WATFORD HOLDINGS LTD. AND SUBSIDIARIES

Consolidated Financial Statements

For the Years Ended
December 31, 2017 and 2016

INDEX TO THE CONSOLIDATED FINANCIAL STATEMENTS

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Watford Holdings Ltd.

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Watford Holdings Ltd. and its subsidiaries as of December 31, 2017 and 2016, and the related consolidated statements of income (loss) and comprehensive income (loss), of changes in shareholders' equity and of cash flows for the years then ended, including the related notes (collectively referred to as the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of their operations and their cash flows for each of the years then ended in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's consolidated financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits of these consolidated financial statements in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers Ltd.

March 9, 2018

We have served as the Company's auditor since 2014.

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WATFORD HOLDINGS LTD.
CONSOLIDATED BALANCE SHEETS
(U.S. dollars in thousands, except share and per share data)

	December 31, 2017	December 31, 2016
Assets		
Investments:		
Term loans, at fair value (Amortized cost: $879,010 and $804,521)	$ 877,818	$ 813,621
Fixed maturities, at fair value (Amortized cost: $1,176,982 and $745,148)	1,177,033	733,133
Short-term investments, at fair value (Cost: $323,663 and $374,269)	323,883	374,480
Equity securities, at fair value (Cost: $63,461 and $1,274)	67,868	2,315
Other investments, at fair value	49,613	—
Total investments	2,496,215	1,923,549
Cash and cash equivalents	54,503	74,893
Accrued investment income	18,261	17,017
Premiums receivable	177,492	189,911
Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses	42,777	24,420
Prepaid reinsurance premiums	24,762	12,145
Deferred acquisition costs, net	85,961	86,379
Receivable for securities sold	36,374	1,326
Intangible assets	7,650	7,650
Funds held by reinsurers	45,196	27,341
Contingent commissions	11,980	12,096
Other assets	13,412	6,023
Total assets	$ 3,014,583	$ 2,382,750
Liabilities		
Reserve for losses and loss adjustment expenses	$ 798,262	$ 510,809
Unearned premiums	330,644	293,480
Losses payable	35,805	17,795
Reinsurance balances payable	18,424	12,289
Payable for securities purchased	42,501	42,922
Payable for securities sold short	34,375	33,157
Revolving credit agreement borrowings	549,165	258,861
Amounts due to affiliates	4,484	3,319
Investment management and performance fees payable	21,036	27,942
Other liabilities	11,383	4,552
Total liabilities	1,846,079	1,205,126
Commitments and Contingencies		
Contingently redeemable preferred shares	220,622	220,253
Shareholders' equity		
Common shares ($0.01 par; shares authorized: 120,000,000 and 80,000,000; shares issued and outstanding: 22,682,875 and 22,682,875)	227	227
Additional paid-in capital	895,386	895,386
Retained earnings	53,241	62,133
Accumulated other comprehensive income (loss)	(972)	(375)
Total Shareholders' Equity	947,882	957,371
Total Liabilities, Contingently Redeemable Preferred Shares and Shareholders' Equity	$ 3,014,583	$ 2,382,750

See Notes to Consolidated Financial Statements

WATFORD HOLDINGS LTD.
CONSOLIDATED STATEMENTS OF INCOME (LOSS) AND COMPREHENSIVE INCOME (LOSS)
(U.S. dollars in thousands, except share data)

	Year Ended December 31,	
	2017	**2016**
Revenues		
Gross premiums written	$ 600,304	$ 535,094
Gross premiums ceded	(47,187)	(21,306)
Net premiums written	553,117	513,788
Change in unearned premiums	(21,391)	(45,818)
Net premiums earned	531,726	467,970
Other underwriting income (loss)	3,180	3,746
Interest income	125,463	122,378
Investment management fees - related parties	(21,451)	(16,563)
Borrowing and miscellaneous other investment expenses	(17,489)	(15,997)
Net interest income	86,523	89,818
Realized and unrealized gains (losses) on investments	1,120	80,643
Investment performance fees - related parties	(14,905)	(24,065)
Net investment income (loss)	72,738	146,396
Total revenues	607,644	618,112
Expenses		
Loss and loss adjustment expenses	(436,402)	(321,581)
Acquisition expenses	(140,726)	(136,733)
General and administrative expenses	(21,174)	(17,956)
Net foreign exchange gains (losses)	1,420	4,893
Total expenses	(596,882)	(471,377)
Income (loss) before income taxes	10,762	146,735
Income tax expense	(21)	(1)
Net income (loss) before preferred dividends	10,741	146,734
Preferred dividends	(19,633)	(19,634)
Net income (loss) available to common shareholders	$ (8,892)	$ 127,100
Other comprehensive income (loss)		
Net foreign currency translation gains (losses)	(597)	(77)
Total comprehensive income (loss)	$ (9,489)	$ 127,023

WATFORD HOLDINGS LTD.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(U.S. dollars in thousands)

	Year Ended December 31,	
	2017	**2016**
Common shares		
Balance at beginning and end of year	$ 227	$ 227
Additional paid-in capital		
Balance at beginning and end of year	895,386	895,386
Accumulated other comprehensive income (loss)		
Balance at beginning of year	(375)	(298)
Currency translation adjustment	(597)	(77)
Balance at end of year	(972)	(375)
Retained earnings (deficit)		
Balance at beginning of year	62,133	(64,967)
Net income (loss) before preferred dividends	10,741	146,734
Preferred share dividends paid and accrued	(19,633)	(19,634)
Balance at end of year	53,241	62,133
Total shareholders' equity	$ 947,882	$ 957,371

See Notes to Consolidated Financial Statements

WATFORD HOLDINGS LTD.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(U.S. dollars in thousands)

	Year Ended December 31, 2017	2016
Operating Activities		
Net income (loss) before preferred dividends	$ 10,741	$ 146,734
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Net realized and unrealized (gains) losses on investments	(4,977)	(80,295)
Amortization of fixed assets	187	199
Changes in:		
Accrued investment income	(1,237)	2,232
Premiums receivable	18,923	(29,409)
Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses	(18,023)	(10,297)
Prepaid reinsurance premiums	(11,716)	(1,534)
Deferred acquisition costs, net	950	(11,480)
Reserve for losses and loss adjustment expenses	272,295	232,174
Unearned premiums	33,106	47,352
Reinsurance balances payable	5,367	(1,196)
Funds held with reinsurers	(17,855)	(27,208)
Other liabilities	18,051	36,149
Other items	(13,587)	(28,333)
Net Cash Provided By Operating Activities	292,225	275,088
Investing Activities		
Purchase of term loans	(827,757)	(619,611)
Purchase of fixed maturity investments	(1,579,591)	(1,058,200)
Purchase of other investments	(50,000)	—
Proceeds from sale, redemptions and maturity of term loans	731,679	667,914
Proceeds from sales, redemptions and maturities of fixed maturity investments	1,162,210	945,578
Net (purchases) sales of short-term investments	50,829	(14,311)
Net (purchases) sales of equity securities	(63,076)	(1,274)
Net settlements of derivative instruments	(1,734)	(6,633)
Purchase of business, net of cash acquired	—	(19,451)
Purchases of furniture, equipment and other assets	(21)	(9)
Net Cash Used For Investing Activities	(577,461)	(105,997)
Financing Activities		
Dividends paid on redeemable preferred shares	(19,264)	(19,263)
Repayments on borrowings	(72,000)	(222,384)
Proceeds from borrowings	359,238	46,000
Borrowings issuance costs	(5,667)	—
Net Cash Provided By (Used For) Financing Activities	262,307	(195,647)
Effects of exchange rate changes on foreign currency cash	2,539	(7,101)
Increase (decrease) in cash	(20,390)	(33,657)
Cash and cash equivalents, beginning of year	74,893	108,550
Cash and cash equivalents, end of year	$ 54,503	$ 74,893
Supplementary information		
Income taxes paid	$ 21	$ 1
Interest paid	$ 15,719	$ 13,795

See Notes to Consolidated Financial Statements

1. Organization

Watford Holdings Ltd. (the “Parent”) and its wholly-owned subsidiary, Watford Re Ltd. (“Watford Re”), were incorporated under the laws of Bermuda on July 19, 2013.

As used herein, the term “Company” or “Companies” collectively refers to the Parent and/or, as applicable, its subsidiaries.

In the first quarter of 2014, the Company raised approximately $1.1 billion of capital consisting of $907.3 million in common equity ($895.6 million net of issuance costs) and $226.6 million in preference equity ($219.2 million net of issuance costs and discount). Through its wholly-owned subsidiary, Arch Reinsurance Ltd. (“ARL”), Arch Capital Group Ltd. (“ACGL”) invested $100.0 million and acquired approximately 11% of the Company’s common equity and a warrant to purchase up to 975,503 of common shares. See Note 15, “Shareholders’ equity” for further details.

Watford Re is licensed as a Class 4 multi-line insurer under the Insurance Act 1978 of Bermuda, as amended, and related regulations (the “Insurance Act”) and is licensed to underwrite general business on an insurance and reinsurance basis. Through Watford Re, the Company primarily underwrites reinsurance on exposures worldwide, and commenced operations in the first quarter of 2014.

In June 2015, the Company formed Watford Insurance Company Europe Limited (“WICE”) in Gibraltar as a wholly-owned subsidiary of Watford Re. WICE is licensed to underwrite business across Europe and commenced operations in the second quarter of 2015.

In September 2015, the Company formed Watford Specialty Insurance Company (“WSIC”), a New Jersey insurance company, and Watford Services Inc. (“Watford Services”), a Delaware service company. WSIC did not undertake any underwriting activities in 2015. WSIC and Watford Services are wholly-owned subsidiaries of Watford Holdings U.S. Inc. (“Holdings U.S.”). Holdings U.S. is the wholly-owned subsidiary of Watford Holdings (U.K.) Limited (“Holdings U.K.”), a company incorporated under the laws of England & Wales in the United Kingdom. Holdings U.K. is a wholly-owned subsidiary of Watford Re.

In August 2016, the Company acquired Watford Insurance Company (“WIC”), domiciled in New Jersey. WIC is a wholly-owned subsidiary of WSIC. See Note 2, “Business acquired” for further details.

Watford Re and WICE have engaged Arch Underwriters Ltd. (“AUL”), a company incorporated in Bermuda and a wholly-owned subsidiary of Arch Capital Group Ltd. (“ACGL”), to act as their insurance and reinsurance manager pursuant to services agreements between AUL and Watford Re and WICE, respectively. AUL manages the day-to-day underwriting activities of Watford Re and WICE, subject to the provisions of the services agreement and the oversight of our board of directors. See Note 12, “Transactions with related parties” for further details.

WSIC and WIC have engaged Arch Underwriters Inc. (“AUI”), a company incorporated in Delaware and a wholly-owned subsidiary of ACGL, to act as their insurance and reinsurance manager pursuant to services agreements between AUI and WSIC and WIC, respectively. AUI manages the day-to-day underwriting activities of WSIC and WIC, subject to the provisions of the services agreement and the oversight of our board of directors. See Note 12, “Transactions with related parties” for further details.

The Company has engaged HPS Investment Partners, LLC (“HPS”) (formerly known as Highbridge Principal Strategies, LLC), as investment manager of the assets in its non-investment grade portfolio pursuant to various investment management agreements. HPS invests the Company’s non-investment grade assets, subject to the terms of the applicable investment management agreements. See Note 12, “Transactions with related parties” for further details.

The Company has engaged Arch Investment Management Ltd. (“AIM”); a Bermuda exempted company with limited liability and a subsidiary of ACGL, as investment manager of the assets in its investment grade portfolio pursuant to various investment management agreements. AIM manages the Company's investment grade assets pursuant to the terms of the investment management agreements with AIM. See Note 12, "Transactions with related parties" for further details.

2. Business acquired

In August 2016, the Company's U.S.-based subsidiary, WSIC, acquired a previously-dormant insurance company that held admitted insurance licenses in all 50 states and the District of Columbia. The carrier was renamed "WIC" and was re-domesticated to New Jersey. WIC's liabilities relating to pre-acquisition business are fully reinsured pursuant to a 100% quota share agreement with The Hanover Insurance Company ("Hanover"), which carries financial strength ratings of A/A/A3 from A.M. Best Company ("A.M. Best"), Standard & Poor's Financial Services, LLC and Moody's Investors Service, respectively. Hanover will not have any liability for, or interest in, business written by WIC. WIC was purchased for approximately $19.5 million in cash. As part of the transaction, total assets purchased included investments of $11.8 million, insurance licenses of $7.7 million and unpaid losses and loss adjustment expenses recoverable of $8.9 million. The assets were offset by reserve for losses and loss adjustment expenses of $8.9 million. The licenses are disclosed as intangible assets at fair market value in the consolidated financial statements and have an indefinite useful life.

3. Significant accounting policies

(a) Basis of presentation

The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP") and include the accounts of the Parent and its subsidiaries. All significant inter-company transactions and balances have been eliminated in consolidation. The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions.

(b) Premium revenues and related expenses

Reinsurance premiums written are recorded based on the type of contracts the Company writes. Premiums on the Company's excess of loss and pro rata reinsurance contracts are estimated when the business is underwritten. For excess of loss contracts, premiums are recorded as written, on the inception date, based on the terms of the contract. Estimates of premiums written under pro rata contracts are recorded in the period in which the underlying risks are expected to incept and are based on information provided by the brokers and the ceding companies. For multi-year reinsurance treaties which are payable in annual installments, premium recognition depends on whether the contract is non-cancellable. If either party retains the ability to cancel or commute coverage prior to expiration, only the initial annual installment is included as premiums written at policy inception. The remaining annual installments would then be included as premiums written at each successive anniversary date within the multi-year term. If, on the other hand, the contract is non-cancellable, the full multi-year premiums would be recognized as written at policy inception.

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

Reinstatement premiums are recognized at the time a loss event occurs, where coverage limits for the remaining life of the contract are reinstated under pre-defined contract terms. Reinstatement premiums, if obligatory, are fully earned when recognized. The accrual of reinstatement premiums is based on an estimate of losses and loss adjustment expenses, which reflects management’s judgment.

