

WATFORD RE LTD. AND SUBSIDIARIES

Consolidated Financial Statements

**For the Years Ended
December 31, 2016 and 2015**

WATFORD RE LTD. AND SUBSIDIARIES

<u>Index to Financial Statements</u>	<u>Pages</u>
Report of Independent Auditors.....	2
Consolidated Balance Sheets at December 31, 2016 and 2015	3
Consolidated Statements of Income (Loss) and Comprehensive Income (Loss) for the years ended December 31, 2016 and 2015	4
Consolidated Statements of Changes in Shareholder's Equity for the years ended December 31, 2016 and 2015.....	5
Consolidated Statements of Cash Flows for the years ended December 31, 2016 and 2015.....	6
Notes to Consolidated Financial Statements.....	7



April 28, 2017

Report of Independent Auditors

To the Board of Directors and Shareholder of Watford Re Ltd.:

We have audited the accompanying consolidated financial statements of Watford Re Ltd. and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2016 and December 31, 2015, and the related consolidated statements of income (loss) and comprehensive income (loss), changes in shareholder's equity and cash flows for the years then ended.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' responsibility

Our responsibility is to express an opinion on the consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Watford Re Ltd. and its subsidiaries as of December 31, 2016 and December 31, 2015, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

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WATFORD RE LTD. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(U.S. dollars in thousands, except share data)

	December 31, 2016	December 31, 2015
Assets		
Investments:		
Term loans (Amortized Cost - \$804,521 and \$813,867)	\$ 813,621	\$ 762,162
Fixed Maturities (Amortized Cost - \$745,148 and \$629,220)	733,133	569,022
Short-term investments (Amortized cost - \$374,269 and \$351,547)	374,480	351,547
Equities (Amortized Cost - \$1,274 and \$Nil)	2,315	-
Investments accounted for using the fair value option	\$ 1,923,549	\$ 1,682,731
Cash and cash equivalents	74,881	108,471
Accrued investment income	17,017	19,249
Premiums receivable	189,911	162,263
Unpaid losses and loss adjustment expenses recoverable	21,518	11,571
Paid losses and loss adjustment expenses recoverable	2,902	2,564
Prepaid reinsurance premiums	12,145	11,129
Deferred acquisition costs	86,379	75,443
Receivable for securities sold	1,326	34,095
Intangible assets	7,650	-
Funds held by reinsurer	27,341	133
Contingent commissions	12,096	5,854
Other assets	6,017	8,850
Total Assets	\$ 2,382,732	\$ 2,122,353
Liabilities		
Reserve for losses and loss adjustment expenses	\$ 510,809	\$ 290,997
Unearned premiums	293,480	249,980
Reinsurance balances payable	12,289	14,112
Payable for securities purchased	42,922	33,062
Payable for securities sold short	33,157	30,583
Borrowings to purchase investments	258,861	435,278
Amounts due to affiliates	3,319	2,590
Losses payable	17,795	7,718
Investment management and performance fees payable	27,942	3,901
Other liabilities	4,552	3,987
Total Liabilities	1,205,126	1,072,208
Shareholder's Equity		
Common shares (\$1.00 par; shares authorized, issued and outstanding: 1,000,000)	1,000	1,000
Additional paid-in capital	1,113,635	1,113,635
Retained earnings (deficit)	63,346	(64,192)
Accumulated other comprehensive loss	(375)	(298)
Total Shareholder's Equity	1,177,606	1,050,145
Total Liabilities and Shareholder's Equity	\$ 2,382,732	\$ 2,122,353

See Notes to Consolidated Financial Statements

WATFORD RE LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME (LOSS) AND
COMPREHENSIVE INCOME (LOSS)

(U.S. dollars in thousands)

	Year End December 31,	
	2016	2015
Revenues		
Net premiums written	\$ 513,788	\$ 465,959
Change in unearned premiums	(45,818)	(68,107)
Net premiums earned	467,970	397,852
Other underwriting income	3,746	4,468
Net interest income	89,819	72,858
Realized and unrealized gain (loss) on investments	80,643	(81,337)
Investment performance fees	(24,065)	-
Total revenues	618,113	393,841
Expenses		
Loss and loss adjustment expenses	(321,581)	(277,659)
Acquisition expenses	(136,733)	(116,441)
Operating expenses	(17,890)	(11,830)
Net foreign exchange gain (loss)	4,893	(1,877)
Total expenses	(471,311)	(407,807)
Net income before income taxes	146,802	(13,966)
Income tax expense	(1)	-
Net income (loss) available to common shareholder	\$ 146,801	\$ (13,966)
Other comprehensive income (loss)		
Net foreign currency translation gain (loss)	(77)	(298)
Total comprehensive income (loss)	\$ 146,724	\$ (14,264)

See Notes to Consolidated Financial Statements

WATFORD RE LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN
SHAREHOLDER'S EQUITY
(U.S. dollars in thousands)

