum capital funding of \$400 million which may consist of statutory capital (policyholders' surplus plus contingency reserves) of no less than \$200 million, dedicated reinsurance trust assets for any primary business reinsured and the value of purchased technology assets;
- maintain minimum statutory capital (defined as policyholders' surplus plus contingency reserves) of no less than \$260 million;
- maintain a risk-to-capital ratio of no greater than 18 to 1;
- refrain from paying dividends to affiliates for three years commencing February 2014;
- insure only (i) GSE-eligible loans, (ii) loans that are GSE-eligible, other than as related to loan amount, (iii) loans originated under a state housing finance agency program, (iv) loans that meet the requirements of a "Qualified Mortgage" under federal regulation, or (v) other loans not included in (i) through (iv) provided that such loans in aggregate not constitute more than 2% of Arch MI U.S.'s total outstanding risk in force with a coverage effective date on or after December 31, 2003;
- obtain prior written approval to enter into transactions involving the issuance of insurance on other than an individual loan "flow" basis;
- not enter into reinsurance or other risk share arrangements without prior written approval; and
- re-domicile from Wisconsin to another state if requested by Fannie Mae.

Arch MI U.S.'s GSE approvals include additional conditions with respect to affiliate expense sharing arrangements, requirements to obtain a financial strength rating, provision of ancillary services (i.e., non-insurance) to customers, changes of ownership, and provisions regarding underwriting policies and claims processing.

In 2013, the GSEs also mandated minimum standards for mortgage insurer master policies, including standards relating to limitations of a mortgage insurer's rescission rights. We have developed a new master policy that conforms to these minimum standards and expect that policy to be implemented in 2014, subject to approval by state insurance regulators.

State Insurance Regulation of Mortgage Insurers. Arch MI U.S. is subject to detailed regulation both by its domiciliary and primary regulator, the Wisconsin Office of the Commissioner of Insurance ("Wisconsin OCI") and by state



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insurance departments in each state in which it is licensed. As mandated by state insurance laws, mortgage insurers are generally mono-line companies restricted to writing a single type of insurance business, such as mortgage insurance business. Arch MI U.S. is subject to Wisconsin statutory requirements as to payment of dividends. The maximum amount of dividends that Arch MI U.S. may pay in any 12-month period without regulatory approval by the Wisconsin OCI is the lesser of adjusted statutory net income or 10% of statutory policyholders' surplus as of the preceding calendar year end. Adjusted statutory net income is defined for this purpose to be the greater of:

net income for the calendar year preceding the date of the dividend, minus realized capital gains for that calendar year; or

aggregate net income for the 3 calendar years preceding the date of the dividend, less realized capital gains for those calendar years and less dividends paid or credited and distributions made within the first 2 of the preceding 3 calendar years.

Generally, Wisconsin law precludes any dividend before giving at least 30 days' notice to the Wisconsin OCI and prohibits paying any dividend unless it is fair and reasonable to do so. In addition to Wisconsin, the GSEs and other states limit or restrict Arch MI U.S.'s ability to pay stockholder dividends.

Mortgage insurance companies licensed in Wisconsin are required to establish contingency loss reserves for purposes of statutory accounting in an amount equal to at least 50% of net earned premiums. These amounts generally cannot be withdrawn for a period of 10 years. However, with prior regulatory approval, a mortgage insurance company may make early withdrawals from the contingency reserve when incurred losses exceed 35% of net premiums earned in a calendar year.

Under Wisconsin law, as well as that of 15 other states, a mortgage insurer must maintain a minimum amount of statutory capital relative to its risk in force in order for the mortgage insurer to continue to write new business. While formulations of minimum capital vary in certain jurisdictions, the most common measure applied allows for a maximum risk-to-capital ratio of 25 to 1. Wisconsin requires a mortgage insurer to maintain a "minimum policyholder position" calculated in accordance with regulations. Policyholders' position consists primarily of statutory policyholders' surplus plus the statutory contingency reserve. While the statutory contingency reserve is reported as a liability on the statutory balance sheet, for risk-to-capital ratio calculations, it is included as capital for purposes of statutory capital.

The NAIC has established a Mortgage Guaranty Insurance Working Group ("Working Group") to make recommendations to the NAIC's Financial Condition Committee regarding changes to the NAIC's Mortgage Guaranty Insurance Model Act. The Working Group has released a draft Model Act which includes proposed changes to minimum statutory capital requirements and changes to the extent to which, and period for which, mortgage insurers must establish and hold contingency reserves. If the NAIC revises the Model Act, some state legislatures are likely to enact and implement part or all of the revised provisions.

Mortgage insurance premium rates are also subject to review and approval by state regulators. Any increase in premium rates must be justified, generally on the basis of the insurer's loss and default experience, expenses and future trend analysis. Arch MI U.S. has approved premium rates for credit union originated mortgage loans in all 50 states and approved premium rates for mortgage banking originated mortgage loans in 48 states.

Legislative and Regulatory Proposals. From time to time various regulatory and legislative changes have been proposed in the insurance and reinsurance industry. Among the proposals that have in the past been or are at present being considered are the possible introduction of federal regulation in addition to, or in lieu of, the current system of state regulation of insurers and the NAIC. In addition, there are a variety of proposals being considered by various state legislatures. Two ongoing areas of work at the NAIC are model rules relating to corporate governance and consideration of enhanced methods of group supervision.

Since the GSEs were placed into the conservatorship of FHFA in 2008, there has been debate regarding the roles of the GSEs, the federal government and private capital in the U.S. housing finance system. The federal government currently plays a dominant role in the U.S. housing finance system through the GSEs and the FHA, VA and Ginnie Mae. There is broad policy consensus toward the need for private capital to play a larger role and government credit risk to be reduced. However, to date there has been a lack of consensus with regard to the specific changes necessary to return a larger role for private capital and reduce the role of government. The size, complexity and centrality of the

GSEs to the current housing

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finance system and the importance of housing to the economy make the transition to any new housing finance system difficult.

GSE and secondary market reform proposals put forward since 2008 include the nearly complete privatization and elimination of the role of the GSEs, recapitalization of the GSEs, and a number of alternatives that combine a federal role with private capital, some of which eliminate the GSEs and others of which envision an on-going role for the GSEs. In February 2011, the U.S. Department of the Treasury released a proposal to reform the U.S. housing finance market. While Treasury's proposal did not provide a particular timeline for GSE reform, it included the substantial reduction of government's footprint in housing finance. With respect to long-term reform, Treasury's proposal outlined three options for a future housing finance system, each of which differs in both the structure and scale of the federal government's future role:

Option 1: Privatized system of housing finance with the federal government's role limited to providing assistance for narrowly targeted groups of borrowers, leaving the vast majority of the mortgage market to the private sector;

Option 2: Similar to Option 1, but with the ability for the federal government to scale up to a larger share of the market if private capital withdraws in times of financial stress; and

Option 3: Similar to Option 2, but with assistance to low- and moderate-income borrowers and with the federal government providing catastrophic reinsurance behind private capital for securities of a targeted range of mortgages.

In August 2013, President Obama issued a set of core principles for housing finance reform which endorsed Option 3 and intended to ensure widespread and consistent access to 30-year fixed rate mortgages while phasing out the role of the GSEs in the housing finance system. The Obama Administration also endorsed intermediate steps to transition to a new housing finance system, including reducing the government's credit risk exposure at the GSEs through: (i) a capital markets approach in which private investors take on the risk of the portfolio's first losses, and (ii) an insurance approach in which well capitalized and regulated private institutions insure a portfolio of mortgages against default and collect insurance premiums.