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

Acquisition expenses consist primarily of brokerage fees, ceding commissions, premium taxes, underwriting fees payable to Arch under our services agreements and other direct expenses that relate to our contracts and policies and are presented net of commissions received from reinsurance we purchase. We amortize deferred acquisition expenses over the related contract term in the same proportion that the premiums are earned. Our acquisition expenses may also include profit commissions paid to our sources of business in the event of favorable underwriting experience.

Deferred acquisition costs, which are based on the related unearned premiums, are carried at their estimated realizable value and take into account anticipated losses and loss adjustment expenses, based on historical and current experience, and anticipated investment income. A premium deficiency occurs if the sum of anticipated losses and loss adjustment expenses, unamortized acquisition costs and anticipated investment income exceed unearned premiums. A premium deficiency is recorded by charging any unamortized acquisition costs to expense to the extent required in order to eliminate the deficiency. If the premium deficiency exceeds unamortized acquisition costs then a liability is accrued for the excess deficiency. No premium deficiency charges were recorded by the Company during 2017 or 2016.

(c) Retroactive Reinsurance Accounting

Retroactive reinsurance reimburses a ceding company for liabilities incurred as a result of past insurable events covered by the underlying policies reinsured. For retroactive contracts that meet the established criteria for reinsurance accounting, written premiums are fully earned and corresponding losses and loss expense are recognized at inception. The initial gain, if applicable, is deferred and amortized into income over an actuarially determined expected payout period. Any future loss is recognized immediately and charged against earnings. The contracts can cause significant variances in gross premiums written, net premiums written, net premiums earned, and net incurred losses in the years in which they are written. Reinsurance contracts sold not meeting the established criteria for reinsurance accounting are recorded using the deposit method.

In certain instances, reinsurance contracts cover losses both on a prospective basis and on a retroactive basis and, accordingly, the Company bifurcates the prospective and retrospective elements of these reinsurance contracts and accounts for each element separately where practical. Underwriting income generated in connection with retroactive reinsurance contracts is deferred and amortized into income over the settlement period while losses are charged to income immediately. Subsequent changes in estimated or actual cash flows under such retroactive reinsurance contracts are accounted for by adjusting the previously deferred amount to the balance that would have existed had the revised estimate been available at the inception of the reinsurance transaction, with a corresponding charge or credit to income.

(d) Reinsurance ceded

The accompanying consolidated statements of income (loss) reflect premiums and losses and loss adjustment expenses and acquisition expenses, net of reinsurance ceded (see Note 4, "Reinsurance"). Ceded unearned premiums are reported as prepaid reinsurance premiums and estimated amounts of reinsurance recoverable on unpaid losses are reported as unpaid losses and loss adjustment expenses recoverable. Reinsurance premiums ceded and unpaid losses and loss adjustment expenses recoverable are estimated in a manner consistent with that of the original policies issued and the terms of the reinsurance contracts. If the reinsurers are unable to satisfy their obligations under the agreements, the Company would be liable for such defaulted amounts. Reinsurance ceding commissions are recognized as income on a pro rata basis over the period of risk. Reinsurance ceding commissions that represent a recovery of acquisition costs are recognized as a reduction to acquisition expenses while the remaining portion is deferred.

(e) Cash and cash equivalents

Cash includes cash equivalents, which are investments with original maturities of three months or less that are not managed by the external investment managers. Cash managed by the external investment managers is included in short-term investments.

(f) Investments

The Company has elected the fair value option for its long and short-term investments in accordance with Financial Accounting Standards Board ("FASB") Accounting Standard Codification ("ASC") 825, *Financial Instruments.* As a result, the Company's investments are reported at fair value with changes in fair value included in "realized and unrealized gain (loss) on investments" in the consolidated statements of income (loss). See Note 7, "Investment information" for further information about the investment portfolios.

The fair values of investments are based on quotations received from nationally recognized pricing services, or when such prices are not available, by reference to broker or underwriter bid indications. Short-term investments are comprised of securities due to mature within one year of the date of issue. Investment transactions are recorded on a trade date basis with balances pending settlement recorded separately in the consolidated balance sheets as receivable for securities sold or payable for securities purchased. See Note 8, "Fair value" for further details.

Net interest income includes interest income together with amortization of market premiums and discounts, net of investment management fees, interest expense and custody fees. Anticipated prepayments and expected maturities are used in applying the interest method for certain investments, such as asset-backed securities. When actual prepayments differ significantly from anticipated prepayments, the effective yield is recalculated to reflect actual payments to date and anticipated future payments. The investment in such securities is adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the security. Such adjustments, if any, are included in interest income when determined. Investment gains or losses realized on the sale of investments are determined on a first-in, first-out basis and are reflected in "realized and unrealized gain (loss) on investments" in the consolidated statements of income (loss).

Performance fees, equal to 15% of income on the non-investment grade portfolio, are reflected in "investment performance fees - related parties" in the consolidated statements of income (loss). See Note 7, "Investment information" for further details.

(g) Derivative instruments

The Company recognizes all derivative financial instruments, including embedded derivative instruments, at fair value in the consolidated balance sheets. The Company's investment and underwriting strategy allows for the use of derivative instruments to enhance investment performance, replicate investment positions or manage market exposures and duration risk that would be allowed under the Company's investment guidelines if implemented in other ways. For such investment derivative instruments, changes in assets and liabilities measured at fair value are recorded as a component of "realized and unrealized gain (loss) on investments." In addition, the Company's derivative instruments include amounts related to underwriting activities where an insurance or reinsurance contract meets the accounting definition of a derivative instrument. For such contracts, changes in fair value are reflected in "other underwriting income" in the consolidated statements of income (loss), as the underlying contract originates from the Company's underwriting operations. See Note 10, "Derivative instruments" for further details.

(h) Reserves for losses and loss adjustment expenses

The reserve for losses and loss adjustment expenses consists of estimates of unpaid reported losses and loss adjustment expenses and estimates for losses incurred but not reported. The reserve for unpaid reported losses and loss adjustment expenses, established by management based on reports from ceding companies and claims from insureds, represents the estimated ultimate cost of events or conditions that have been reported to or specifically identified by the Company. Such reserves are supplemented by management's estimates of reserves for losses incurred for which reports or claims have not been received. The Company's reserves are based on a combination of reserving methods, incorporating ceding company and industry loss development patterns. The Company selects the initial expected loss and loss adjustment expense ratios based on information derived by AUL and AUI managers during the initial pricing of the business, supplemented by industry data where appropriate. Such ratios consider, among other things, rate changes and changes in terms and conditions that have been observed in the market. The Company, in conjunction with data and analysis supplied by AUL and AUI, reviews the reserves regularly and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments, if any, are reflected in income in the period in which they are determined. Inherent in the estimates of ultimate losses and loss adjustment expenses are expected trends in claims severity and frequency and other factors which may vary significantly as claims are settled. Accordingly, ultimate losses and loss adjustment expenses may differ materially from the amounts recorded in the accompanying consolidated financial statements. Losses and loss adjustment expenses are recorded on an un-discounted basis. See Note 5, "Reserve for losses and loss adjustment expenses" for further details.

(i) Foreign exchange

Monetary assets and liabilities, such as premiums receivable and the reserve for losses and loss adjustment expenses, denominated in foreign currencies are revalued at the exchange rate in effect at the balance sheet date with the resulting foreign exchange gains and losses included in net income. Accounts that are classified as non-monetary, such as deferred acquisition costs and the unearned premium reserves, are not subsequently re-measured. In the case of foreign currency denominated cash and investments, the change in exchange rates between the local currency and the Company's functional currency at each balance sheet date is included as a component of net foreign exchange gains and losses included in the consolidated statements of income (loss).

Assets and liabilities of foreign operations whose functional currency is not the U.S. Dollar are translated at the prevailing exchange rates at each balance sheet date. Revenues and expenses of such foreign operations are translated at average exchange rates during the year. The net effect of the translation adjustments for foreign operations is included in accumulated other comprehensive income.

(j) Intangible assets

The Company's intangible assets with indefinite lives include licenses held by its U.S. insurance subsidiary which allow such subsidiary to write insurance business in various jurisdictions. These indefinite-lived intangible assets are carried at or below fair value and are tested annually for impairment, either qualitatively or quantitatively, and between annual tests if events or change in circumstances indicate that it is more likely than not that the asset is impaired. If intangible assets are impaired, such assets are written down to their fair values with the related expense recorded in the Company's results of operations.

(k) Income taxes

Deferred income taxes reflect the expected future tax consequences of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and amounts used for income tax purposes. A valuation allowance is recorded if it is more likely than not that some or all of a deferred tax asset may not be realized. The Company considers future taxable income and feasible tax planning strategies in assessing the need for a valuation allowance. In the event the Company determines that it will not be able to realize all or part of its deferred income tax assets in the future, an adjustment to the deferred income tax assets would be charged to income in the period in which such determination is made. In addition, if the Company subsequently assesses that the valuation allowance is no longer needed, a benefit would be recorded to income in the period in which such determination is made. See Note 11, "Income taxes" for more information.

The Company recognizes a tax benefit where it concludes that it is more likely than not that the tax benefit will be sustained on audit by the taxing authority based solely on the technical merits of the associated tax position. If the recognition threshold is met, the Company recognizes a tax benefit measured at the largest amount of the tax benefit that, in the Company's judgment, is greater than 50% likely to be realized. The Company records related interest and penalties in income tax expense.

(l) Warrants

The Company issued certain warrant contracts to Arch and HPS in conjunction with the initial capitalization of the Company which may be settled by the Company using either the physical settlement or net-share settlement methods. In the event these warrants are exercised and settled, the fair value of these warrants would be recorded in equity as additional paid-in capital based on an option-pricing model (Black-Scholes) used to calculate the fair value of the warrants issued.

(m) Recent accounting pronouncements

Issued and effective as of December 31, 2017

In May 2015, the FASB issued Accounting Standards Update 2015-09, *Disclosures about Short-Duration Contracts* ("ASU 2015-09"). ASU 2015-09 amends ASC 944 (Financial Services-Insurance) to expand the disclosures that an insurance entity must provide about its short-duration insurance contracts. Under ASU 2015-09, the FASB focused on targeted improvements to provide users with additional information about insurance liabilities, including the nature, amount, timing, and uncertainty of future cash flows related to insurance liabilities. The amendments in ASU 2015-09 are effective for annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016 for U.S. GAAP reporters. The guidance was applied retrospectively and only impacted the Company's disclosures. See Note 6, "Short duration contracts".

In October 2016, the FASB issued Accounting Standards Update 2016-17, *Consolidation (Topic 810): Interests Held Through Related Parties That Are Under Common Control* ("ASU 2016-17"). ASU 2016-17 alters how the Company needs to consider indirect interests in a variable interest entity held through an entity under common control. The new guidance amends ASU 2015-02 Consolidation (Topic 810): Amendments to the Consolidation Analysis, issued in February 2015. ASU 2016-17 is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. This pronouncement does not have a material impact on the Company's consolidated financial statements and disclosures.

Issued but not yet effective as of December 31, 2017

The FASB issued Accounting Standard Update 2014-09, *Revenue from Contracts with Customers (Topic 606)* ("ASU 2014-09") in May 2014, and has updated through various Accounting Standard Updates in 2016. This ASU (and as updated in 2016) creates a new comprehensive revenue recognition standard that will serve as a single source of revenue guidance for all companies in all industries. The guidance applies to all companies that either enter into contracts with customers to transfer goods or services, or enter into contracts for the transfer of non-financial assets, unless such contracts are within the scope of other standards, such as insurance contracts or financial instruments. The ASU also requires enhanced disclosures about revenue. The ASU is effective for financial statements issued for fiscal years beginning after December 15, 2017, and the Company intends on adopting the ASU using the modified retrospective method, whereby the cumulative effect of adoption will be recognized as an adjustment to retained earnings at the date of initial application. The adoption of this ASU will not impact the Company's premium revenues or revenues from its investment portfolio, which represent substantially all of the Company's consolidated revenues. Based on the Company's evaluation of impacted revenue streams, the ASU is not expected to have a material effect on the Company's consolidated financial statements and the cumulative effect adjustment to retained earnings at the date of the initial application is not expected to be material.

In January 2016, the FASB issued Accounting Standards Update 2016-01, *Financial Instruments-Overall (Subtopic 825-10)-Recognition and Measurement of Financial Assets and Financial Liabilities* ("ASU 2016-01"). The new accounting guidance was issued to enhance the reporting model for financial instruments and to provide improved financial information to readers of the financial statements. Among other provisions focused on improving the recognition and measurement of financial instruments, the ASU requires that equity investments be measured at fair value on the balance sheet with changes in fair value reported in the income statement and that an exit price notion be used when measuring the fair value of financial instruments for disclosure purposes. The ASU is effective in the 2018 first quarter and, aside from limited situations, cannot be early adopted. This pronouncement will not have a material impact on the Company's consolidated financial statements and disclosures.

In February 2016, the FASB issued Accounting Standards Update 2016-02, *Leases* ("ASU 2016-02"). The new accounting guidance requires that the lessee recognize an asset and a liability for leases with a lease term greater than 12 months regardless of whether the lease is classified as operating or financing. Under current accounting, operating leases are not reflected in the balance sheet. This accounting guidance is effective for the 2019 first quarter, though early application is permitted, and should be applied on a modified retrospective basis. The Company is assessing the impact the implementation of this standard will have on its consolidated financial statements and disclosures, but does not believe such impact will be material.

In August 2016, the FASB issued Accounting Standards Update 2016-15, *Statement of Cash Flows (Topic 230), a Consensus of the FASB's Emerging Issues Task Force* ("ASU 2016-15"). ASU 2016-15 intended to reduce diversity in practice in how certain transactions are classified in the statement of cash flows. ASU 2016-15 is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company is assessing the impact the implementation of this standard will have on its consolidated financial statements and disclosures, but does not believe such impact will be material.

In October 2016, the FASB issued Accounting Standards Update 2016-16, *Income Taxes-Intra-Entity Transfers of Assets Other than Inventory* (Topic 740) ("ASU 2016-16"). ASU 2016-16 will require companies to recognize the income tax effects of inter-company sales and transfers of assets other than inventory (e.g., intangible assets) in the period in which the transfer occurs. ASU 2016-16 is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is assessing the impact the implementation of this standard will have on its consolidated financial statements and disclosures, but does not believe such impact will be material.

In August 2017, the FASB issued Accounting Standards Update 2017-12, *Derivatives and Hedging (Topic 815), Targeted Improvements to Accounting for Hedging Activities* ("ASU 2017-12"). ASU 2017-12 intends to improve the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements. ASU 2017-12 is effective January 1, 2019. The Company is assessing the impact the implementation will have on its consolidated financial statements and disclosures, but does not believe such impact will be material.

4. Reinsurance

Through reinsurance agreements with ARL and Arch Reinsurance Company (“ARC”), subsidiaries of ACGL and as well as other, less material reinsurance agreements, the Company cedes a portion of its premiums. The effects of reinsurance on the Company’s written and earned premiums, losses and loss adjustment expenses were as follows:

	Year Ended December 31,	
	2017	2016
Premiums written	*($ in thousands)*	
Direct	$ 133,983	$ 66,807
Assumed	466,321	468,287
Ceded	(47,187)	(21,306)
Net	$ 553,117	$ 513,788
Premiums earned		
Direct	$ 96,125	$ 39,561
Assumed	471,073	448,181
Ceded	(35,472)	(19,772)
Net	$ 531,726	$ 467,970
Losses and Loss Adjustment Expenses		
Direct	$ 71,679	$ 26,230
Assumed	393,565	306,721
Ceded	(28,842)	(11,370)
Net	$ 436,402	$ 321,581

The Company monitors the financial condition of its reinsurers and attempts to place coverages only with financially sound carriers. At December 31, 2017 and 2016, a majority of the Company’s reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) were due from ARL, which has a rating of “A+” from A.M. Best. Although the Company has not experienced any material credit losses to date, an inability of its reinsurers to meet their obligations to it over the relevant exposure periods for any reason could have a material adverse effect on its financial condition and results of operations.

5. Reserve for losses and loss adjustment expenses

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 for the years ended December 31, 2017 and 2016:

	Twelve months ended December 31,	
	2017	**2016**
	($ in thousands)	
Gross reserve for losses and loss adjustment expenses at beginning of year	$ 510,809	$ 290,997
Unpaid losses and loss adjustment expenses recoverable	21,518	11,571
Net reserve for losses and loss adjustment expenses at beginning of year	489,291	279,426
Net incurred losses and loss adjustment expenses relating to losses occurring in:		
Current year	399,530	318,523
Prior years	36,872	3,058
Total net losses and loss adjustment expenses	436,402	321,581
Foreign exchange gains (losses)	14,832	(12,360)
Net paid losses and loss adjustment expenses relating to losses occurring in:		
Current year	(70,423)	(46,198)
Prior years	(111,696)	(53,158)
Total paid losses and loss adjustment expenses	(182,119)	(99,356)
Net reserve for losses and loss adjustment expenses at end of year	758,406	489,291
Unpaid losses and loss adjustment expenses recoverable	39,856	21,518
Gross reserve for losses and loss adjustment expenses at end of year	$ 798,262	$ 510,809

During 2017, the Company recorded net unfavorable development on prior year loss reserves of $36.9 million. The net unfavorable prior year development was driven by casualty reinsurance and other specialty reinsurance contracts. Casualty reinsurance experienced net unfavorable development of $33.8 million primarily due to the U.K. Ministry of Justice's reduction of the discount rate known as the “Ogden” rate and adverse development on certain large multi-line and professional liability contracts. The Ogden rate was reduced from 2.5% to negative 0.75%; the resulting claims development in 2017 was higher than expected.

Other specialty reinsurance experienced net unfavorable development of $5.2 million primarily due to worse than expected emergence on nonstandard and U.K. motor quota share contracts. The remaining lines had net favorable prior year development of $2.2 million due to better than expected emergence of reported losses.

During 2016, the Company recorded net unfavorable development on prior year loss reserves of $3.1 million due to an increase in estimates for medium and short-tail lines.

6. Short duration contracts

The Company is required by applicable insurance laws and regulations and U.S. GAAP to establish reserves for losses and loss adjustment expenses ("loss reserves") that arise from the business it underwrites. Loss reserves are balance sheet liabilities representing estimates of future amounts required to pay losses and loss adjustment expenses for insured or reinsured events which have occurred at or before the balance sheet date. Loss reserves do not reflect contingency reserve allowances to account for future loss occurrences. Losses arising from future events will be estimated and recognized at the time the losses are incurred and could be substantial.

Loss reserves are comprised of (1) case reserves for claims reported, (2) additional case reserves, or ACRs, and (3) IBNR reserves. Loss reserves are established to provide for loss adjustment expenses and represent the estimated expense of settling claims, including legal and other fees and the general expenses of administering the claims adjustment process. Periodically, adjustments to the reported or case reserves may be made as additional information regarding the claims is reported or payments are made.

IBNR reserves are established to provide for incurred claims which have not yet been reported at the balance sheet date as well as to adjust for any projected variance in case reserving. Actuaries estimate ultimate losses and loss adjustment expenses using various generally accepted actuarial methods applied to known losses and other relevant information. Like case reserves, IBNR reserves are adjusted as additional information becomes known or payments are made. The process of estimating reserves involves a considerable degree of judgment by management and, as of any given date, is inherently uncertain.

Ultimate losses and loss adjustment expenses are generally determined by extrapolation of claim emergence and settlement patterns observed in the past that can reasonably be expected to persist into the future. In forecasting ultimate losses and loss adjustment expenses with respect to any line of business, past experience with respect to that line of business is the primary resource, developed through both industry and company experience, but cannot be relied upon in isolation. Uncertainties in estimating ultimate losses and loss adjustment expenses are magnified by the time lag between when a claim actually occurs and when it is reported and settled. This time lag is sometimes referred to as the "claim-tail." The claim-tail for most property coverages is typically short (usually several months up to a few years). The claim-tail for certain professional liability, executive assurance and health care coverages, which are generally written on a claims-made basis, is typically longer than property coverages but shorter than casualty lines. The claim-tail for liability/casualty coverages, such as general liability, products liability, multiple peril coverage and workers' compensation, may be especially long as claims are often reported and ultimately paid or settled years, or even decades, after the related loss events occur. During the claims reporting and settlement period, additional facts regarding coverages written in prior accident years, as well as about actual claims and trends, may become known and, as a result, management may adjust its reserves. If management determines that an adjustment is appropriate, the adjustment is recorded in the accounting period in which such determination is made in accordance with U.S. GAAP. Accordingly, if loss reserves need to be increased or decreased in the future from amounts currently established, future results of operations would be negatively or positively impacted, respectively.

In addition, the inherent uncertainties of estimating such reserves are even greater for our reinsurance lines of business, due primarily to the following factors: (1) the claim-tail for reinsurers is generally longer because claims are first reported to the ceding company and then to the reinsurer through one or more intermediaries, (2) the reliance on premium estimates, where reports have not been received from the ceding company, in the reserving process, (3) the potential for writing a number of reinsurance contracts with different ceding companies with the same exposure to a single loss event, (4) the diversity of loss development patterns among different types of reinsurance contracts, (5) the necessary reliance on the ceding companies for information regarding reported claims and (6) the differing reserving practices among ceding companies.

In determining ultimate losses and loss adjustment expenses, the cost to indemnify claimants, provide needed legal defense and other services for insureds and administer the investigation and adjustment of claims are considered. These claim costs are influenced by many factors that change over time, such as expanded coverage definitions as a result of new court decisions, inflation in costs to repair or replace damaged property, inflation in the cost of medical services and legislated changes in statutory benefits, as well as by the particular, unique facts that pertain to each claim. As a result, the rate at which claims arose in the past and the costs to settle them may not always be representative of what will occur in the future. The factors influencing changes in claim costs are often difficult to isolate or quantify and developments in paid and incurred losses are frequently subject to multiple and conflicting interpretations. Changes in coverage terms or claims handling practices may also cause future experience and/or development patterns to vary from the past. A key objective of actuaries in developing estimates of ultimate losses and loss adjustment expenses, and resulting IBNR reserves, is to identify aberrations and systemic changes occurring within historical experience and accurately adjust for them so that the future can be projected reliably. Pricing actuaries devote considerable effort to understanding and analyzing a ceding company and program administrator's operations and loss history during the underwriting of the business, using a combination of ceding company, program administrator, and industry statistics. Such statistics normally include historical premium and loss data by class of business, individual claim information for larger claims, distributions of insurance limits provided, loss reporting and payment patterns, and rate change history. Because of the factors previously discussed, this process requires the substantial use of informed judgment and is inherently uncertain.

As mentioned above, there can be a considerable time lag from the time a claim is reported to a ceding company to the time it is reported to the reinsurer. The lag can be several years in some cases and may be attributed to a number of reasons; including the time it takes to investigate a claim, delays associated with the litigation process, the deterioration in a claimant's physical condition many years after an accident occurs, the case reserving approach of the ceding company, etc. In the reserving process, the Company assumes that such lags are predictable, on average, over time and therefore the lags are contemplated in the loss reporting patterns used in their actuarial methods. This means that reserves for our reinsurance lines of business must rely on estimates for a longer period of time than for our insurance lines of business. Backlogs in the recording of assumed reinsurance can also complicate the accuracy of loss reserve estimation. As of December 31, 2017 there were no significant backlogs related to the processing of assumed reinsurance information for our reinsurance lines of business.

Although loss reserves are initially determined based on underwriting and pricing analysis, we apply several generally accepted actuarial methods, as discussed below, on a quarterly basis. Each quarter, as part of the reserving process, actuaries at our operations reaffirm that the assumptions used in the reserving process continue to form a sound basis for projection of liabilities. If actual loss activity differs substantially from expectations based on historical information, an adjustment to loss reserves may be supported. Estimated loss reserves for more mature underwriting years are will be based more on actual loss activity and historical patterns than on the initial assumptions based on pricing indications. More recent underwriting years rely more heavily on internal pricing assumptions. We place more or less reliance on a particular actuarial method based on the facts and circumstances at the time the estimates of loss reserves are made.

These methods generally fall into one of the following categories or are hybrids of one or more of the following categories:

- *Expected loss methods: these* methods are based on the assumption that ultimate losses vary proportionately with premiums. Expected loss and loss adjustment expense ratios are typically developed based upon the information derived by underwriters and actuaries during the initial pricing of the business, supplemented by industry data available from organizations, such as statistical bureaus and consulting firms, where appropriate. These ratios consider, among other things, rate changes and changes in terms and conditions that have been observed in the market. Expected loss methods are useful for estimating ultimate losses and loss adjustment expenses in the early years of long-tailed lines of business, when little or no paid or incurred loss information is available, and is commonly applied when limited loss experience exists for a company.

- *Historical incurred loss development methods:* these methods assume that the ratio of losses in one period to losses in an earlier period will remain constant in the future. These methods use incurred losses (i.e., the sum of cumulative historical loss payments plus outstanding case reserves) over discrete periods of time to estimate future losses. Historical incurred loss development methods may be preferable to historical paid loss development methods because they explicitly take into account open cases and the claims adjusters' evaluations of the cost to settle all known claims. However, historical incurred loss development methods necessarily assume that case reserving practices are consistently applied over time. Therefore, when there have been significant changes in how case reserves are established, using incurred loss data to project ultimate losses may be less reliable than other methods.

- *Historical paid loss development methods:* these methods, like historical incurred loss development methods, assume that the ratio of losses in one period to losses in an earlier period will remain constant. These methods use historical loss payments over discrete periods of time to estimate future losses and necessarily assume that factors that have affected paid losses in the past, such as inflation or the effects of litigation, will remain constant in the future. Because historical paid loss development methods do not use incurred losses to estimate ultimate losses, they may be more reliable than the other methods that use incurred losses in situations where there are significant changes in how incurred losses are established by a company's claims adjusters. However, historical paid loss development methods are more leveraged (meaning that small changes in payments have a larger impact on estimates of ultimate losses) than actuarial methods that use incurred losses because cumulative loss payments take much longer to equal the expected ultimate losses than cumulative incurred amounts. In addition, and for similar reasons, historical paid loss development methods are often slow to react to situations when new or different factors arise than those that have affected paid losses in the past.

- *Adjusted historical paid and incurred loss development methods:* these methods take traditional historical paid and incurred loss development methods and adjust them for the estimated impact of changes from the past in factors such as inflation, the speed of claim payments or the adequacy of case reserves. Adjusted historical paid and incurred loss development methods are often more reliable methods of predicting ultimate losses in periods of significant change, provided the actuaries can develop methods to reasonably quantify the impact of changes. As such, these methods utilize more judgment than historical paid and incurred loss development methods.

- *Bornhuetter-Ferguson, or B-F, paid and incurred loss methods:* these methods utilize actual paid and incurred losses and expected patterns of paid and incurred losses, taking the initial expected ultimate losses into account to determine an estimate of expected ultimate losses. The B-F paid and incurred loss methods are useful when there are few reported claims and a relatively less stable pattern of reported losses.

- *Additional analysis:* other methodologies are often used in the reserving process for specific types of claims or events, such as catastrophic or other specific major events. These include vendor catastrophe models, which are typically used in the estimation of loss reserves at the early stage of known catastrophic events before information has been reported to an insurer or reinsurer, and analysis of specific industry events, such as large lawsuits or claims.

In the initial reserving process for short-tail lines, consisting of property catastrophe and other exposures, we rely on a combination of the reserving methods discussed above. For known catastrophic events, our reserving process also includes the usage of catastrophe models and a heavy reliance on analysis which includes ceding company inquiries and management judgment. The development of property losses may be unstable, especially where there is high catastrophic exposure, may be characterized by high severity, low frequency losses for excess and catastrophe-exposed business and may be highly correlated across contracts. As time passes, for a given underwriting year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. We make a number of key assumptions in reserving for short-tail lines, including that historical paid and reported development patterns are stable, catastrophe models provide useful information about our exposure to catastrophic events that have occurred and our underwriters' judgment and guidance received from ceding companies as to potential loss exposures may be relied on. The expected loss ratios used in the initial reserving process for our property exposures will vary over time due to changes in pricing, reinsurance structure, estimates of catastrophe losses, terms and conditions and geographical distribution. As losses in property lines are reported relatively quickly, expected loss ratios are selected for the current underwriting year incorporating the experience for earlier underwriting years, adjusted for rate changes, inflation, changes in reinsurance programs, expectations about present and future market conditions and expected attritional losses based on modeling. Due to the short-tail nature of property business, reported loss experience emerges quickly and ultimate losses are known in a comparatively short period of time.