Several reform proposals have been and are currently being considered by Congress. On July 24, 2012, the House Financial Services Committee passed H.R. 2767, "The Protecting American Taxpayers and Homeowners Act of 2013" (the "PATH Act"), a comprehensive secondary market reform plan similar to Option 1 including a very limited risk-bearing role for government and winding down of the GSEs, as well as extensive reforms to the FHA. Legislation in the Senate is likely to be influenced by, among other things, proposed bipartisan legislation co-authored by Senators Bob Corker (R-TN) and Mark Warner (D-VA), titled S. 1217, "The Housing Finance Reform and Taxpayer Protection Act" (the "Corker-Warner Bill"). The Corker-Warner Bill sets a framework for GSE and secondary market reform that includes winding down the GSEs over a five year period and the creation of a new entity, the Federal Mortgage Insurance Corporation, or FMIC, as a successor to FHFA with responsibility for running a catastrophic government insurance fund for certain mortgage-backed securities and regulating the operation of the secondary market. Among its provisions, properly underwritten mortgages meeting certain conditions, including private mortgage insurance on loans with LTVs in excess of 80%, will be eligible to be securitized with the catastrophic government guarantee provided by FMIC. The prospects for passage of housing finance and GSE reform legislation remain uncertain in both the House and Senate.

New federal legislation could reduce the level of private mortgage insurance coverage used by the GSEs as credit enhancement, eliminate the GSE charter requirement altogether or otherwise alter or eliminate the role of the GSEs, and thereby materially affect Arch MI U.S.'s ability to compete and the demand for its products.

As the regulator and conservator of the GSEs, FHFA has the authority to establish the priorities of the GSEs and to control and direct their operations. FHFA has made changes to the business and operations of the GSEs, in part under the direction of an FHFA-developed strategic plan for the conservatorship of the GSEs. This strategic plan called for the contraction of the role of the GSEs and expansion of the role of private capital through a number of actions, including shrinking the portfolios of the GSEs, raising guaranty fees and consideration of expanded use of credit risk sharing with private market participants, including private mortgage insurance and capital markets. On January 6, 2014, U.S. Representative Melvin Watt was sworn in as Director of FHFA. It is unknown how or to what extent FHFA's strategic plan for the GSEs will change under its new director.

Arch MI U.S. competes with the single-family mortgage insurance programs of FHA, which is part of HUD. Congress is considering legislation to reform FHA. In 2012, an FHA reform bill, H.R. 4264 "The FHA Emergency Fiscal

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Solvency Act of 2012," passed the House of Representatives. In July 2013, the House Financial Services Committee passed the PATH Act, which contains among its provisions extensive reforms to FHA. Also in July 2013, the Senate Banking Committee passed the S. 1376 "The FHA Solvency Act of 2013." Despite areas of similarity, there are significant differences between the PATH Act and the FHA Solvency Act of 2013. The prospects for passage of FHA reform legislation in either the House or Senate, and how differences in proposed reforms between the House and Senate might be resolved in any final legislation, are uncertain. If FHA reform were to raise FHA premiums, tighten FHA credit guidelines, make other changes which make lender use of the FHA less attractive, or implement credit risk sharing between the FHA and private mortgage insurers, these changes may be beneficial to Arch MI U.S. However, there can be no assurance that any FHA reform legislation will be enacted into law, and what provisions may be contained in any final legislation, if any.

We are unable to predict whether any of these proposed laws and regulations will be adopted, the form in which any such laws and regulations would be adopted, or the effect, if any, these developments would have on our operations and financial condition. See "—U.S. Insurance Regulation—General."

Basel III. In 1988, the Basel Committee on Banking Supervision developed the Basel Capital Accord ("Basel I"), which set out international benchmarks for assessing banks' capital adequacy requirements. In 2005, the Basel Committee issued an update to Basel I ("Basel II"), which, among other things, governs the capital treatment of mortgage insurance purchased by domestic and international banks in respect of their origination and securitization activities. In November 2010, the U.S. agreed to a new capital framework known as Basel III. This new capital framework is replacing the Basel II capital rules, which have not yet been implemented for U.S. depository institutions or holding companies. The Basel III framework applies to the 10 to 12 largest U.S. banking organizations, as well as to banking companies. It may also be imposed on non-banking financial companies that are determined by the relevant regulators to present systemic risks to the U.S. financial system. The Basel III framework refines the Basel II risk-based structure by requiring the use of highly stressed scenarios in determining the appropriate levels of risk undertaken by banks, and it also increases the required minimum capital ratios. The Basel III framework restricts the instruments that can count toward meeting the capital requirements, placing greater emphasis on common equity and retained earnings. Finally, Basel III will impose a new minimum liquidity standard on banking organizations.

The phase in period for the Basel III regime for larger banking organizations began on January 1, 2014 and for community banks will begin on January 1, 2015. The final regulations increase the amount of capital and the quality of the capital required to be held by banks. In addition, the capital rules continue to risk-weight assets based on internal models that use inputs such as the probability of default and the bank's expected loss given a default. The final regulations continue the current risk weighting of residential mortgage assets and the treatment of mortgage insurance as reducing the risk weighting on mortgages where the borrower has made a down payment of less than 10% of the value of the residential property. Draft Basel III regulations proposed by the regulators in 2012 would have increased the risk weightings of residential mortgage assets and did not require that mortgage insurance be factored into the calculation of the risk weightings. In addition, the final regulations increase the risk weighting for mortgage servicing assets held by banks and require the mortgage servicing assets above certain levels be deducted from the calculation of Tier I equity. Since most low down payment mortgages originated today are either sold to the GSEs or insured by the FHA or guaranteed by the VA, we cannot predict what, if any, impact to the mortgage insurance industry the Basel III regulations will have. Since a significant percentage of the mortgages insured by the mortgage insurance industry are serviced by banks or bank-owned mortgage companies, the changes in risk weighting for mortgage servicing assets and the deductions from Tier I equity capital for mortgage servicing assets above certain levels could cause shifts in the amounts of mortgages serviced by banks and bank affiliates or subsidiaries relative to non-banking organizations. It is difficult to predict the impact these shifts may have on the quality of the servicing of insured mortgages or the ultimate impact on the mortgage insurance industry.

#### United Kingdom Insurance Regulation

General. The Financial Services Authority (the "FSA"), which on April 1, 2013 was replaced by the Prudential Regulatory Authority ("PRA") and the Financial Conduct Authority ("FCA"), regulated insurance and reinsurance companies and firms carrying on insurance mediation activities operating in the U.K. under the Financial Services and Markets Act 2000 (the "FSMA"). In May 2004, Arch Insurance Company Europe was licensed and authorized by the



FSA. It holds the relevant permissions for the classes of insurance business which it underwrites in the U.K. In 2009, AUAL was licensed and authorized by the FSA and the Lloyd's Franchise Board. AUAL holds the relevant permissions for the classes of insurance business which are underwritten in the U.K. by Arch Syndicate 2012. Arch Syndicate 2012 has one member, Arch Syndicate Investments Ltd. Arch Risk Partners was licensed and authorized by the FSA in February 2012 to conduct

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insurance mediation activities. All U.K. companies are also subject to a range of statutory provisions, including the laws and regulations of the Companies Acts 2006 (as amended) (the “U.K. Companies Acts”).