In the initial reserving process for medium-tail and long-tail lines, consisting of casualty, other specialty, and other exposures, we primarily rely on the expected loss method. The development of medium-tail and long-tail business may be unstable, especially if there are high severity major events, with business written on an excess of loss basis typically having a longer tail than business written on a pro rata basis. As time passes, for a given exposure, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. We make a number of key assumptions in reserving for medium-tail and long-tail lines, including that the pricing loss ratio is the best estimate of the ultimate loss ratio at the time the contract is entered into, historical paid and reported development patterns are stable and our claims personnel and underwriters analysis of our exposure to major events are assumed to be our best estimate of our exposure to the known claims on those events. The expected loss ratios used in initial reserving process for medium-tail and long-tail contracts will vary over time due to changes in pricing, terms and conditions and reinsurance structure. As the credibility of historical experience for earlier underwriting year's increases, the experience from these underwriting years will be used in the actuarial analysis to determine future underwriting year expected loss ratios, adjusted for changes in pricing, loss trends, terms and conditions and reinsurance structure.

Our reinsurance business receives reports of claims notices from ceding companies and record case reserves based upon the amount of reserves recommended by the ceding company. Case reserves on known events may be supplemented by ACRs, which are often estimated by our reinsurance operations' claims personnel ahead of official notification from the ceding company, or when our reinsurance operations' judgment regarding the size or severity of the known event differs from the ceding company. In certain instances, our reinsurance operations establish ACRs even when the ceding company does not report any liability on a known event. In addition, specific claim information reported by ceding companies or obtained through claim audits can alert our reinsurance operations to emerging trends such as changing legal interpretations of coverage and liability, claims from unexpected sources or classes of business, and significant changes in the frequency or severity of individual claims.

Our reinsurance business relies heavily on information reported by ceding companies, as discussed above. In order to determine the accuracy and completeness of such information, underwriters, actuaries, and claims personnel at our reinsurance operations often perform audits of ceding companies and regularly review information received from ceding companies for unusual or unexpected results. Material findings are usually discussed with the ceding companies. Our reinsurance operations sometimes encounter situations where they determine that a claim presentation from a ceding company is not in accordance with contract terms. In these situations, our reinsurance operations attempt to resolve the dispute with the ceding company. Most situations are resolved amicably and without the need for litigation or arbitration. However, in the infrequent situations where a resolution is not possible, our reinsurance operations will vigorously defend their position in such disputes.

For our insurance program and coinsurance line of business, Arch's claim personnel, under our service arrangements, determine whether to establish a case reserve for the estimated amount of the ultimate settlement of individual claims. The estimate reflects the judgment of claims personnel based on general corporate reserving practices, the experience and knowledge of such personnel regarding the nature and value of the specific type of claim and, where appropriate, advice of counsel. We contract with a number of outside third-party administrators in the claims process who, in certain cases, have limited authority to establish case reserves. The work of these administrators is reviewed and monitored by such claims personnel.

Our reserves for loss and loss adjustment expenses primarily relate to short-duration contracts with various characteristics (e.g. type of coverage, geography, claims duration). We have considered such information in determining the level of disaggregation for disclosures related to our short-duration contracts, as detailed in the table below:

Level of disaggregation	Included product lines
Casualty reinsurance - pro rata	Executive assurance, medical malpractice liability, other professional liability, workers' compensation, excess and umbrella liability and excess auto liability all written primarily on a treaty pro rata basis
Casualty reinsurance - excess of loss	Executive assurance, medical malpractice liability, other professional liability, workers' compensation, excess and umbrella liability and excess auto liability all written primarily on an treaty excess of loss basis
Other specialty reinsurance	Personal and commercial auto (other than excess auto liability), surety, accident and health, and workers compensation catastrophe written primarily on a treaty basis
Property catastrophe reinsurance	Property catastrophe reinsurance
Insurance programs and coinsurance	Primary and excess general liability, umbrella liability, professional liability, workers' compensation, personal and commercial automobile, inland marine and property business with minimal catastrophe exposure written on a direct basis

We have determined the following product lines to be insignificant for disclosure purposes: (i) mortgage reinsurance, (ii) marine and aviation reinsurance; (iii) other property reinsurance; and (iv) agriculture reinsurance. Such amounts are included as reconciling items.

We do not include claim count information in our short duration triangles for reinsurance. A significant percentage of our reinsurance business is written on a proportional basis, for which individual loss information is typically unavailable.

For our insurance programs and coinsurance line of business, we generally consider a reported claim to be per claimant, and we include claims with nil or nominal payments and/or case reserves.

We write the majority of our reinsurance contracts on an underwriting year basis and therefore may involve multiple accident years. Pursuant to customary cedent/reinsurer reporting requirements, the cedent reports premium for a given contract to us in total for the contract period, not separated by accident year. Similarly, for certain contract structures, the paid and outstanding losses will also be reported in total for the contract period, not by accident year. The short duration disclosure requires us to separately disclose paid losses, case reserves and IBNR losses by accident year, which necessitates an allocation of the underwriting year data between each of the applicable accident years. To separate reported losses by accident year we employ certain assumptions, which can lead to anomalies in the presentation of individual accident year results.

The following tables present information on the short-duration contracts by line of business:

Casualty reinsurance - Pro Rata ($000's)

	Incurred losses and allocated loss adjustment expenses, net of reinsurance				December 31, 2017
	Year ended December 31,				Total of IBNR liabilities plus expected development on reported claims
Accident year	2014 unaudited	2015 unaudited	2016 unaudited	2017	
2014	$ 43,887	$ 43,237	$ 44,456	$ 45,868	$ 15,529
2015		165,827	166,118	174,386	70,778
2016			177,782	186,911	104,357
2017				178,510	130,382
			Total	$ 585,675	
	Cumulative paid losses and allocated loss adjustment expenses, net of reinsurance				
2014	$ 883	$ 6,881	$ 14,021	$ 20,748	
2015		13,380	38,650	70,295	
2016			12,139	45,212	
2017				15,369	
			Total	151,624	
Liabilities for losses and loss adjustment expenses, net of reinsurance				$ 434,051	

Casualty reinsurance - Excess of Loss ($000's)

	Incurred losses and allocated loss adjustment expenses, net of reinsurance				December 31, 2017
	Year ended December 31,				Total of IBNR liabilities plus expected development on reported claims
Accident year	2014 unaudited	2015 unaudited	2016 unaudited	2017	
2014	$ 4,855	$ 5,873	$ 5,425	$ 11,879	$ 317
2015		28,437	29,565	37,099	5,031
2016			38,982	43,363	11,295
2017				46,203	22,195
			Total	$ 138,544	
	Cumulative paid losses and allocated loss adjustment expenses, net of reinsurance				
2014	$ —	$ 2	$ 73	$ 685	
2015		104	649	2,079	
2016			233	834	
2017				107	
			Total	3,705	
Liabilities for losses and loss adjustment expenses, net of reinsurance				$ 134,839	

Other specialty reinsurance ($000's)

	Incurred losses and allocated loss adjustment expenses, net of reinsurance				December 31, 2017
	Year ended December 31,				Total of IBNR liabilities plus expected development on reported claims
Accident year	2014 unaudited	2015 unaudited	2016 unaudited	2017	
2014	$ 16,745	$ 17,117	$ 17,005	$ 17,671	$ 1,154
2015		66,264	67,854	72,038	7,630
2016			57,091	57,939	13,337
2017				83,618	30,273
			Total	$ 231,266	

	Cumulative paid losses and allocated loss adjustment expenses, net of reinsurance			
2014	$ 4,835	$ 12,472	$ 14,304	$ 15,479
2015		29,770	48,133	58,201
2016			24,654	38,621
2017				30,427
			Total	142,728
Liabilities for losses and loss adjustment expenses, net of reinsurance				$ 88,538

Property catastrophe reinsurance ($000's)

	Incurred losses and allocated loss adjustment expenses, net of reinsurance				December 31, 2017
	Year ended December 31,				Total of IBNR liabilities plus expected development on reported claims
Accident year	2014 unaudited	2015 unaudited	2016 unaudited	2017	
2014	$ 1,583	$ 1,194	$ 870	$ 841	$ 59
2015		4,732	3,626	2,837	255
2016			5,194	4,205	597
2017				22,587	1,716
			Total	$ 30,470	

	Cumulative paid losses and allocated loss adjustment expenses, net of reinsurance			
2014	$ —	$ 241	$ 592	$ 626
2015		394	822	1,406
2016			1,041	1,974
2017				6,628
			Total	10,634
Liabilities for losses and loss adjustment expenses, net of reinsurance				$ 19,836

Insurance programs and coinsurance ($000's except claim amount)

Incurred losses and allocated loss adjustment expenses, net of reinsurance					December 31, 2017	
	Year ended December 31,					
Accident year	2014 unaudited	2015 unaudited	2016 unaudited	2017	Total of IBNR liabilities plus expected development on reported claims	Cumulative number of reported claims
2014	$ —	$ —	$ —	$ —	$ —	—
2015		1,055	1,055	1,186	120	770
2016			26,838	26,524	3,574	31,432
2017				$ 61,204	23,208	49,195
			Total	$ 88,914		

Cumulative paid losses and allocated loss adjustment expenses, net of reinsurance				
2014	$ —	$ —	$ —	$ —
2015		9	412	750
2016			6,163	16,051
2017				18,906
			Total	35,707
Liabilities for losses and loss adjustment expenses, net of reinsurance				$ 53,207

The following table presents the average annual percentage payout of incurred losses and allocated loss adjustment expenses by age, net of reinsurance, as of December 31, 2017:

	Average annual percentage payout of incurred losses and loss adjustment expenses by age, net of reinsurance			
	Year 1	Year 2	Year 3	Year 4
Casualty reinsurance - pro rata	6.2%	15.1%	16.9%	14.7%
Casualty reinsurance - excess of loss	0.3%	1.0%	2.2%	5.2%
Other specialty reinsurance	36.9%	30.9%	12.2%	6.6%
Property catastrophe reinsurance	17.0%	22.0%	31.1%	4.0%
Insurance programs and coinsurance	18.3%	35.6%	28.6%	N/A

For the year ended December 31, 2017, the Company did not make any significant changes in its methodologies or assumptions.

The following table represents a reconciliation of the disclosures of net incurred and paid loss development tables to the reserve for losses and loss adjustment expenses at December 31, 2017:

	December 31, 2017
Net outstanding liabilities:	*($ in thousands)*
Casualty reinsurance - pro rata	$ 434,051
Casualty reinsurance - excess of loss	134,839
Other specialty reinsurance	88,538
Insurance programs and coinsurance	53,207
Property catastrophe reinsurance	19,836
Other short duration lines not included in disclosures (1)	24,202
Total for short duration lines	754,673
Unpaid losses and loss adjustment expenses recoverable:	
Other specialty reinsurance	15,755
Insurance programs and coinsurance	12,660
Casualty reinsurance - pro rata	4,920
Casualty reinsurance - excess of loss	1,373
Property catastrophe reinsurance	5
Other short duration lines not included in disclosures (1)	5,143
Total for short duration lines	39,856
Unallocated claims adjustment expenses	3,733
	3,733
Reserve for losses and loss adjustment expenses	$ 798,262

(1) Other short duration lines includes liabilities acquired in the purchase of WIC of $5.1 million, which are 100% reinsured pursuant to a 100% quota share agreement, and other miscellaneous items.

7. Investment information

The following table summarizes the fair value of the Company's securities held as at December 31, 2017 and 2016, for which the fair value option was elected:

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2017		($ in thousands)		
Term loan investments	$ 879,010	$ 14,525	$ (15,717)	$ 877,818
Fixed maturities:				
Corporate bonds	713,393	21,719	(19,221)	715,891
U.S. government and government agency bonds	233,810	3	(2,794)	231,019
Asset-backed securities	100,105	2,329	(1,287)	101,147
Mortgage-backed securities	11,372	—	(2,082)	9,290
Non-U.S. government and government agency bonds	102,687	1,538	(20)	104,205
Municipal government and government agency bonds	15,615	1	(135)	15,481
Short term investments	323,663	220	—	323,883
Other investments	50,000	—	(387)	49,613
Equities	63,461	6,825	(2,418)	67,868
Total	$ 2,493,116	$ 47,160	$ (44,061)	$ 2,496,215

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2016		($ in thousands)		
Term loan investments	$ 804,521	$ 21,895	$ (12,795)	$ 813,621
Fixed maturities:				
Corporate bonds	494,639	19,741	(28,278)	486,102
U.S. government and government agency bonds	199,262	50	(2,370)	196,942
Asset-backed securities	31,547	227	(1,450)	30,324
Non-U.S. government and government agency bonds	15,363	89	—	15,452
Municipal government and government agency bonds	4,337	8	(32)	4,313
Short term investments	374,269	222	(11)	374,480
Equities	1,274	1,041	—	2,315
Total	$ 1,925,212	$ 43,273	$ (44,936)	$ 1,923,549

The amortized cost and fair value of our term loans, fixed maturities and short-term investments summarized by contractual maturity as of December 31, 2017 and 2016 were as follows:

	December 31, 2017		
	Amortized Cost	Estimated Fair Value	% of Fair Value
		($ in thousands)	
Due in one year or less	$ 339,205	$ 339,358	14.3%
Due after one year through five years	1,197,346	1,193,733	50.2%
Due after five years through ten years	718,766	721,973	30.3%
Due after ten years	12,861	13,233	0.6%
Asset-backed securities	100,105	101,147	4.2%
Mortgage-backed securities	11,372	9,290	0.4%
Total	$ 2,379,655	$ 2,378,734	100.0%

	December 31, 2016		
	Amortized Cost	Estimated Fair Value	% of Fair Value
		($ in thousands)	
Due in one year or less	$ 447,137	$ 446,743	23.3%
Due after one year through five years	900,587	909,235	47.3%
Due after five years through ten years	543,407	533,666	27.8%
Due after ten years	1,260	1,266	0.1%
Asset-backed securities	31,547	30,324	1.5%
Total	$ 1,923,938	$ 1,921,234	100.0%

The table below summarizes the credit quality of our total investments as of December 31, 2017 and 2016, as rated by Standard & Poor's Financial Services, LLC, "Standard & Poor's", Moody's Investors Service, "Moody's", or Fitch Ratings Inc., "Fitch", as applicable:

		Credit Rating (1)									
December 31, 2017	**Fair Value**	**AAA**	**AA**	**A**	**BBB**	**BB**	**B**	**CCC**	**CC**	**D**	**Not Rated**
Term loan investments	$ 877,818	$ —	$ —	$ —	$ 42,673	$ 68,556	$ 526,183	$ 131,743	$ 4,485	$ 4,324	$ 99,854
Fixed maturities:											
Corporate bonds	715,891	9,263	63,651	131,605	43,657	57,037	157,702	194,409	—	5,584	52,983
U.S. government and government agency bonds	231,019	14,676	216,343	—	—	—	—	—	—	—	—
Asset-backed securities	101,147	12,201	3,003	3,419	—	15,353	34,155	—	—	—	33,016
Mortgage-backed securities	9,290	—	—	—	—	—	1,027	—	—	6,682	1,581
Non-U.S. government and government agency bonds	104,205	2,785	95,514	5,906	—	—	—	—	—	—	—
Municipal government and government agency bonds	15,481	13,721	1,265	495	—	—	—	—	—	—	—
Total fixed income instruments	2,054,851	52,646	379,776	141,425	86,330	140,946	719,067	326,152	4,485	16,590	187,434
Short term investments	323,883	366	224,176	767	70,149	—	21,404	—	—	—	7,021
Total fixed income instruments and short term investments	2,378,734	53,012	603,952	142,192	156,479	140,946	740,471	326,152	4,485	16,590	194,455
Other Investments	49,613										
Equities	67,868										
Total	$ 2,496,215	$ 53,012	$ 603,952	$ 142,192	$ 156,479	$ 140,946	$ 740,471	$ 326,152	$ 4,485	$ 16,590	$ 194,455

(1) For individual fixed maturity investments, Standard & Poor's ratings are used. In the absence of a Standard & Poor's rating, ratings from Moody's are used, followed by ratings from Fitch.

		Credit Rating (1)								
December 31, 2016	**Fair Value**	**AAA**	**AA**	**A**	**BBB**	**BB**	**B**	**CCC**	**D**	**Not Rated**
Term loan investments	$ 813,621	$ —	$ —	$ —	$ 15,024	$ 112,298	$ 321,078	$ 222,490	$ —	$ 142,731
Fixed maturities:										
Corporate bonds	486,102	860	3,629	5,942	13,150	53,970	107,603	266,938	9,733	24,277
U.S. government and government agency bonds	196,942	—	196,942	—	—	—	—	—	—	—
Asset-backed securities	30,324	—	—	—	—	9,940	3,195	—	—	17,189
Non-U.S. government and government agency bonds	15,452	—	15,452	—	—	—	—	—	—	—
Municipal government and government agency bonds	4,313	429	2,576	1,039	—	—	—	—	—	269
Total fixed income instruments	1,546,754	1,289	218,599	6,981	28,174	176,208	431,876	489,428	9,733	184,466
Short-term investments	374,480	—	—	108,662	262,291	—	—	—	—	3,527
Total fixed income instruments and short-term investments	1,921,234	1,289	218,599	115,643	290,465	176,208	431,876	489,428	9,733	187,993
Equities	2,315									
Total	$ 1,923,549	$ 1,289	$ 218,599	$ 115,643	$ 290,465	$ 176,208	$ 431,876	$ 489,428	$ 9,733	$ 187,993

(1) For individual fixed maturity investments, Standard & Poor's ratings are used. In the absence of a Standard & Poor's rating, ratings from Moody's are used, followed by ratings from Fitch.

Fair value option

The Company elected to carry all fixed maturity securities and other investments at fair value under the fair value option afforded by accounting guidance regarding the fair value option for financial assets and liabilities. Changes in fair value of investments accounted for using the fair value option are included in "realized and unrealized gain (loss) on investments" in the consolidated statements of income (loss). The Company elected to use this option as investments are not necessarily held to maturity, and in order to address simplification and cost-benefit considerations.

Net investment income (loss)

The components of net investment income (loss) for the years ended December 31, 2017 and 2016 were derived from the following sources:

	Year Ended December 31, 2017			
	Net Interest Income	**Net Unrealized Gains (Losses)**	**Net Realized Gains (Losses)**	**Net Investment Income (Loss)**
Net investment income (loss) by asset class:	*($ in thousands)*			
Term loan investments	$ 73,472	$ (10,354)	$ 346	$ 63,464
Fixed maturities	49,179	8,017	(660)	56,536
Short term investments	1,016	220	(1,745)	(509)
Equities	339	2,902	2,781	6,022
Other investments	—	(387)	—	(387)
Cash and cash equivalents	1,457	—	—	1,457
Investment management fees - related parties	(21,451)	—	—	(21,451)
Borrowing and miscellaneous other investment expenses	(17,489)	—	—	(17,489)
Investment performance fees - related parties	—	—	—	(14,905)
	$ 86,523	$ 398	$ 722	$ 72,738

	Year Ended December 31, 2016			
	Net Interest Income	**Net Unrealized Gains (Losses)**	**Net Realized Gains (Losses)**	**Net Investment Income (Loss)**
Net investment income (loss) by asset class	*($ in thousands)*			
Term loan investments	$ 66,018	$ 60,825	$ (15,298)	$ 111,545
Fixed maturities	53,192	41,982	(1,422)	93,752
Short term investments	2,441	1,278	(7,763)	(4,044)
Equities	—	1,041	—	1,041
Cash and cash equivalents	727	—	—	727
Investment management fees - related parties	(16,563)	—	—	(16,563)
Borrowing and miscellaneous other investment expenses	(15,997)	—	—	(15,997)
Investment performance fees - related parties	—	—	—	(24,065)
	$ 89,818	$ 105,126	$ (24,483)	$ 146,396

Pledged assets

Certain of the Company's invested assets are held in trust and pledged in support of insurance and reinsurance liabilities as well as to collateralize our credit facilities. At December 31, 2017 and 2016, the Company held $2.0 billion and $1.6 billion, respectively, in pledged assets. Included within total pledged assets, the Company held $6.0 million and $6.6 million, respectively, in deposits with U.S. regulatory authorities.

8. Fair value

Fair value hierarchy

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

The levels in the hierarchy are defined as follows:

- *Level 1:* Inputs to the valuation methodology are observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets;
- *Level 2:* Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument; and
- *Level 3:* Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The availability of observable inputs can vary by financial instrument and is affected by a wide variety of factors including, for example, the type of financial instrument, whether the financial instrument is new and not yet established in the marketplace, and other characteristics particular to the transaction. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires significantly more judgment. The degree of judgment exercised by the Company in determining fair value is greatest for financial instruments categorized in Level 3. In periods of market dislocation, the observability of prices and inputs may be reduced for many financial instruments. This may lead to a change in the valuation techniques used to estimate the fair value measurement and cause an instrument to be reclassified between levels within the fair value hierarchy.

Fair value measurements on a recurring basis

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

The Company determines the existence of an active market based on its judgment as to whether transactions for the financial instrument occur in such market with sufficient frequency and volume to provide reliable pricing information. The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. The Company uses quoted values and other data provided by nationally recognized independent pricing sources as inputs into its process for determining fair values of its fixed maturity investments. Each price source has its own proprietary method for determining the fair value of securities that are not actively traded. In general, these methods involve the use of "matrix pricing" in which the independent pricing source uses observable market inputs including, but not limited to, investment yields, credit risks and spreads, benchmarking of like securities, broker-dealer quotes, reported trades and sector groupings to determine a reasonable fair value.

Where multiple quotes or prices are obtained, a price source hierarchy is maintained in order to determine which price source would be used (*i.e.,* a price obtained from a pricing service with more seniority in the hierarchy will be used over a less senior one in all cases). The hierarchy prioritizes pricing services based on availability and reliability and assigns the highest priority to index providers. Based on the above review, the Company will challenge any prices for a security or portfolio which are considered not to be representative of fair value.

In certain circumstances, when fair values are unavailable from these independent pricing sources, quotes are obtained directly from broker-dealers who are active in the corresponding markets. Such quotes are subject to the validation procedures noted above. Where quotes are unavailable, fair value is determined by the investment manager using quantitative and qualitative assessments such as internally modeled values, which are reviewed by the Company's management.

Of the $2.5 billion of financial assets and liabilities measured at fair value at December 31, 2017, approximately $198.5 million, or 8.1% were priced using non-binding broker-dealer quotes or modeled valuations. Of the $1.8 billion of financial assets and liabilities measured at fair value at December 31, 2016, approximately $131.4 million, or 7.1%, were priced using non-binding broker-dealer quotes or modeled valuations.

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

Fixed Maturities. The Company uses the market approach valuation technique to estimate the fair value of its fixed maturity securities, when possible. The market approach includes obtaining prices from independent pricing services, such as index providers and pricing vendors, as well as to a lesser extent quotes from broker-dealers. The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. Each source has its own proprietary method for determining the fair value of securities that are not actively traded. In general, these methods involve the use of "matrix pricing" in which the independent pricing source uses observable market inputs including, but not limited to, investment yields, credit risks and spreads, benchmarking of like securities, broker-dealer quotes, reported trades and sector groupings to determine a reasonable fair value.

The following describes the significant inputs generally used to determine the fair value of the Company's investment securities by asset class:

Term Loans. Fair values are estimated by using quoted prices obtained from independent pricing services for term loan investments with similar characteristics, pricing models or matrix pricing. Such investments are generally classified within Level 2. The fair values for certain of the Company's term loans are determined by the investment manager using quantitative and qualitative assessments such as internally modeled values, which are reviewed by the Company's management. The modeled values are based on peer loans and comparison to industry-specific market data. In addition, the investment manager assesses the fair value based on the valuation of the underlying holdings in accordance with the fund's governing documents. Significant unobservable inputs used to price these securities may include changes in peer and/or comparable credit spreads, accretion of any original issue discount and changes in the issuer's debt leverage since issue. Changes in peer credit spreads, comparable credits spreads, and issuer debt leverage are negatively correlated with the modeled fair value measurement. Such investments are generally classified within Level 3.

Corporate Bonds. Valuations are provided by independent pricing services, substantially all through index providers and pricing vendors with a small amount through broker-dealers. The fair values of these securities are generally determined using the spread above the risk-free yield curve. These spreads are generally obtained from the new issue market, secondary trading and from broker-dealers who trade in the relevant security market. As the significant inputs used in the pricing process for corporate bonds are observable market inputs, the fair value of the majority of these securities are classified within Level 2. The fair values for certain of the Company's corporate bonds are determined by the investment manager using quantitative and qualitative assessments such as internally modeled values, which are reviewed by the Company's management. The modeled values are based on peer bonds and comparison to industry-specific market data. In addition, the investment manager assesses the fair value based on the valuation of the underlying holdings in accordance with the bonds' governing documents. Significant unobservable inputs used to price these securities may include changes in peer and/or comparable credit spreads, accretion of any original issue discount and changes in the issuer's debt leverage since issue. Changes in peer credit spreads, comparable credits spreads, and issuer debt leverage are negatively correlated with the modeled fair value measurement. Such investments are generally classified within Level 3.

Asset-Backed Securities. Valuations are provided by independent pricing services, substantially all through index providers and pricing vendors with a small amount through broker-dealers. The fair values of these securities is generally determined through the use of pricing models (including option adjusted spread) which use spreads to determine the appropriate average life of the securities. These spreads are generally obtained from the new issue market, secondary trading and from broker-dealers who trade in the relevant security market. The pricing services also review prepayment speeds and other indicators, when applicable. As the significant inputs used in the pricing process for asset-backed securities are observable market inputs, the fair value of these securities are classified within Level 2.

Mortgage-Backed Securities. Valuations are provided by independent pricing services, substantially all through pricing vendors and index providers with a small amount through broker-dealers. The fair values of these securities are generally determined through the use of pricing models (including option adjusted spread) which use spreads to determine the expected average life of the securities. These spreads are generally obtained from the new issue market, secondary trading and from broker-dealers who trade in the relevant security market. The pricing services also review prepayment speeds and other indicators, when applicable. As the significant inputs used in the pricing process for mortgage-backed securities are observable market inputs, the fair value of these securities are classified within Level 2.

U.S. Government and Government Agencies. Valuations are provided by independent pricing services, with all prices provided through index providers and pricing vendors. The Company determined that all U.S. Treasuries would be classified as Level 1 securities due to observed levels of trading activity, the high number of strongly correlated pricing quotes received on U.S. Treasuries and other factors.

Non-U.S. Government Securities. Valuations are provided by independent pricing services, with all prices provided through index providers and pricing vendors. The fair values of these securities are generally based on international indices or valuation models which include daily observed yield curves, cross-currency basis index spreads and country credit spreads. As the significant inputs used in the pricing process for non-U.S. government securities are observable market inputs, the fair value of these securities are classified within Level 2.

Municipal Government Bonds. Valuations are provided by independent pricing services, with all prices provided through index providers and pricing vendors. The fair values of these securities are generally determined using spreads obtained from broker-dealers who trade in the relevant security market, trade prices and the new issue market. As the significant inputs used in the pricing process for municipal bonds are observable market inputs, the fair value of these securities are classified within Level 2.