The primary statutory goals of the FSA were to maintain and promote confidence in the U.K. financial system, secure the appropriate degree of protection for consumers and reduce financial crime. The FSA regulatory regime imposed risk management, solvency and capital requirements on U.K. insurance companies. The FSA had broad authority to supervise and regulate insurance companies and firms carrying on insurance mediation which extended to enforcement of the provisions of the FSMA and intervention in the operations of an insurance company. The FSA regime was based on principles from which all of its rules and guidance derived. Among these principles, the FSA increasingly emphasized a “culture of compliance” in those firms it regulated. The FSA carried out regular Advanced Risk Responsive Operating Framework (“ARROW”) assessments of regulated firms to ensure compliance with its rules and guidance. The FSA conducted risk assessments of Arch Insurance Company Europe in 2006 and 2008 and of Arch Insurance Company Europe and AUAL in 2011. The assessments provided the FSA’s views on Arch Insurance Company Europe’s and AUAL’s risk profile and regulatory capital requirements. In some cases, the FSA could have required remedial action or adjustments to a company’s management, operations, capital requirements, claims management or business plan.

The objectives of the PRA are to promote the safety and soundness of all firms it supervises and to secure an appropriate degree of protection for policyholders. The objectives of the FCA are to ensure customers receive financial services and products that meet their needs, to promote sound financial systems and markets and to ensure that firms are stable and resilient with transparent pricing information and which compete effectively and have the interests of their customers and the integrity of the market at the heart of how they run their business. The responsibilities of the FSA were split so that the PRA assumed responsibility for prudential regulation of banks and insurers, while the FCA assumed responsibility for the conduct of business regulation in the wholesale and retail markets. The ARROW assessment has been replaced, and the PRA and FCA adopted separate methods of assessing regulated firms. Arch Insurance Company Europe and AUAL are subject to regulation by both the PRA and FCA. Arch Risk Partners is subject to regulation by the FCA only.

Lloyd’s Supervision. The operations of AUAL and related Arch Syndicate 2012 and its corporate member, Arch Syndicate Investments Ltd (“ASIL”), are subject to the byelaws and regulations made by (or on behalf of) the Council of Lloyd’s, and requirements made under those byelaws. The Council of Lloyd’s, established in 1982 by Lloyd’s Act 1982, has overall responsibility and control of Lloyd’s. Those byelaws, regulations and requirements provide a framework for the regulation of the Lloyd’s market, including specifying conditions in relation to underwriting and claims operations of Lloyd’s participants. Lloyd’s is also subject to the provisions of the FSMA and was itself authorized and regulated as an insurer by the FSA. As of April 1, 2013, Lloyd’s is authorized by the PRA and regulated by the PRA and FCA. Those entities acting within the Lloyd’s market are required to comply with the requirements of the FSMA and provisions of the PRA’s or FCA’s rules, although the PRA has delegated certain of its powers, including some of those relating to prudential requirements, to Lloyd’s. ASIL, as a member of Lloyd’s, is required to contribute 0.5% of Arch Syndicate 2012’s premium income limit for each year of account to the Lloyd’s central fund. The Lloyd’s central fund is available if members of Lloyd’s assets are not sufficient to meet claims for which the member is liable. As a member of Lloyd’s, ASIL may also be required to contribute to the central fund by way of a supplement to a callable layer of up to 3% of Arch Syndicate 2012’s premium income limit for the relevant year of account. In addition, AUAL, on behalf of Arch Syndicate 2012, is approved to underwrite excess and surplus lines insurance in most states in the U.S. through Lloyd’s licenses. Such activities must be in compliance with the Lloyd’s requirements.

Financial Resources. Arch Insurance Company Europe, AUAL (on behalf of itself, Arch Syndicate 2012 and ASIL) and Arch Risk Partners were each required to demonstrate to the FSA that each had adequate financial assets to meet the financial resources requirement for its category. However, since the FSA split into the PRA and FCA, Arch Insurance Company Europe and AUAL (on behalf of itself, Arch Syndicate 2012 and ASIL) are now each be required to demonstrate the adequacy of its financial assets to the PRA, while Arch Risk Partners is required to demonstrate the adequacy of its financial assets to the FCA. On a periodic basis, Arch Insurance Europe was required to provide the FSA and Lloyd’s with its own risk-based assessment of its capital needs, taking into account comprehensive risk factors, including market, credit, operational, liquidity and group risks to generate a revised calculation of its expected

liabilities which, in turn, enabled the FSA and Lloyd's to provide individual capital guidance and requirements to Arch Insurance Europe. Following the split of the FSA into the PRA and FCA, similar requirements from the PRA have taken effect. Arch Insurance Europe's surplus is above the risk-based capital threshold allowed by the FSA's (now PRA's) individual capital assessment of Arch Insurance Europe. The FSA required, and now the PRA requires, that Arch Insurance Europe maintain a margin of solvency calculation based on the classes of business for which it is authorized and within its premium income projections applied to its worldwide general business.

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Reporting Requirements. Like all U.K. companies, Arch Insurance Europe and Arch Risk Partners must file and submit their annual audited financial statements in accordance with IFRS and related reports to the Registrar of Companies under the U.K. Companies Acts together with an annual return of certain core corporate information and changes from the prior year. This requirement is in addition to the regulatory returns required to be filed annually with the FSA (now the PRA or the FCA, as applicable) for Arch Insurance Company Europe, AUAL and Arch Risk Partners and, in the case of AUAL and ASIL, Lloyd's.

Financial Services Compensation Scheme. The Financial Services Compensation Scheme ("FSCS") is a scheme established under FSMA to compensate eligible policyholders of insurance companies who may become insolvent. FSCS is funded by levies it has the power to impose on all insurers. Arch Insurance Europe and/or Arch Risk Partners could be required to pay levies to FSCS.

Restrictions on Acquisition of Control. Under FSMA, the prior consent of the FSA was required, and now the PRA or FCA, as applicable, is required, before any person can become a controller or increase its control over any regulated company, including Arch Insurance Company Europe, AUAL and Arch Risk Partners, or over the parent undertaking of any regulated company. Therefore, the FSA's prior consent was required, and now the PRA's or FCA's prior consent, as applicable, is required before any person can become a controller of ACGL. Prior consent is also required from Lloyd's before any person can become a controller or increase its control over a corporate member or a managing agent or a parent undertaking of a corporate member or managing agent. A controller is defined for these purposes as a person who holds (either alone or in concert with others) 10% or more of the shares or voting power in the relevant company or its parent undertaking.

Restrictions on Payment of Dividends. Under English law, all companies are restricted from declaring a dividend to their shareholders unless they have "profits available for distribution." The calculation as to whether a company has sufficient profits is based on its accumulated realized profits minus its accumulated realized losses. U.K. insurance regulatory laws do not prohibit the payment of dividends, but the FSA required, and now the PRA or FCA, as applicable, requires that insurance companies and insurance intermediaries maintain certain solvency margins and may restrict the payment of a dividend by Arch Insurance Company Europe, AUAL, ASIL or Arch Risk Partners. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Financial Condition, Liquidity and Capital Resources— Liquidity and Capital Resources" and note 20, "Statutory Information," of the notes accompanying our financial statements.