Short-Term Investments. The Company determined that certain of its short-term investments, held in highly liquid money market-type funds, and equities would be included in Level 1 as their fair values are based on quoted market prices in active markets. The fair values of other short-term investments are generally determined using the spread above the risk-free yield curve and are classified within Level 2. Certain of the Company's term loans purchased before December 31, 2017 with maturity dates less than one year but greater than 30 days are included in short-term investments. The fair values of these term loans are determined by the investment manager using quantitative and qualitative assessments such as internally modeled values, which are reviewed by the Company's management. The modeled values are based on peer loans and comparison to industry-specific market data. In addition, the investment manager assesses the fair value based on the valuation of the underlying holdings in accordance with governing documents. Significant unobservable inputs used to price these securities may include changes in peer and/or comparable credit spreads, accretion of any original issue discount and changes in the issuer's debt leverage since issue. Changes in peer credit spreads, comparable credits spreads, and issuer debt leverage are negatively correlated with the modeled fair value measurement. Such investments are generally classified within Level 3.

Equity Securities. The Company determined that exchange-traded equity securities would be included in Level 1 as their values are based on quoted market prices in active markets. Other equity securities are initially valued at cost which approximates fair value. In subsequent measurement periods, the fair values of these securities are determined using non-binding broker-dealer quotes. These equity securities are included in Level 2 of the valuation hierarchy. Where such quotes are unavailable, fair value is determined by the investment manager using quantitative and qualitative assessments such as internally modeled values, which are reviewed by the Company's management. As the significant inputs used to price these securities are unobservable, the fair value of these securities are classified as Level 3. Significant unobservable inputs used to price preferred stock may include changes in peer and/or comparable credit spreads, accretion of any original issue discount and changes in the issuer's debt leverage since issue. Changes in peer credit spreads, comparable credit spreads, and issuer debt leverage are negatively correlated with the modeled fair value measurement.

Derivative Instruments. The Company values the government-sponsored enterprise credit-risk sharing transactions using a valuation methodology based on observable inputs from non-binding broker-dealer quotes and/or recent trading activity. As the inputs used in the valuation process are observable market inputs, the fair value of these securities are classified within Level 2.

Other Investments. The fair value of the Company's investment in the hedge fund is measured using the most recently available NAV as advised by a third party administrator. The fair value of this investment is measured using the NAV as a practical expedient and therefore has not been categorized within the fair value hierarchy.

Measuring the Fair Value of Other Investments Using Net Asset Valuations

The fair value of the hedge fund is estimated using NAVs as advised by the third party administrator. The fund NAVs are based on the administrator's valuation of the underlying holdings in accordance with the fund's governing documents and in accordance with U.S. GAAP.

The Company often does not have access to financial information relating to the underlying securities held within the fund therefore management is unable to corroborate the fair values placed on the securities underlying the asset valuations provided by fund manager or fund administrator. In order to assess the reasonableness of the NAVs, we perform a number of monitoring procedures on a quarterly basis, to assess the quality of the information provided by fund manager and funds administrator. These procedures include, but are not limited to, regular review and discussion of the fund's performance with its manager.

The fair value of the hedge fund is measured using the NAV practical expedient, therefore the fair value of the fund has not been categorized within the fair value hierarchy. The following table presents the Company's financial assets and liabilities measured at fair value by level as at December 31, 2017 and 2016:

December 31, 2017	Estimated Fair Value	Fair Value Measurement Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets measured at fair value:		*($ in thousands)*		
Term loans	$ 877,818	$ —	$ 815,340	$ 62,478
Fixed maturities:				
Corporate bonds	715,891	—	691,181	24,710
U.S. government and government agency bonds	231,019	231,019	—	—
Asset-backed securities	101,147	—	101,147	—
Mortgage-backed securities	9,290	—	9,290	—
Non-U.S. government and government agencies	104,205	—	104,205	—
Municipal government and government agency bonds	15,481	—	15,481	—
Short-term investments	323,883	295,458	28,425	—
Equities	67,868	1,995	12,952	52,921
Other underwriting derivative assets	336	—	336	—
Other investments measured at net asset value (1)	49,613	—	—	—
Total assets measured at fair value	$ 2,496,551	$ 528,472	$ 1,778,357	$ 140,109
Liabilities measured at fair value:				
Payable for securities sold short:				
Corporate bonds	29,750	—	29,750	—
Equities	4,625	4,625	—	—
Total liabilities measured at fair value	$ 34,375	$ 4,625	$ 29,750	$ —

(1) In accordance with applicable accounting guidance, Other Investments that are measured at fair value using the net asset value practical expedient have not been classified in the fair value hierarchy. The fair value amounts presented in this table are intended to permit reconciliation of the fair value hierarchy to the amounts presented in the consolidated balance sheets.

December 31, 2016	Estimated Fair Value	Fair Value Measurement Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets measured at fair value:		($ in thousands)		
Term loans	$ 813,621	$ —	$ 741,392	$ 72,229
Fixed maturities:				
Corporate bonds	486,102	—	464,338	21,764
U.S. government and government agency bonds	196,942	196,942	—	—
Asset-backed securities	30,324	—	30,324	—
Non-U.S. government and government agencies	15,452	—	15,452	—
Municipal government and government agency bonds	4,313	—	4,313	
Short-term investments	374,480	372,355	—	2,125
Equities	2,315	—	2,315	—
Other underwriting derivative assets	154	—	154	—
Total assets measured at fair value	$ 1,923,703	$ 569,297	$ 1,258,288	$ 96,118
Liabilities measured at fair value:				
Payable for securities sold short:				
Corporate bonds	26,551	—	26,551	—
Non-U.S. government and government agencies	6,606	—	6,606	—
Total liabilities at fair value	$ 33,157	$ —	$ 33,157	$ —

When the fair value of financial assets and financial liabilities cannot be derived from active markets, the fair value is determined using a variety of valuation techniques that include the use of models. The inputs to these models are taken from observable markets where possible, but where this is not feasible, estimation is required to establish fair values. Changes in assumptions about these factors could affect the reported fair value of financial instruments and the level where the instruments are disclosed in the fair value hierarchy.

The transfers into and out of fair value hierarchy levels reflect the fair value of the securities at the end of the reporting period.

During 2017, one equity security was re-presented as a Level 1 from Level 2. There were no additional transfers between Level 1 and Level 2 in 2017 or 2016.

The following table presents a reconciliation of the beginning and ending balances for all the financial assets measured at fair value on a recurring basis using Level 3 inputs for 2017 or 2016:

Year Ended December 31, 2017	Beginning Balance	Transfers in (out) of Level 3 (1)	Reclass of Level 3 Security (2)	Net Purchases (Sales) (3)	Net Unrealized Gains (Losses)(4)	Net Unrealized Foreign Exchange Gains (Losses)	Ending Balance
Term loans	$ 72,229	$ 39,501	$ 2,125	$ (51,422)	$ 45	$ —	$ 62,478
Corporate bonds	21,764	—	—	—	103	2,843	24,710
Short-term investments (2)	2,125	—	(2,125)	—	—	—	—
Equities	—	—	—	52,261	660	—	52,921
Total	$ 96,118	$ 39,501	$ —	$ 839	$ 808	$ 2,843	$ 140,109

Year Ended December 31, 2016	Beginning Balance	Transfers in (out) of Level 3	Net Purchases (Sales)(3)	Net Unrealized Gains (Losses)(4)	Net Unrealized Foreign Exchange Gains (Losses)	Ending Balance
Term loans	$ 43,763	$ —	$ 26,520	$ 1,946	$ —	$ 72,229
Corporate bonds	22,168	—	—	218	(622)	21,764
Other underwriting derivatives (5)	(238)	238		—	—	—
Short-term investments	—	—	2,125	—	—	2,125
Total	$ 65,693	$ 238	$ 28,645	$ 2,164	$ (622)	$ 96,118

(1) During the year, the Company was unable to obtain recent independent pricing for a term loan which was purchased during 2015. As such, the security was transferred from Level 2 to Level 3 at its fair value as of December 31, 2016.

(2) As of December 31, 2017, it was determined that a Level 3 security would be held for longer than 1 year, and as such was reclassified from short-term investments to term loans. The security was transferred into term loans at its fair value as of December 31, 2016.

(3) For the year ended December 31, 2017, the net purchases (sales) consisted of $54.4 million of term loan calls and redemptions, $52.3 million of equity purchases and $3.0 million of term loan purchases. For the year ended December 31, 2016, the net purchases (sales) consisted of $31.1 million of term loan purchases, $4.6 million of term loan sales and $2.1 million of short-term investment purchases.

(4) Realized and unrealized gains or losses on Level 3 investments are included in “realized and unrealized gain (loss) on investments” in the Company’s consolidated statements of income (loss).

(5) Realized and unrealized gains or losses in other underwriting derivatives classified as Level 3 are included in “other underwriting income (loss)” in the Company’s consolidated statements of income (loss). The transfer to Level 2 from Level 3 made during 2016 was primarily due to a review of the inputs used on certain other derivatives and occurred at the end of the period prior to the valuation. The transfer was effective December 31, 2016. See Note 10, “Derivative instruments” for further details.

Financial instruments disclosed, but not carried, at fair value

The Company uses various financial instruments in the normal course of its business. The carrying values of cash and cash equivalents, accrued investment income, receivable for securities sold, certain other assets, payable for securities purchased and certain other liabilities approximated their fair values at December 31, 2017 and 2016 due to their respective short maturities. As these financial instruments are not actively traded, their respective fair values are classified within Level 2.

Fair value measurements on a non-recurring basis

The Company measures the fair value of certain assets on a non-recurring basis, generally quarterly, annually, or when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. The Company uses a variety of techniques to measure the fair value of these assets when appropriate, as described below:

Intangible Assets

The Company tests intangible assets for impairment whenever events or changes in circumstances indicate the carrying amount may not be recoverable. When the Company determines intangible assets may be impaired, the Company uses techniques including discounted expected future cash flows, to measure fair value.

9. Borrowings to purchase investments

Secured credit facility

On November 30, 2017, Watford Re amended and restated its $800.0 million secured credit facility with Bank of America, N.A. “Bank of America” through Watford Asset Trust I, “Watford Trust” which had originally been entered into in June 2015. Watford Re owns all of the beneficial interests of Watford Trust. The facility expires on November 30, 2021 and is backed by a portion of Watford Re’s non-investment grade portfolio which has been transferred to Watford Trust and which continues to be managed by HPS pursuant to an investment management agreement between HPS and Watford Trust. The purpose of the facility is to provide borrowing capacity, including for the purchase of loans, securities and other assets and distributing cash or any such loans, securities or other assets to Watford Re. Borrowings on the facility may be made at LIBOR or an alternative base rate at our option, in either case plus an applicable margin. The applicable margin varies based on the applicable base rate and, in the case of LIBOR rate borrowings, the currency in which the borrowing is denominated. In addition, the facility allows for us to issue up to $400.0 million in evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which we have entered into reinsurance arrangements. We pay a fee on each letter of credit equal to the amount available to be drawn under such letter of credit multiplied by an applicable percentage. The applicable percentage varies based on the currency in which the letter of credit is denominated.

As at December 31, 2017 and 2016, Watford Re, through Watford Trust, had borrowed approximately $441.1 million and $256.7 million respectively. Bank of America requires the Company to hold cash and investments in deposit with, or in trust accounts with respect to the borrowed funds and outstanding letters of credit. As at December 31, 2017 and 2016, the Company was required to hold $728.6 million and $773.9 million, respectively, in such deposits and trust accounts. Watford Re has deferred the issuance and extension costs relating to the borrowings of $14.5 million and is subsequently amortizing the deferred costs over the term of the borrowing arrangements.

Custodian bank facility

During the years ended December 31, 2017 and 2016, the Company borrowed $108.0 million and $2.2 million from the Company’s custodian bank to purchase U.S.-denominated securities. The Company pays interest based on 3-month LIBOR plus a margin and the borrowed amount is payable upon demand.

The custodian bank requires the Company to hold cash and investments in deposit with, or in an investment account with respect to the borrowed funds. As at December 31, 2017 and 2016, the Company was required to hold $150.5 million and $3.0 million, respectively, in such deposits and investment accounts. The foreign exchange gain or loss on revaluation on the borrowed Euro denominated funds is included as a component of foreign exchange gains (losses) included in the consolidated statements of net income (loss).

Revolving credit agreement borrowings

As at December 31, 2017 and 2016, the Company had total revolving credit agreement borrowings of $549.2 million and $258.9 million, respectively, which consist of the Secured Facility and borrowings from the custodian bank as discussed above.

During 2017 and 2016, interest expense incurred on the Secured Facility and borrowings from the custodian bank was $15.9 million and $14.0 million, respectively. The interest expense incurred is included as a component of borrowings and miscellaneous other investment expenses in the Company’s consolidated statements of income (loss).

As of December 31, 2017 and 2016, the fair value of the Company's outstanding borrowings approximated their carrying value.

10. Derivative instruments

The Company's underwriting strategy allows it to enter into government-sponsored enterprise credit-risk sharing transactions. These transactions are accounted for as derivatives. During 2016, these transactions were transferred from Level 3 to Level 2 primarily due to inputs to the existing valuation methodology which were considered observable based on non-binding broker dealer quotes. The derivative assets and derivative liabilities relating to these transactions are included in other assets and other liabilities, respectively, in the Company's consolidated balance sheets. Realized and unrealized gains and losses from other derivatives classified as Level 2 in 2017 and 2016 are included in other underwriting income (loss) in the Company's consolidated statements of net income (loss). The risk in force of these transactions is considered the notional amount.

As at December 31, 2017 and 2016, the Company held $17.9 million and $20.6 million, respectively, in assets as collateral for these transactions. These assets are included in fixed maturities accounted for using the fair value option in the Company's consolidated balance sheets.

The following table summarizes information on the fair values and notional amount of the Company's derivative instruments at December 31, 2017 and 2016:

	Estimated Fair Value			
	Asset Derivatives	Liability Derivatives	Net Derivatives	Notional Amount (1)
December 31, 2017		*($ in thousands)*		
Other underwriting derivatives	$ 336	$ —	$ 336	$ 84,855
Total	$ 336	$ —	$ 336	$ 84,855
December 31, 2016				
Other underwriting derivatives	$ 154	$ —	$ 154	$ 102,258
Total	$ 154	$ —	$ 154	$ 102,258

(1) The notional amount represents the absolute value of all outstanding contacts.