European Union Considerations. Through their respective authorizations in the U.K., a Member State of the European Union ("EU"), Arch Insurance Company Europe's, AUAL's and Arch Risk Partners' authorizations are recognized throughout the European Economic Area ("EEA"), subject only to certain notification and application requirements. This authorization enables Arch Insurance Company Europe, AUAL and Arch Risk Partners to establish a branch in any other Member State of the EU, where such entity will be subject to the insurance regulations of each such Member State with respect to the conduct of its business in such Member State, but remain subject only to the financial and operational supervision by the FSA. The framework for the establishment of branches in Member States of the EU other than the U.K. was generally set forth, and remains subject to, directives adopted by the European Council, the legislative body of the EU, which directives are then implemented in each Member State. Arch Insurance Company Europe currently has branches in Denmark, Germany, Italy, Spain and Sweden and may establish branches in other Member States of the EU in the future. Further, through its authorizations in an EU Member State, Arch Risk Partners, Arch Insurance Company Europe and AUAL have the freedom to provide insurance services anywhere in the EEA subject to compliance with certain rules governing such provision, including notification to the FSA (now the PRA or FCA, as applicable).

On November 25, 2009, the EU adopted a new directive directed at insurance and reinsurance companies known as Solvency II. Solvency II is a new regulatory regime which will impose economic risk-based solvency requirements across all EU Member States and consists of three pillars: (1) Pillar I—quantitative capital requirements, based on a valuation of the entire balance sheet; (2) Pillar II—qualitative regulatory review, which includes governance, internal controls, enterprise risk management and supervisory review process; and (3) Pillar III—market discipline, which is accomplished through reporting of the insurer's financial condition to regulators and the public. Secondary legislation under Solvency II is currently being discussed by the European Parliament and Council and by the European

Commission, and the directive will then have to be implemented in the U.K. by the U.K. Government, the PRA and the FCA (and in all other EU jurisdictions by their respective governments and insurance supervisors). The Solvency II directive is currently due to be transposed into national law by EU Member States on March 31, 2015 and due to apply to firms as of January 1, 2016. In the meantime, and as a result of the delays in enacting the so-called Omnibus II Directive (a directive intended to amend in

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part the existing solvency regime), the European Insurance and Occupational Pensions Authority (“EIOPA”) has published guidelines (“EIOPA Guidelines”) on the interim measures national supervisors should be taking before Solvency II comes into force, with such measures to be implemented through phasing-in provisions as of January 1, 2014. Arch Insurance Company Europe, AUAL and Syndicate 2012 will be required to comply with Solvency II requirements.

Canada Insurance Regulation

Arch Insurance Canada, which commenced underwriting on January 1, 2013, is subject to federal, as well as provincial and territorial, regulation in Canada. The Office of the Superintendent of Financial Institutions (“OSFI”) is the federal regulatory body that, under the Insurance Companies Act (Canada), regulates federal Canadian and non-Canadian insurance companies operating in Canada. The primary goal of OSFI is to supervise the safety and soundness of insurance companies with the aim of securing the appropriate level of protection of insureds by imposing risk management, solvency and capital requirements on such companies. Arch Insurance Canada is subject to regulation in the provinces and territories in which it underwrites insurance, and the primary goal of insurance regulation at the provincial and territorial levels is to govern the market conduct of insurance companies. Arch Insurance Canada is licensed to carry on insurance business by OSFI and in each province and territory.

Under the Insurance Companies Act (Canada), Arch Insurance Canada is required to maintain an adequate amount of capital in Canada, calculated in accordance with a test promulgated by OSFI called the Minimum Capital Test (“MCT”). Arch Insurance Canada is required to file financial information with OSFI on an ongoing basis, including annual audited financial statements in accordance with IFRS. The appointed actuary of our Canadian operations must report annually on the adequacy of their reserves. OSFI’s continuing supervision includes analysis of this information and periodic examinations of Arch Insurance Canada. OSFI has implemented a risk-based methodology for assessing insurance companies operating in Canada known as its “Supervisory Framework.” In applying the Supervisory Framework, OSFI considers the inherent risks of the business and the quality of risk management for each significant activity of operating entity.

Ireland Insurance and Reinsurance Regulation

General. The Central Bank of Ireland (“CBOI”) regulates insurance and reinsurance companies authorized in Ireland. We have two Irish operating subsidiaries: Arch Re Europe and Arch MI Europe. Arch Re Europe was licensed and authorized by the CBOI as a non-life reinsurer in October 2008 and as a life reinsurer in November 2009. Arch MI Europe was licensed and authorized by the CBOI as a non-life insurer in December 2011.

Both Arch Re Europe and Arch MI Europe are subject to the regulation and supervision of the CBOI. Arch Re Europe must comply with the European Communities (Reinsurance) Regulations, 2006, rules made thereunder and, insofar as relevant to reinsurance, the Irish Insurance Acts 1909 to 2009, regulations promulgated there under, regulations relating to reinsurance business promulgated under the European Communities Act 1972, the Irish Central Bank Acts 1942 to 2013 as amended, regulations promulgated there under and directions, guidelines and codes of conduct issued by the CBOI, including from January 1, 2014, the CBOI Guidelines of Preparing for Solvency II issued by EIOPA on September 27, 2013. Irish authorized reinsurers, such as Arch Re Europe, are also subject to the general body of Irish laws and regulations including the provisions of the Companies Acts 1963-2013. Arch MI Europe must comply with the Irish Insurance Acts 1909 to 2009, regulations promulgated thereunder, regulations relating to insurance business promulgated under the European Communities Act 1972, the Irish Central Bank Acts 1942 to 2013, as amended, regulations promulgated thereunder and directions and guidelines and codes of conduct issued by the CBOI, including from January 1, 2014, the CBOI Guidelines of Preparing for Solvency II.

Financial Resources. Both Arch Re Europe and Arch MI Europe are required to maintain reserves, particularly in respect of underwriting liabilities and a solvency margin as provided for in the Irish insurance acts and regulations mentioned above. Arch Re Europe must maintain assets constituting statutory reserves which must comply with principles including obligations to secure sufficiency, liquidity, security, quality, profitability and currency matching of investments. An appointed actuary must opine on the adequacy of the statutory reserves of both Arch Re Europe and Arch MI Europe annually.

Reporting Requirements. Like most Irish companies, Arch Re Europe and Arch MI Europe must file and submit their annual audited financial statements in accordance with Irish generally accepted accounting principles and related

reports to the Registrar of Companies (“Registrar”) under the Companies Acts 1963-2013 together with an annual return of certain

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core corporate information. Changes to core corporate information during the year must also be notified to the Registrar. These requirements are in addition to the regulatory returns required to be filed annually with the CBOI. Restrictions on Payment of Dividends. Under Irish company law, Arch Re Europe and Arch MI Europe are permitted to make distributions only out of profits available for distribution. A company's profits available for distribution are its accumulated, realized profits, so far as not previously utilized by distribution or capitalization, less its accumulated, realized losses, so far as not previously written off in a reduction or reorganization of capital duly made. Further, the CBOI has powers to intervene if a dividend payment were to lead to a breach of regulatory capital requirements. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Financial Condition, Liquidity and Capital Resources—Liquidity and Capital Resources" and note 20, "Statutory Information," of the notes accompanying our financial statements.