11. Income taxes

Watford Holdings and Watford Re are incorporated under the laws of Bermuda and, under current law, are not obligated to pay any taxes in Bermuda based upon income or capital gains. In the event that any legislation is enacted in Bermuda imposing such taxes, a written undertaking has been received from the Bermuda Minister of Finance under the Exempted Undertakings Tax Protection Act 1966 that such taxes will not be applicable to Watford Holdings and Watford Re until March 31, 2035.

WICE is incorporated under the laws of Gibraltar and regulated by the Gibraltar Financial Services Commission (the "FSC") under the Financial Services (Insurance Company) Act (the "Gibraltar Act"). As a result, WICE will be subject to corporation tax. The current rate of tax on applicable profits is 10%. The open tax years that are potentially subject to examination by Gibraltar tax authorities are 2017, 2016 and 2015.

Watford Holdings (UK) Limited is incorporated in the United Kingdom and is subject to UK corporate income tax. The UK corporate income tax rates were reduced from 20% to 19% on April 1, 2017 and will be further reduced to 17% from April 1, 2020. The open tax years that are potentially subject to examination by UK tax authorities are 2017 and 2016.

Watford Holdings (U.S.) Inc is incorporated in the U.S. and files a consolidated U.S. federal tax return with its subsidiaries Watford Specialty Insurance Company, Watford Insurance Company, and Watford Services Inc. The U.S. federal tax rate was 35% through December 31, 2017. On December 22, 2017, the U.S. government passed new legislation (The United States Tax Cuts and Jobs Acts, or "TCJA") which reduced the corporate income tax rate to 21% for tax years beginning after December 31, 2017. Deferred taxes at December 31, 2017 have been measured based on the enacted tax rate of 21%. The open tax years that are potentially subject to examination by U.S. tax authorities are 2017, 2016 and 2015.

The components of income taxes attributable to operations were as follows:

	Year Ended December 31,	
	2017	2016
	($ in thousands)	
Current income tax expense (benefit):		
United States	$ —	$ 1
Gibraltar	21	—
United Kingdom	—	—
	21	1
Deferred income tax expense (benefit):		
United States	—	—
Gibraltar	—	—
United Kingdom	—	—
	—	—
Total income tax expense (benefit)	$ 21	$ 1

The Company's income or loss after preferred dividends and before income taxes was earned in the following jurisdictions:

	Year Ended December 31,	
	2017	2016
	($ in thousands)	
Income (loss) before income taxes:		
Bermuda	$ (6,041)	$ 129,041
United States	(1,485)	(2,257)
Gibraltar	(1,293)	317
United Kingdom	(52)	—
Total income (loss) before income taxes	$ (8,871)	$ 127,101

The reconciliation between the Company's effective tax rate and the expected tax rate at the Bermuda statutory income rate is as follows:

	Year Ended December 31,	
	2017	2016
	($ in thousands)	
Expected income tax expense (benefit) at Bermuda statutory rate	$ —	$ —
Foreign taxes at local expected rates	(659)	(758)
Change in tax rate related to U.S. tax reform	664	—
Change in valuation allowance	17	(3)
Other	(1)	762
Total income tax expense (benefit)	$ 21	$ 1

Deferred income tax assets and liabilities reflect temporary differences based on enacted tax rates between the carrying amounts of assets and liabilities for financial reporting and income tax purposes. Significant components of the Company's deferred income tax assets and liabilities were as follows:

	Year Ended December 31,	
	2017	2016
	($ in thousands)	
Deferred income tax assets:		
Net operating loss	$ 1,068	$ 1,449
Unearned premium reserve	49	43
Loss reserves	10	4
Ceding commissions	170	—
Capitalized expenses	109	210
Goodwill and intangible assets	—	148
Deferred tax assets before valuation allowance	1,406	1,854
Valuation allowance	(1,127)	(1,110)
Deferred tax assets net of valuation allowance	279	744
Deferred income tax liabilities:		
Deferred acquisition costs	—	(265)
Goodwill and intangible assets	(27)	—
Investment basis differences	(252)	(479)
Total deferred tax liabilities	(279)	(744)
Net deferred income tax assets (liabilities)	$ —	$ —

The Company provides a valuation allowance to reduce certain deferred tax assets to an amount which management expects to more likely than not be realized. As of December 31, 2017 and 2016, the Company's valuation allowance was $1.1 million and $1.1 million, respectively. The 2017 valuation allowance primarily related to U.S., Gibraltar and U.K. operating loss carry-forwards. Under applicable law, the existing U.S. net operating loss carry-forwards begin to expire in 2035. The Gibraltar and U.K. net operating loss carry-forwards do not expire.

The Company recognizes a tax benefit where it concludes that it is more likely than not that the tax benefit will be sustained on audit by the taxing authority based solely on the technical merits of the associated tax position. The Company records interest and penalties related to unrecognized tax benefits in the provision for income taxes. As of

December 31, 2017 and 2016 the Company's total unrecognized tax benefits, including interest and penalties, were nil.

Federal excise taxes

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 rate of tax, unless reduced by an applicable U.S. tax treaty, is one percent for all reinsurance premiums. The Company incurs federal excise taxes on certain of its reinsurance transactions. For the years ended December 31, 2017 and 2016, the Company incurred approximately $3.6 million and $4.0 million, respectively, of federal excise taxes. Such amounts are reflected as acquisition expenses in the Company's consolidated statements of income (loss).

12. Transactions with related parties

In March 2014, ARL invested $100.0 million in the Parent and acquired approximately 11% of its common equity. AUL acts as the insurance and reinsurance manager for Watford Re and WICE while AUI acts as the insurance and reinsurance manager for WSIC and WIC, all under separate long-term services agreements. HPS manages the Company's non-investment grade portfolio as investment manager and AIM manages the Company's investment grade portfolio as investment manager, each under separate long-term services agreements. ARL and HPS were granted warrants to purchase additional common equity based on performance criteria. In recognition of the sizable ownership interest, two senior executives of ACGL were appointed to our board of directors. The services agreements with AUL and AUI and the investment management agreements with HPS and AIM provide for services for an extended period of time with limited termination rights by the Company. In addition, these agreements allow for AUL, AUI, HPS and AIM to participate in the favorable results of the Company in the form of performance fees.

AUL and AUI

Watford Re and WICE entered into services agreements with AUL. WSIC and WIC entered into services agreements with AUI. AUL and AUI provide services related to the management of the underwriting portfolio for an initial term ending December 2020. The services agreements perpetually renew automatically in five-year increments unless either we or Arch gives notice to not renew at least 24 months before the end of the then-current term.

As part of the services agreements, AUL and AUI make available to the Companies, on a non-exclusive basis, certain designated employees who serve as officers of the Companies and underwrite business on behalf of the Companies (the "Designated Employees"). AUL and AUI also provide portfolio management, Designated Employee supervision, exposure modeling, loss reserve recommendations, claims-handling, accounting and other related services as part of the services agreements.

In return for their services, AUL and AUI receive fees from the Companies, including an underwriting fee and profit commission, as well as reimbursement for the services of the Designated Employees and reimbursements for an allocated portion of the expenses related to seconded employees, plus other expenses incurred on behalf of the Company.

The related AUL and AUI fees and reimbursements incurred in the consolidated statement of income (loss) for the years ended December 31, 2017 and 2016 were as follows:

	Year Ended December 31,	
	2017	**2016**
Consolidated statement of income (loss) items:	*($ in thousands)*	
Acquisition expenses	10,755	7,207
General and administrative expenses	6,599	5,433
	17,354	12,640

HPS

Certain HPS principals and management own common and preference shares of the Company.

In return for its investment services, HPS receives a management fee, a performance fee and allocated operating expenses. The management fee is calculated at an annual rate of 1.5% of the aggregate net asset value of the assets that are managed by HPS, payable quarterly in arrears. For purposes of calculating the management fees, net asset value is determined by HPS in accordance with the investment management agreements and is measured before reduction for any management fees, performance fees or any expense reimbursement and as adjusted for any non-routine intra-month withdrawals. We have also agreed to reimburse HPS for certain expenses related to the management of our non-investment grade portfolio as set forth in the investment management agreements.

The performance fee is equal to 15% of Income (as defined in such investment management agreements relating to Watford Re, WICE and Watford Trust) or Aggregate Income (as defined in such investment management agreements relating to WSIC and WIC), as applicable, if any, on the assets managed by HPS, calculated and payable as of each fiscal year-end and the date on which the investment management agreements are terminated and not renewed. No performance fees will be paid to HPS if the high water mark (as defined in such investment management agreements) is not met.

During the year ended December 31, 2017, the Company invested $50.0 million in a private fund ("Master Fund") as part of HPS's investment strategy. HPS acts as the Trading Manager and provides certain administrative management services to the Master Fund. As at December 31, 2017, the Master Fund balance was $365.7 million, and the Company's investment represents approximately 13.6% of the Fund. The management fees and performance fees on the Master Fund will be subject to the existing fee structure of the existing investment management agreement between the Company and HPS, as discussed above.

The related consolidated statement of income (loss) for the years ended December 31, 2017 and 2016, and consolidated balance sheet account balances for HPS management fees and performance fees as of December 31, 2017 and 2016 were as follows:

	Year Ended December 31,	
	2017	**2016**
Consolidated statement of income (loss) items:	*($ in thousands)*	
Investment management fees - related parties	20,827	16,327
Investment performance fees - related parties	14,905	24,065
	35,732	40,392

	December 31,	
	2017	**2016**
Consolidated balance sheet items:	*($ in thousands)*	
Other investments, at fair value	49,613	—
Investment management and performance fees payable	21,107	27,942

AIM

Watford Re, WSIC, WICE, and WIC entered into investment management agreements with AIM pursuant to which AIM manages our investment grade portfolio. Each of the Watford Re, WICE, WSIC and WIC investment management agreements with AIM has a one-year term, which terms end annually on March 31, July 31, January 31 and July 31, respectively. The terms will continue to renew for successive one-year periods; provided, however, that either the Company or AIM may terminate any of the investment management agreements with AIM at any time upon 45 days prior written notice. To date, there has been no such notice filed on such agreements.

In return for its investment management services, AIM receives a monthly management fee. The management fee is based on a percentage of the aggregate asset value of the AIM managed portfolio. For the purposes of calculating the management fees, asset value is determined by AIM in accordance with the investment management agreements and is measured before deduction of any management fees or expense reimbursement. We have also agreed to reimburse AIM for additional services related to investment consulting and oversight services, administrative operations and risk analytic support services related to the management of our portfolio, as set forth in the investment management agreements.

The related consolidated statement of income (loss) for the years ended December 31, 2017 and 2016 were as follows:

	Year Ended December 31,	
	2017	**2016**
Consolidated statement of income (loss) items:	*($ in thousands)*	
Investment management fees - related parties	624	236

	Year Ended December 31,	
	2017	**2016**
Consolidated balance sheet items:	*($ in thousands)*	
Investment management and performance fees payable (1)	(71)	—

(1) The negative balance in “investment management and performance fees payable” relates to an over-accrual of investment management fees.

ACGL

Certain directors, executive officers and management of ACGL own common and preference shares of the Company.

The Company reinsures ARL and other ACGL subsidiaries and affiliates for property and casualty risks on a quota share basis. ACGL cedes business to us pursuant to inward retrocession agreements our operating subsidiaries have entered into with ACGL. Pursuant to these inward retrocession agreements we pay a ceding fee based on the business ceded and the applicable retrocession agreement. For the years ended December 31, 2017 and 2016, we incurred ceding fees to Arch, in aggregate, of $17.0 million and $16.2 million, respectively, under these inward retrocession agreements. Such fees, in addition to origination fees, are reflected in “acquisition expenses” on the consolidated statement of income (loss).

The related consolidated statement of income (loss) and consolidated balance sheets account balances for these transactions (excluding AUL and AUI expenses described above) for the years ended December 31, 2017 and 2016 were as follows:

	Year Ended December 31,	
	2017	2016
Consolidated statement of income (loss) items:	($ in thousands)	
Gross premiums written	$ 289,484	$ 338,937
Gross premiums ceded	(32,028)	(13,817)
Net premiums earned	278,423	290,994
Losses and loss adjustment expenses	(223,954)	(189,007)
Acquisition expenses	(97,192)	(93,803)
Consolidated balance sheet items:		
Total investments	590,157	358,559
Premiums receivable	115,192	137,252
Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses	27,817	18,059
Prepaid reinsurance premiums	16,853	8,763
Deferred acquisition costs, net	60,863	71,804
Funds held by reinsurers	39,687	25,155
Contingent commissions	1,794	447
Reserve for losses and loss adjustment expenses	517,450	358,237
Unearned premiums	191,226	204,516
Reinsurance balances payable	14,104	10,352
Amounts due to affiliates	4,484	3,319
Losses payable	33,065	15,092

13. Commitments and contingencies

Concentrations of credit risk

For our reinsurance agreements, the creditworthiness of a counterparty is evaluated by the Company, taking into account credit ratings assigned by independent agencies. The credit approval process involves an assessment of factors, including, among others, the counterparty country and industry exposures. Collateral may be required, at the discretion of the Company, on certain transactions based on the creditworthiness of the counterparty.

The areas where significant concentrations of credit risk may exist include unpaid losses and loss adjustment expenses recoverable, prepaid reinsurance premiums and paid losses and loss adjustment expenses recoverable net of reinsurance balances payable (collectively, “net reinsurance recoverables”), investments and cash and cash equivalent balances.

The Company’s reinsurance recoverables, net of prepaid reinsurance premiums and reinsurance balances payable, resulting from reinsurance agreements entered into with ARL as at December 31, 2017 and 2016 amounted to $30.6 million and $16.5 million, respectively. ARL has an “A+” credit rating from A.M. Best.

A credit exposure exists with respect to reinsurance recoverables as they may become uncollectible. The Company manages its credit risk in its reinsurance relationships by transacting with reinsurers that it considers financially sound and, if necessary, the Company may hold collateral in the form of funds, trust accounts and/or irrevocable letters of credit. This collateral can be drawn on for amounts that remain unpaid beyond specified time periods on an individual reinsurer basis.

In addition, the Company underwrites a significant amount of its business through brokers and a credit risk exists should any of these brokers be unable to fulfill their contractual obligations with respect to the payments of insurance and reinsurance balances owed to the Company.