European Union Considerations. As a reinsurance company authorized in Ireland, a Member State of the EU, Arch Re Europe's authorization is recognized throughout the EEA, subject only to any notification requirements imposed by other EU Member States. This authorization enables Arch Re Europe to provide reinsurance services, or to establish a branch, in any other Member State of the EEA. Although, in doing so, it may be subject to the laws of such Member States with respect to the conduct of its business in such Member State, company law registrations and other matters, it will remain subject to financial and operational supervision by the CBOI only. Arch Re Europe has a branch in Denmark, Arch Re Accident & Health ApS ("Arch Re Denmark"), which is an underwriting agency underwriting accident and health business for Arch Re Europe. Arch Re Europe also has a branch in the U.K., which underwrites non-life reinsurance risk for Arch Re Europe. Finally, Arch Re Europe also has a branch outside the EEA, Arch Reinsurance Europe Underwriting Limited, Dublin (Ireland), Zurich Branch ("Arch Re Europe Swiss Branch"). As an insurance company authorized in Ireland, a Member State of the EU, Arch MI Europe's authorization is recognized throughout the EEA, subject to certain notifications requirements imposed under the European Directives and there being no objection from the CBOI and the Member States concerned, and it may establish branches and provide insurance services in all EEA Member States.

#### Switzerland Reinsurance Regulation

In November 2006, Arch Re Bermuda opened Arch Reinsurance Ltd., Hamilton (Bermuda), European Branch Zurich ("Arch Re Bermuda Swiss Branch"). In December 2008, Arch Re Europe opened Arch Re Europe Swiss Branch as a branch office. Upon the opening of this branch in the fourth quarter of 2008, the operations of Arch Re Bermuda Swiss Branch were transferred to Arch Re Europe Swiss Branch. Arch Re Bermuda Swiss Branch was formally de-registered from the commercial register of the Canton of Zurich in early 2009. As both Arch Re Europe and Arch Re Bermuda are domiciled outside of Switzerland and their activities were and are limited to reinsurance, their respective branches in Switzerland were and are not required to be licensed by the Swiss insurance regulatory authorities.

#### European Union Insurance and Reinsurance Regulation

The single system established in the EU for regulation and supervision of the general insurance sector and its single passport regime had until 2007 applied only to direct insurance, and there was no common regulation of reinsurance in the EU. However, direct insurers established in a Member State of the EEA who were also authorized by their domestic regulatory authorities to transact reinsurance have had freedom to establish branches in and provide insurance services to all EEA states and that freedom has in practice been extended to their reinsurance activities. In December 2005, the EU published the Reinsurance Directive (the "Directive") as a first step in harmonization of reinsurance regulation in the single market. Member States of the EU and the EEA were required to implement the Directive by December 2007. Pure reinsurers established in a Member State of the EU now have freedom to establish branches in and provide services to all EEA states under a regime comparable to that enjoyed by direct insurers, and they will be subject to similar rules in relation to licensing and financial supervision.

Arch Insurance Company Europe, AUAL and Arch Risk Partners, being established in the U.K. and authorized by the FSA (now the PRA and FCA), are able, subject to regulatory notifications and there being no objection from the relevant U.K. regulator, and the Member States concerned, to establish branches and provide insurance and reinsurance services in all EEA Member States. Arch Re Europe, being established in Ireland and authorized by the CBOI to write reinsurance, is able, subject to similar regulatory notifications and there being no objection from the



CBOI and the Member States concerned, to establish branches and provide reinsurance services in those EEA states which have implemented the

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Directive. The Directive itself does not prohibit EEA insurers from obtaining reinsurance from reinsurers licensed outside the EEA, such as Arch Re Bermuda. As such, and subject to the specific rules in particular Member States, Arch Re Bermuda may do business from Bermuda with insurers in EEA Member States, but it may not directly operate its reinsurance business within the EEA. Unless agreement is reached between the European Commission and Bermuda to accord Bermuda based reinsurers with market access on the basis of the equivalent nature of Bermuda regulation, each individual EEA Member State may impose conditions on reinsurance provided by Bermuda based reinsurers which could restrict their future provision of reinsurance to the EEA Member State concerned. A number of EEA Member States currently restrict the extent to which Bermudian reinsurers may promote their services in those Member States, and a few have certain prohibitions on the purchase of insurance from reinsurers not authorized in the EEA. The Directive is scheduled to be repealed and replaced by new provisions under Solvency II on January 1, 2016. However, this may change depending on whether the implementation date for Solvency II is extended again from January 1, 2016.

Article 172 of Solvency II will, when it comes into force, provide that reinsurance contracts concluded by insurance undertakings in the EEA with reinsurers having their head office in a country whose solvency regime has been determined to be equivalent to Solvency II shall be treated in the same manner as reinsurance contracts with undertakings in the EEA authorized under Solvency II. The European Commission is considering whether the solvency regime in Bermuda is equivalent to that laid down in Solvency II. In October 2011, EIOPA, which is established under European Law as an independent advisory body to the European Parliament, the European Council and the European Commission and specifically to assist in preparing equivalence decisions, advised that Bermuda meets the criteria set out in EIOPA's methodology for equivalence assessments under Solvency II subject to certain caveats set out in EIOPA's report. EIOPA will revisit its assessment of the equivalence of the solvency regime in Bermuda when implementation measures for Solvency II have been agreed.

On September 27, 2013, EIOPA published the EIOPA Guidelines, which are intended to ensure that national EEA supervisors, insurance and reinsurance companies and groups take active steps towards implementing key areas of Solvency II in a consistent and convergent way. The EIOPA Guidelines, which are addressed to national EEA supervisors and require local implementation, are applicable on a phased basis from January 1, 2014 and cover the Solvency II areas of systems of governance, forward-looking assessment of "own risks," submission of information to national supervisors and pre-application of internal models.

**TAX MATTERS**

The following summary of the taxation of ACGL and the taxation of our shareholders is based upon current law and is for general information only. Legislative, judicial or administrative changes may be forthcoming that could affect this summary.

The following legal discussion (including and subject to the matters and qualifications set forth in such summary) of certain tax considerations (a) under "—Taxation of ACGL—Bermuda" and "—Taxation of Shareholders—Bermuda Taxation" based upon the advice of Conyers Dill & Pearman Limited, Hamilton, Bermuda and (b) under "—Taxation of ACGL—United States," "—Taxation of Shareholders—United States Taxation," "—Taxation of Our U.S. Shareholders" and "—Taxation of Non-U.S. Shareholders" is based upon the advice of Cahill Gordon & Reindel LLP, New York, New York (the advice of such firms does not include accounting matters, determinations or conclusions relating to the business or activities of ACGL). The summary is based upon current law and is for general information only. The tax treatment of a holder of our shares (common shares or series C non-cumulative preferred shares), or of a person treated as a holder of our shares for U.S. federal income, state, local or non-U.S. tax purposes, may vary depending on the holder's particular tax situation. Legislative, judicial or administrative changes or interpretations may be forthcoming that could be retroactive and could affect the tax consequences to us or to holders of our shares.

**Taxation of ACGL****Bermuda**

Under current Bermuda law, ACGL is not subject to tax on income or profits, withholding, capital gains or capital transfers. ACGL has obtained from the Minister of Finance under the Exempted Undertakings Tax Protection Act 1966 an assurance that, in the event that Bermuda enacts legislation imposing tax computed on profits, income, any capital asset, gain or appreciation, or any tax in the nature of estate duty or inheritance, the imposition of any such tax

shall not be applicable to ACGL or to any of our operations or our shares, debentures or other obligations until March 31, 2035. We

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could be subject to taxes in Bermuda after that date. This assurance will be subject to the proviso that it is not to be construed so as to prevent the application of any tax or duty to such persons as are ordinarily resident in Bermuda (we are not so currently affected) or to prevent the application of any tax payable in accordance with the provisions of the Land Tax Act 1967 or otherwise payable in relation to any property leased to us or our insurance subsidiary. We pay annual Bermuda government fees, and our Bermuda insurance and reinsurance subsidiary pays annual insurance license fees. In addition, all entities employing individuals in Bermuda are required to pay a payroll tax and other sundry taxes payable, directly or indirectly, to the Bermuda government.

United States

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 definitive identification of activities which constitute being engaged in a trade or business in the U.S. is not provided by the Internal Revenue Code of 1986, as amended (the "Code"), or regulations or court decisions, there can be no assurance that the U.S. Internal Revenue Service will not contend successfully that ACGL or its non-U.S. subsidiaries are or have been engaged in a trade or business in the United States. A foreign corporation deemed to be so engaged would be subject to U.S. income tax, as well as the branch profits tax, on its income, which is treated as effectively connected with the conduct of that trade or business unless the corporation is entitled to relief under the permanent establishment provisions of a tax treaty. Such income tax, if imposed, would be based on effectively connected income computed in a manner generally analogous to that applied to the income of a domestic corporation, except that deductions and credits generally are not permitted unless the foreign corporation has timely filed a U.S. federal income tax return in accordance with applicable regulations. Penalties may be assessed for failure to file tax returns. The 30% branch profits tax is imposed on net income after subtracting the regular corporate tax and making certain other adjustments.

Under the income tax treaty between Bermuda and the United States (the "Treaty"), ACGL's Bermuda insurance subsidiaries will be subject to U.S. income tax on any insurance premium income found to be effectively connected with a U.S. trade or business only if that trade or business is conducted through a permanent establishment in the United States. No regulations interpreting the Treaty have been issued. While there can be no assurances, ACGL does not believe that any of its Bermuda insurance subsidiaries has a permanent establishment in the United States. Such subsidiaries would not be entitled to the benefits of the Treaty if (i) less than 50% of ACGL's shares were beneficially owned, directly or indirectly, by Bermuda residents or U.S. citizens or residents, or (ii) any such subsidiary's income were used in substantial part to make disproportionate distributions to, or to meet certain liabilities to, persons who are not Bermuda residents or U.S. citizens or residents. While there can be no assurances, ACGL believes that its Bermuda insurance subsidiaries are eligible for Treaty benefits.

The Treaty clearly applies to premium income, but may be construed as not protecting investment income. If ACGL's Bermuda insurance subsidiaries were considered to be engaged in a U.S. trade or business and were entitled to the benefits of the Treaty in general, but the Treaty were not found to protect investment income, a portion of such subsidiaries' investment income could be subject to U.S. federal income tax.

Non-U.S. insurance companies carrying on an insurance business within the United States have a certain minimum amount of effectively connected net investment income, determined in accordance with a formula that depends, in part, on the amount of U.S. risk insured or reinsured by such companies. If any of ACGL's non-U.S. insurance subsidiaries is considered to be engaged in the conduct of an insurance business in the United States, a significant portion of such company's investment income could be subject to U.S. income tax.

Non-U.S. corporations not engaged in a trade or business in the United States are nonetheless subject to U.S. income tax on certain "fixed or determinable annual or periodic gains, profits and income" derived from sources within the United States as enumerated in Section 881(a) of the Code (such as dividends and certain interest on investments), subject to exemption under the Code or reduction by applicable treaties.

The United States also imposes an excise tax on insurance and reinsurance premiums paid to non-U.S. insurers or reinsurers with respect to risks located in the United States. The rates of tax, unless reduced by an applicable U.S. tax treaty, are 4% for non-life insurance premiums and 1% for life insurance and all reinsurance premiums.



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### United Kingdom

Our U.K. subsidiaries are companies incorporated and have their central management and control in the U.K., and are therefore resident in the U.K. for corporation tax purposes. As a result, they will be subject to U.K. corporate tax on their respective worldwide profits. The main rate of U.K. corporation tax for the financial year starting April 1, 2013 is 23% on profits, but progressive decreases in the rate have been announced to take effect on April 1, 2014 through 2015 from 21% to 20%.

### Canada

In January 2005, Arch Insurance received its federal license to commence underwriting in Canada and began writing business in the first quarter of 2005 through its branch operation. Effective January 1, 2013, the branch operation was domesticated into Arch Insurance Canada, a Canadian federal insurance company subsidiary of Arch Insurance. Arch Insurance Canada is taxed on its worldwide income. The general federal corporate income tax rate in Canada is currently 15%. Provincial and territorial corporate income tax rates are added to the general federal corporate income tax rate and generally vary between 10% and 16%.

### Ireland

Arch Re Europe was licensed and authorized by the CBOI as a non-life reinsurer in October 2008 and as a life reinsurer in November 2009. Arch MI Europe was licensed and authorized by the CBOI as a non-life insurer in 2011. Each of Arch Re Europe and Arch MI Europe is incorporated and resident in Ireland for corporation tax purposes and will be subject to Irish corporate tax on its worldwide profits, including the profits of Arch Re Europe Swiss Branch and its U.K. branch. Any creditable foreign tax (i.e., Swiss or U.K.) payable will be creditable against Arch Re Europe's Irish corporate tax liability on the results of Arch Re Europe's Swiss and U.K. branches. The current rate of Irish corporation tax applicable to such profits is 12.5%.

### Switzerland

Arch Re Europe Swiss Branch is subject to Swiss corporation tax on the profit which is allocated to the branch. The effective tax rate is approximately 21.17% for Swiss federal, cantonal and communal corporation taxes on the profit. The effective tax rate of the annual cantonal and communal capital taxes on the equity which is allocated to Arch Re Europe Swiss Branch is approximately 0.172%.

### Denmark

Arch Re Denmark, established as a subsidiary of Arch Re Bermuda, is subject to Danish corporation taxes on its profits at a rate of 25% for 2013 and the preceding years. For 2014, the corporate tax rate has been reduced to 24.5%, for 2015 to 23.5% and for 2016 and onwards to 22%.

### Taxation of Shareholders

The following summary sets forth certain United States federal income tax considerations related to the purchase, ownership and disposition of our common shares and our series C non-cumulative preferred shares ("preferred shares"). Unless otherwise stated, this summary deals only with shareholders ("U.S. Holders") that are United States Persons (as defined below) who hold their common shares and preferred shares as capital assets and as beneficial owners. The following discussion is only a general summary of the United States federal income tax matters described herein and does not purport to address all of the United States federal income tax consequences that may be relevant to a particular shareholder in light of such shareholder's specific circumstances. In addition, the following summary does not describe the United States federal income tax consequences that may be relevant to certain types of shareholders, such as banks, insurance companies, regulated investment companies, real estate investment trusts, financial asset securitization investment trusts, dealers in securities or traders that adopt a mark-to-market method of tax accounting, tax exempt organizations, expatriates or persons who hold the common shares or preferred shares as part of a hedging or conversion transaction or as part of a straddle, who may be subject to special rules or treatment under the Code. This discussion is based upon the Code, the Treasury regulations promulgated there under and any relevant administrative rulings or pronouncements or judicial decisions, all as in effect on the date of this annual report and as currently interpreted, and does not take into account possible changes in such tax laws or interpretations thereof, which may apply retroactively. This discussion does not include any description of the tax laws of any state or local governments within the United States, or of



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any foreign government, that may be applicable to our common shares or preferred shares or the shareholders. Persons considering making an investment in the common shares or preferred shares should consult their own tax advisors concerning the application of the United States federal tax laws to their particular situations as well as any tax consequences arising under the laws of any state, local or foreign taxing jurisdiction prior to making such investment. If a partnership holds our common shares or preferred shares, the tax treatment of a partner will generally depend upon the status of the partner and the activities of the partnership. If you are a partner of a partnership holding our common shares or preferred shares, you should consult your tax advisor.