The Company's investment portfolios are managed in accordance with investment guidelines that include standards of diversification, which limit the allowable holdings of any single issue. There were no investments in any entity in excess of 10% of the Company's shareholders' equity at December 31, 2017 and 2016, other than cash and cash equivalents held in operating and investment accounts with financial institutions with credit ratings between "A" and "AA-."

Letter of credit and revolving credit facilities

On May 19, 2015, Watford Re renewed its letter of credit facility with Lloyds Bank Plc, New York Branch (the "Lloyds Facility"). The Lloyds Facility amount was reduced from $200.0 million to $100.0 million. On May 19, 2017, the Lloyds facility was renewed through to May 19, 2018, and is expected to be renewed. The principal purpose of the Lloyds Facility is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which the Company has entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from the Company as required under insurance regulations in the United States. The amount of letters of credit issued is driven by, among other things, the timing and payment of catastrophe losses, loss development of existing reserves, the payment pattern of such reserves, the further expansion of the Company's business and the loss experience of such business. When issued, the letters of credit are secured by certificates of deposit or cash. In addition, the Lloyds Facility also requires the maintenance of certain covenants, which the Company was in compliance with at December 31, 2017 and 2016. At such dates, the Company had $70.1 million and $65.9 million, respectively, in restricted assets as collateral for outstanding letters of credit issued from the Lloyds Facility, which were secured by certificates of deposit. These amounts are reflected as short-term investments in the Company's consolidated balance sheets.

Secured credit facility

On November 30, 2017, Watford Re amended and restated its $800 million secured credit facility (the "Secured Facility") with Bank of America, N.A. which expires on November 30, 2021. The purpose of the Secured Facility is to provide borrowings, backed by Watford Re's investment portfolios. In addition, the Secured Facility allows for Watford Re to issue up to $400.0 million in evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which the Company has entered into reinsurance arrangements. At December 31, 2017, Watford Re had $441.1 million and $43.9 million in borrowings and outstanding letters of credit, respectively. At December 31, 2016, Watford Re had $256.7 million and $186.6 million in borrowings and outstanding letters of credit, respectively. At December 31, 2017 and 2016, Watford Re was in compliance with all covenants contained in the Secured Facility.

Leases and purchase obligations

At December 31, 2017 the future minimum rental commitments for the Company's operating lease are as follows:

Future rental commitments		**December 31, 2017**
2018	$	323
2019		323
2020		323
2021		323
2022		323
Thereafter		242
Total	$	1,857

The lease is for the rental of office space, with an expiration date of September 2, 2023. Rental expense for each of the years ended December 31, 2017 and 2016 was $0.3 million.

Employment and other arrangements

The Company has employment agreements with certain of its executive officers. Such employment arrangements provide for compensation in the form of base salary, annual bonus, participation in the Company's employee benefit programs and the reimbursements of expenses.

Investment commitments

As at December 31, 2017 and 2016, the Company had unfunded commitments of $1.0 million and $1.1 million, respectively, relating to term loans within its investment portfolios. As at December 31, 2017 and 2016, the Company had unfunded commitments of $10.9 million and $Nil, respectively, relating to equities within its investment portfolios.

14. Contingently redeemable preference shares

In March 2014, the Company issued 9,065,200 8½% cumulative redeemable preference shares ("Preference Shares"). The Company recorded the Preference Shares in the mezzanine section of its consolidated balance sheets in accordance with applicable accounting guidance. The Preference Shares have a par value of $0.01 per share and a liquidation preference of $25.00 per share. The Preference Shares were issued at a discounted amount of $24.50 per share. Holders of the Preference Shares are entitled to receive, if declared by the board of directors, quarterly cash dividends on the last day of March, June, September, and December. Dividends accrue (i) from (and including) June 30, 2014 to (but excluding) June 30, 2019 (the "Fixed Rate Period") at 8½% (the "Fixed Rate") of the $25 per share liquidation preference per annum (equivalent to $2.125 per share per annum) and (ii) from) (and including) June 30, 2019 (the "Floating Rate Period"), at a floating rate per annum (the "Floating Rate") equal to three-month U.S. dollar LIBOR *plus* a margin; provided, that, if, at any time, the three-month U.S. dollar LIBOR shall be less than 1%, then the three-month U.S. dollar LIBOR for purposes of calculating the Floating Rate at the time of such calculation shall be 1%. The Preference Shares may be redeemed by the Company on or after June 30, 2019 or at the option of the preferred shareholders at any time on or after June 30, 2034 at the liquidation price of $25.00 per share. Because the redemption features are not solely within the control of the Company, the Preference Shares are recorded in the mezzanine section of its consolidated balance sheets. Preference Share dividends, including the accretion of the discount and issuance costs, are included in "Preference dividends" in the Company's consolidated statements of income (loss).

On September 28, 2017, the Company's shareholders increased the authorized preferred share capital to 20 million preference shares from 10 million preference shares at a par value of $0.01 per share. For the year ended December 31, 2017, no additional preference shares have been issued.

During 2017 and 2016, preferred dividends paid on the Preference Shares totaled $19.3 million and $19.3 million, respectively, and accretion of the discount and issuance costs was $0.4 million and $0.4 million, respectively.

15. Shareholders' equity

Common shares

On September 28, 2017, the Company's shareholders increased the authorized share capital of the Company to 80 million common shares from 40 million common shares at a par value of $0.01 per share. For the year ended December 31, 2017, no additional common shares have been issued.

The Company issued 22,682,875 common shares in March 2014. The issued and outstanding share capital of the Company consists of 22,682,875 common shares, par value of $0.01 per share at December 31, 2017 and 2016.

Warrants

In connection with our initial private placement, we issued to Arch warrants to purchase up to 975,503 of common shares and to HPS warrants to purchase up to 729,188 of common shares. The warrants expire on March 25, 2020, and are exercisable at any time following a public share offering by the Company. The exercise price of the warrants is determined on the date of exercise so that, if all such warrants then outstanding were exercised in full on such exercise date in respect of the common shares then subject to such warrants, initial holders who purchased common shares in our initial private placement would achieve a 15% target return (including dilution from such warrants and excluding dilution from start-up expenses related to our formation and initial private placement or any warrants we may issue in the future) from March 25, 2014, the initial closing of our private placement, through the date of such exercise, based on the $40.00 initial purchase price per common share paid by such initial holders and the market value of the common shares that would be necessary for the initial holders to achieve such target return if the initial holders disposed of their common shares on the date of such exercise.

The warrants issued to Arch and HPS contain a provision where, at the holder's request and at our option and in our sole discretion, the holder may, subject to certain conditions, receive cash in lieu of common shares upon exercise of the warrants. The amount of the cash payment is calculated by multiplying (i) the number of common shares for which the warrant is being exercised by (ii) the volume weighted average price per common share for the 20 trading days immediately prior to (but not including) the date of exercise less the strike price. We are not, however, required to net cash settle the warrants.

16. Retirement plans

For purposes of providing employees with retirement benefits, the Company maintains defined contribution retirement plans. Contributions are based on the participants' eligible compensation. For the years ended December 31, 2017 and 2016, the Company expensed approximately $0.2 million and $0.2 million, respectively, related to these retirement plans.

17. Legal proceedings

The Company, in common with the insurance industry in general, is subject to litigation and arbitration in the normal course of its business. As of December 31, 2017, the Company was not a party to any litigation or arbitration which is expected by management to have a material adverse effect on the Company's results of operations or financial condition and liquidity.

18. Statutory information

Bermuda

Under the Insurance Act, Watford Re, the Company's reinsurance subsidiary, is registered as a Class 4 insurer and is required to annually prepare and file statutory financial statements and a statutory financial return with the Bermuda Monetary Authority ("BMA"). The Insurance Act also requires Watford Re to maintain minimum share capital and 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 margins and enhanced capital requirement pertaining to its general business. At December 31, 2017 and 2016, all such requirements were met.

Watford Re is also required under its Class 4 license to maintain a minimum liquidity ratio whereby the value of its relevant assets is not less than 75% of the amount of its relevant liabilities for general business. As of December 31, 2017 and 2016, Watford Re met the minimum liquidity ratio requirement.

Under the Insurance Act, Watford Re is subject to capital requirements calculated using the Bermuda Solvency Capital Requirement model ("BSCR Model"), which is a standardized statutory risk-based capital model used to measure the risk associated with Watford Re's assets, liabilities and premiums. The BSCR Model is based on an economic balance sheet ("EBS") derived from the U.S. GAAP financial statements, with certain adjustments related to loss reserves, intangibles and contingencies, among others. Under the BSCR Model, Watford Re's minimum required statutory capital and surplus is referred to as the enhanced capital requirement ("ECR"). The ECR is the greater of the calculated BSCR and the minimum solvency margin ("MSM"). Watford Re is required to calculate and submit the ECR to the BMA annually.

The BSCR for Watford Re for the year ended December 31, 2017 will not be filed with the BMA until April 2018. As such, the minimum required statutory capital and surplus, the ECR, disclosed as at December 31, 2017 was $550.0 million, being the higher of the then-current MSM and the estimated BSCR as of December 31, 2017. The minimum required statutory capital and surplus as at December 31, 2016 was $517.5 million, respectively, which in each case is the ECR, being the higher of the then-current MSM and BSCR on those dates. As of December 31, 2017 and 2016, Watford Re met its ECR.

The Bermuda Companies Act 1981 limits Watford Re's ability to pay dividends and distributions to its Parent if there are reasonable grounds for believing that: (a) Watford Re is, or would after the payment be, unable to pay its liabilities as they become due; or (b) the realizable value of Watford Re's assets would thereby be less than the aggregate of its liabilities and its issued share capital and share premium accounts.

Under the Insurance Act, Watford Re may declare dividends subject to it continuing to meet its minimum solvency and capital requirements, which includes continuing to hold statutory capital and surplus equal to or exceeding its ECR. Watford Re is prohibited from declaring or paying in any fiscal year dividends of more than 25% of its prior year's statutory capital and surplus unless Watford Re files with the BMA a signed affidavit by at least two members of the board of directors attesting that a dividend would not cause the company to fail to meet its relevant margins. As of December 31, 2017, Watford Re could pay dividends or return capital in 2018 of approximately $290.3 million without providing an affidavit to the BMA.

Watford Re is also prohibited, without prior approval of the BMA, from reducing by 15% or more its prior year statutory capital. During 2017 and 2016, Watford Re paid $19.3 million and $19.3 million, respectively, in dividends to the Parent based on solvency and capital requirements in those years.

Gibraltar

WICE is licensed by the Gibraltar Financial Services Commission ("GFSC") under the Gibraltar Financial Services (Insurance Companies) Act ("the Gibraltar Act") to underwrite various insurance businesses across Europe. Under the Gibraltar Act, WICE is subject to capital requirements and is required to prepare and submit annual financial statements to the GFSC as outlined in the Gibraltar Act and in accordance with Gibraltar Generally Accepted Accounting Practice.

WICE shall notify the GFSC of any proposals to declare or pay a dividend on any of its share capital. WICE shall not declare or pay any dividend within 14 days of the date of notification. As of December 31, 2017 and 2016, WICE was in compliance with the GFSC dividend requirement.

United States

The Company's U.S. subsidiaries file financial statements prepared in accordance with statutory accounting practices prescribed or permitted by insurance regulators. Statutory net income and statutory policyholders' surplus, as reported to the insurance regulatory authorities, differ in certain respects from the amounts prepared in accordance with U.S. GAAP. The main differences between statutory net income and U.S. GAAP net income relate to unrealized gains (losses) on investments and deferred acquisition costs, among others. In addition, other differences between statutory policyholders' surplus and U.S. GAAP shareholder's equity are unrealized appreciation or decline in value of investments and non-admitted assets, among others.

The Company's U.S. subsidiaries are subject to insurance laws and regulations in the jurisdictions in which they operate. The ability of the Company's regulated U.S. subsidiaries to pay dividends or make distributions is dependent on their ability to meet applicable regulatory standards. These regulations include restrictions that limit the amount of dividends or other distributions, such as loans or cash advances, available to common shareholders without prior approval of the insurance regulatory authorities. Any dividends or distributions made by WSIC or WIC would result in an increase in available capital at Holdings U.S. WSIC and WIC can declare a maximum of $6.5 million and $2.0 million, respectively, of dividends during 2018, without prior approval from the New Jersey Commissioner of Insurance.

The statutory policyholders' surplus for WSIC at December 31, 2017 and 2016 was $64.5 million and $65.1 million, respectively. The minimum required statutory policyholders' surplus, referred to as authorized control level risk-based capital, for WSIC at December 31, 2017 and 2016 was $3.0 million and $3.1 million, respectively.

The statutory policyholders' surplus for WIC at December 31, 2017 and 2016 was $20.1 million and $20.7 million, respectively. The minimum required statutory policyholders' surplus, referred to as authorized control level risk-based capital, for WIC at December 31, 2017 and 2016 was $671.3 thousand and $716.0 thousand, respectively.

The statutory capital and surplus in our significant regulatory jurisdictions at December 31, 2017 and 2016 was as follows:

	December 31,			
	2017		2016	
	Actual	Required	Actual	Required
	($ in thousands)			
Statutory capital and surplus:				
Bermuda (1)	$ 1,161,004	$ 550,000	$ 1,164,589	$ 517,486
United States	84,668	3,707	85,771	3,835
Gibraltar	23,372	12,281	15,256	5,363

(1) The BSCR for Watford Re for the year ended December 31, 2017 will not be filed with the BMA until April 2018. As such, the required statutory capital and surplus as at December 31, 2017 is an estimate of ECR.

The statutory net income (loss) in our significant regulatory jurisdictions at December 31, 2017 and 2016 was as follows:

	Year Ended December 31,	
	2017	2016
	($ in thousands)	
Statutory net income (loss):		
Bermuda	$ 10,982	$ 146,801
United States	111	218
Gibraltar	1,320	290

19. Subsequent events

The Company has completed its subsequent events evaluation for the period subsequent to the balance sheet date of December 31, 2017 through March 9, 2018, the date the consolidated financial statements were available to be issued, and concluded that there are no subsequent events requiring recognition or disclosure.