For purposes of this discussion, the term “United States Person” means:

- a citizen or resident of the United States,
- a corporation or entity treated as a corporation created or organized in or under the laws of the United States, any state thereof, or the District of Columbia,
- an estate the income of which is subject to United States federal income taxation regardless of its source,
- a trust if either (x) a court within the United States is able to exercise primary supervision over the administration of such trust and one or more United States persons have the authority to control all substantial decisions of such trust or (y) the trust has a valid election in effect to be treated as a United States person for U.S. federal income tax purposes or
- any other person or entity that is treated for U.S. federal income tax purposes as if it were one of the foregoing.

### Bermuda Taxation

Currently, there is no Bermuda withholding tax on dividends paid by us.

### United States Taxation

**Taxation of Dividends.** The preferred shares should be properly classified as equity rather than debt for U.S. federal income tax purposes. Subject to the discussions below relating to the potential application of the CFC, “related person insurance income” (“RPII”) and PFIC rules, as defined below, cash distributions, if any, made with respect to our common shares or preferred shares will constitute dividends for U.S. federal income tax purposes to the extent paid out of our current or accumulated earnings and profits (as computed using U.S. tax principles). If a U.S. Holder of our common shares or our preferred shares is an individual or other non-corporate holder, dividends paid, if any, to that holder that constitute qualified dividend income will be taxable at the rate applicable for long-term capital gains (generally up to 20%), provided that such person meets a holding period requirement. Generally in order to meet the holding period requirement, the United States Person must hold the common shares for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date and must hold preferred shares for more than 90 days during the 181-day period beginning 90 days before the ex-dividend date. Dividends paid, if any, with respect to common shares or preferred shares generally will be qualified dividend income, provided the common shares or preferred shares are readily tradable on an established securities market in the U.S. in the year in which the shareholder receives the dividend (which should be the case for shares that are listed on the NASDAQ Stock Market or the New York Stock Exchange) and ACGL is not considered to be a passive foreign investment company in either the year of the distribution or the preceding taxable year. No assurance can be given that the preferred shares will be considered readily tradable on an established securities market in the United States. See “—Taxation of Our U.S. Shareholders” below.

A U.S. Holder that is an individual, estate or a trust that does not fall into a special class of trusts that is exempt from such tax, will be subject to a 3.8% tax on the lesser of (1) the U.S. Holder’s “net investment income” for the relevant taxable year and (2) the excess of the U.S. Holder’s modified adjusted gross income for the taxable year over a certain threshold (which in the case of individual will be between \$125,000 and \$250,000, depending on the individual’s circumstances). A U.S. Holder’s net investment income will generally include its dividend income and its net gains from the disposition of our common shares and preferred shares, unless such dividend income or net gains are derived in the ordinary course of the conduct of a trade or business (other than a trade or business that consists of certain passive or trading activities).

Distributions with respect to the common shares and the preferred shares will not be eligible for the dividends received deduction allowed to U.S. corporations under the Code. To the extent distributions on our common shares and





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preferred shares exceed our earnings and profits, they will be treated first as a return of the U.S. Holder's basis in our common shares and our preferred shares to the extent thereof, and then as gain from the sale of a capital asset. Sale, Exchange or Other Disposition. Subject to the discussions below relating to the potential application of the CFC, RPII and PFIC rules, holders of common shares and preferred shares generally will recognize capital gain or loss for U.S. federal income tax purposes on the sale, exchange or disposition of common shares or preferred shares, as applicable.

**Redemption of Preferred Shares.** A redemption of the preferred shares will be treated under section 302 of the Code as a dividend if we have sufficient earnings and profits, unless the redemption satisfies one of the tests set forth in section 302(b) of the Code enabling the redemption to be treated as a sale or exchange, subject to the discussion herein relating to the potential application of the CFC, RPII and PFIC rules. Under the relevant Code section 302(b) tests, the redemption should be treated as a sale or exchange only if it (1) is substantially disproportionate, (2) constitutes a complete termination of the holder's stock interest in us or (3) is "not essentially equivalent to a dividend." In determining whether any of these tests are met, shares considered to be owned by the holder by reason of certain constructive ownership rules set forth in the Code, as well as shares actually owned, must generally be taken into account. It may be more difficult for a United States Person who owns, actually or constructively by operation of the attribution rules, any of our other shares to satisfy any of the above requirements. The determination as to whether any of the alternative tests of section 302(b) of the Code is satisfied with respect to a particular holder of the preference shares depends on the facts and circumstances as of the time the determination is made.

### Taxation of Our U.S. Shareholders

#### Controlled Foreign Corporation Rules

Under our bye-laws, the 9.9% voting restriction applicable to the Controlled Shares of a U.S. Person (as defined in our bye-laws) generally does not apply to certain of our investors. Depending upon the ownership of these investors and as a result of certain attribution rules, we and our foreign subsidiaries could be controlled foreign corporations ("CFCs"). That status as a CFC would not cause us or any of our subsidiaries to be subject to U.S. federal income tax. Such status also would have no adverse U.S. federal income tax consequences for any U.S. Holder that is considered to own less than 10% of the total combined voting power of our shares or those of our foreign subsidiaries. Only U.S. Holders that are considered to own 10% or more of the total combined voting power of our shares or those of our foreign subsidiaries (taking into account shares actually owned by such U.S. Holder as well as shares attributed to such U.S. Holder under the Code or the regulations there under) (a "10% U.S. Voting Shareholder") would be affected by our status as a CFC. The preferred shares generally should not be considered voting stock for purposes of determining whether a United States Person would be a "10% U.S. Voting Shareholder." The shares may, however, become entitled to vote (as a class along with any other class of preferred shares of ACGL then outstanding) for the election of two additional members of the board of directors of ACGL if ACGL does not declare and pay dividends for the equivalent of six or more dividend periods. In such case, the preferred shares should be treated as voting stock for as long as such voting rights continue. Our bye-laws are intended to prevent any U.S. Holder from being considered a 10% U.S. Voting Shareholder by limiting the votes conferred by the Controlled Shares (as defined in our bye-laws) of any U.S. Person to 9.9% of the total voting power of all our shares entitled to vote. However, because under our bye-laws certain funds associated with Warburg Pincus LLC and Hellman & Friedman LLC generally are entitled to vote their directly owned common shares in full, a U.S. Holder that is attributed (under the Code or the regulations there under) common shares owned by such funds may be considered a 10% U.S. Voting Shareholder. If we are a CFC, a U.S. Holder that is considered a 10% U.S. Voting Shareholder would be subject to current U.S. federal income taxation (at ordinary income tax rates) to the extent of all or a portion of the undistributed earnings and profits of ACGL and our subsidiaries attributable to "subpart F income" (including certain insurance premium income and investment income) and may be taxable at ordinary income tax rates on any gain realized on a sale or other disposition (including by way of repurchase or liquidation) of our shares to the extent of the current and accumulated earnings and profits attributable to such shares.

While our bye-laws are intended to prevent any member from being considered a 10% U.S. Voting Shareholder (except as described above), there can be no assurance that a U.S. Holder will not be treated as a 10% U.S. Voting Shareholder, by attribution or otherwise, under the Code or any applicable regulations there under.



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### Related Person Insurance Income Rules

Generally, we do not expect the gross RPII (related person insurance income) of any of our non-U.S. subsidiaries to equal or exceed 20% of its gross insurance income in any taxable year for the foreseeable future and do not expect the direct or indirect insureds (and related persons) of any such subsidiary to directly or indirectly own 20% or more of either the voting power or value of our stock. Consequently, we do not expect any U.S. person owning common shares or preferred shares to be required to include in gross income for U.S. federal income tax purposes RPII income, but there can be no assurance that this will be the case.

Section 953(c)(7) of the Code generally provides that Section 1248 of the Code (which generally would require a U.S. Holder to treat certain gains attributable to the sale, exchange or disposition of common shares or preferred shares as a dividend) will apply to the sale or exchange by a U.S. shareholder of shares in a foreign corporation that is characterized as a CFC under the RPII rules if the foreign corporation would be taxed as an insurance company if it were a domestic corporation, regardless of whether the U.S. shareholder is a 10% U.S. Voting Shareholder or whether the corporation qualifies for either the RPII 20% ownership exception or the RPII 20% gross income exception.

Although existing Treasury Department regulations do not address the question, proposed Treasury regulations issued in April 1991 create some ambiguity as to whether Section 1248 and the requirement to file Form 5471 would apply when the foreign corporation has a foreign insurance subsidiary that is a CFC for RPII purposes and that would be taxed as an insurance company if it were a domestic corporation. We believe that Section 1248 and the requirement to file Form 5471 will not apply to a less than 10% U.S. Shareholder because ACGL is not directly engaged in the insurance business. There can be no assurance, however, that the U.S. Internal Revenue Service will interpret the proposed regulations in this manner or that the Treasury Department will not take the position that Section 1248 and the requirement to file Form 5471 will apply to dispositions of our common shares or our preferred shares.

If the U.S. Internal Revenue Service or U.S. Treasury Department were to make Section 1248 and the Form 5471 filing requirement applicable to the sale of our shares, we would notify shareholders that Section 1248 of the Code and the requirement to file Form 5471 will apply to dispositions of our shares. Thereafter, we would send a notice after the end of each calendar year to all persons who were shareholders during the year notifying them that Section 1248 and the requirement to file Form 5471 apply to dispositions of our shares by U.S. Holders. We would attach to this notice a copy of Form 5471 completed with all our information and instructions for completing the shareholder information.

### Tax-Exempt Shareholders

Tax-exempt entities may be required to treat certain Subpart F insurance income, including RPII, that is includible in income by the tax-exempt entity as unrelated business taxable income. Prospective investors that are tax exempt entities are urged to consult their tax advisors as to the potential impact of the unrelated business taxable income provisions of the Code.

### Passive Foreign Investment Companies

Sections 1291 through 1298 of the Code contain special rules applicable with respect to foreign corporations that are “passive foreign investment companies” (“PFICs”). In general, a foreign corporation will be a PFIC if 75% or more of its income constitutes “passive income” or 50% or more of its assets produce passive income. If we were to be characterized as a PFIC, U.S. Holders would be subject to a penalty tax at the time of their sale of (or receipt of an “excess distribution” with respect to) their common shares or preferred shares. In general, a shareholder receives an “excess distribution” if the amount of the distribution is more than 125% of the average distribution with respect to the shares during the three preceding taxable years (or shorter period during which the taxpayer held the stock). In general, the penalty tax is equivalent to an interest charge on taxes that are deemed due during the period the shareholder owned the shares, computed by assuming that the excess distribution or gain (in the case of a sale) with respect to the shares was taxable in equal portions throughout the holder’s period of ownership. The interest charge is equal to the applicable rate imposed on underpayments of U.S. federal income tax for such period. A U.S. shareholder may avoid some of the adverse tax consequences of owning shares in a PFIC by making a qualified electing fund (“QEF”) election. A QEF election is revocable only with the consent of the IRS and has the following consequences to a shareholder:

For any year in which ACGL is not a PFIC, no income tax consequences would result.

For any year in which ACGL is a PFIC, the shareholder would include in its taxable income a proportionate share of the net ordinary income and net capital gains of ACGL and certain of its non-U.S. subsidiaries.

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The PFIC statutory provisions contain an express exception for income “derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business...” This exception is intended to ensure that income derived by a bona fide insurance company is not treated as passive income, except to the extent such income is attributable to financial reserves in excess of the reasonable needs of the insurance business. The PFIC statutory provisions contain a look-through rule that states that, for purposes of determining whether a foreign corporation is a PFIC, such foreign corporation shall be treated as if it “received directly its proportionate share of the income” and as if it “held its proportionate share of the assets” of any other corporation in which it owns at least 25% of the stock. We believe that we are not a PFIC, and we will use reasonable best efforts to cause us and each of our majority owned non-U.S. insurance subsidiaries not to constitute a PFIC.

No regulations interpreting the substantive PFIC provisions have yet been issued. Each U.S. Holder should consult his tax advisor as to the effects of these rules.

### Proposed Legislation

On November 19, 2013, Senate Finance Committee then-Chairman Max Baucus (D-MT) released a tax reform discussion draft on international tax issues. A provision in the discussion draft would change the definition of a U.S. shareholder for CFC purposes and overhaul the PFIC rules, including eliminating the PFIC exception for certain insurance companies. On February 26, 2014, the House Ways and Means Committee Chairman Dave Camp published a tax reform proposal titled “Tax Reform Act of 2014.” The tax form proposal contains a provision that would significantly modify the PFIC exception for certain insurance companies.

Prospective investors should consult their own tax advisor regarding the likelihood that the provisions in these discussion drafts and tax reform proposal are enacted and any effect of such provisions.

### United States Taxation of Non-U.S. Shareholders

#### Taxation of Dividends

Cash distributions, if any, made with respect to common shares or preferred shares held by shareholders who are not United States Persons (“Non-U.S. holders”) generally will not be subject to United States withholding tax.

#### Sale, Exchange or Other Disposition

Non-U.S. holders of common shares or preferred shares generally will not be subject to U.S. federal income tax with respect to gain realized upon the sale, exchange or other disposition of such shares unless such gain is effectively connected with a U.S. trade or business of the Non-U.S. holder in the United States or such person is present in the United States for 183 days or more in the taxable year the gain is realized and certain other requirements are satisfied.

#### Information Reporting and Backup Withholding

Non-U.S. holders of common shares or preferred shares will not be subject to U.S. information reporting or backup withholding with respect to dispositions of common shares effected through a non-U.S. office of a broker, unless the broker has certain connections to the United States or is a United States person. No U.S. backup withholding will apply to payments of dividends, if any, on our common shares or our preferred shares.

Sections 1471 through 1474 to the Code, known as the Foreign Account Tax Compliance Act (“FATCA”), impose a withholding tax of 30% on (i) U.S.-source interest, dividends and certain other types of income, and (ii) the gross proceeds from the sale or disposition of assets which produce such types of income, which are received by a foreign financial institution (“FFI”), unless such FFI enters into an agreement with the IRS to obtain certain information as to the identity of the direct and indirect owners of accounts in such institution. In addition, a 30% withholding tax may be imposed on the above payments to certain non-financial foreign entities which do not (i) certify to each respective withholding agent that they have no “substantial U.S. owners” (i.e., a U.S. 10% direct or indirect shareholder), or (ii) provide such withholding agent with the certain information as to the identity of such substantial U.S. owners. The United States is in the process of negotiating intergovernmental agreements to implement FATCA (“IGAs”) with a number of jurisdictions. Bermuda has signed an IGA with the United States. Different rules than those described above may apply under such an IGA.

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