	Year End December 31,	
	2016	2015
Common Shares		
Balance at beginning and end of year	\$ 1,000	\$ 1,000
Additional Paid-in Capital		
Balance at beginning and end of year	1,113,635	1,113,635
Accumulated other comprehensive income (loss)		
Balance at beginning of year	(298)	-
Currency translation adjustment	(77)	(298)
Balance at end of year	(375)	(298)
Retained Earnings (Deficit)		
Balance at beginning of year	(64,192)	(30,963)
Net income (loss)	146,801	(13,966)
Dividends paid to parent	(19,263)	(19,263)
Balance at end of year	63,346	(64,192)
Total Shareholder's Equity	\$ 1,177,606	\$ 1,050,145

See Notes to Consolidated Financial Statements

WATFORD RE LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(U.S. dollars in thousands)

	Year Ended December 31,	
	2016	2015
Operating Activities		
Net income (loss)	\$ 146,801	\$ (13,966)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Net unrealized (gains) losses on investments	(105,774)	84,530
Net realized losses on investments	25,479	2,179
Amortization of fixed assets	199	192
Changes in:		
Accrued investment income	2,232	(10,712)
Premiums receivable	(29,409)	(21,657)
Unpaid losses and loss adjustment expenses recoverable	(9,949)	(8,925)
Paid losses and loss adjustment expenses recoverable	(348)	(1,845)
Prepaid reinsurance premiums	(1,534)	(2,157)
Deferred acquisition costs	(11,480)	(25,971)
Reserve for losses and loss adjustment expenses	232,174	228,794
Unearned premiums	47,352	70,264
Reinsurance balances payable	(1,196)	3,833
Other liabilities	36,149	9,092
Other items, net	(55,541)	(11,039)
Net cash provided by Operating Activities	275,155	302,612
Investing Activities		
Purchase of term loans	(619,611)	(862,626)
Purchase of fixed maturity investments	(1,058,200)	(637,366)
Proceeds from sale, redemptions and maturity of term loans	667,914	708,192
Proceeds from sales, redemptions, and maturities of fixed maturity investments	945,578	307,496
Net purchases of short-term investments	(14,311)	(72,584)
Net purchases of equity securities	(1,274)	-
Net settlements of derivative instruments	(6,633)	101
Purchase of business net of cash acquired	(19,451)	-
Purchases of furniture, equipment and other assets	(9)	(50)
Net cash used for Investing Activities	(105,997)	(556,837)
Financing Activities		
Dividends paid	(19,263)	(19,263)
(Repayments on) borrowings to purchase investments	(176,384)	381,180
Borrowings issuance costs	-	(8,821)
Net cash (used for) provided by Financing Activities	(195,647)	353,096
Effects of exchange rate changes on foreign currency cash	(7,101)	(1,720)
Increase (decrease) in cash	(33,590)	97,151
Cash and cash equivalents, beginning of period	108,471	11,320
Cash and cash equivalents, end of period	\$ 74,881	\$ 108,471
Income taxes paid	\$ 1	\$ -
Interest paid	\$ 13,795	\$ 2,114

See Notes to Consolidated Financial Statements

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

1. Organization

Watford Re Ltd. (the “Company” or “Watford Re”) was incorporated under the laws of Bermuda on July 19, 2013 and is a wholly-owned subsidiary of Watford Holdings Ltd. (the “Parent”). The Parent was incorporated under the laws of Bermuda on July 19, 2013.

The Company 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. The Company primarily underwrites reinsurance on exposures worldwide. The Company commenced operations in the first quarter of 2014.

In the first quarter of 2014, the Parent 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 1.0 million common shares.

In June 2015, the Company formed Watford Insurance Company Europe Limited (“WICE”) in Gibraltar as a wholly owned subsidiary. 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., a New Jersey service company. WSIC did not undertake any underwriting activities in 2015. WSIC and Watford Services Inc. 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 the Company.

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.

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

Watford Re and WICE have engaged Arch Underwriters Ltd. (“AUL”), a company incorporated in Bermuda and a wholly owned subsidiary of Arch Capital Group Limited (“ACGL”), to act as their insurance and reinsurance manager pursuant to services agreements between AUL, 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 11, “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 11, “Transactions with Related Parties,” for further details.

The Company has engaged HPS Investment Partners, LLC (formerly known as Highbridge Principal Strategies, LLC) (“HPS”) as investment manager of the assets in its non-investment grade portfolio pursuant to various investment management agreements. HPS will invest the Company’s non-investment grade assets in

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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select opportunities across its credit platform, subject to the terms of the investment management agreements with HPS. See Note 11, “Transactions with Related Parties,” for further details.

The Company has engaged Arch Investment Management Ltd. (“Arch IM”), 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. Arch IM will manage the Company’s investment grade assets pursuant to the terms of the investment management agreements with Arch IM. See Note 11, “Transactions with Related Parties,” for further details.

2. Business Acquired

In August 2016, 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 to 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, S&P and Moody’s, 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 (\$11.8 million), insurance licenses (\$7.7 million) and unpaid losses and loss adjustment expenses recoverable (\$8.9 million). The assets were offset by reserve for losses and loss adjustment expenses (\$8.9 million). The licenses are disclosed 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 Company and its subsidiaries. All significant intercompany 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. To facilitate year-to-year comparisons, certain reclassifications have been made to prior year consolidated financial statement amounts to conform to the current year presentation. There was no effect on net income from this change in presentation.

(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.

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

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 and other expenses related to the Company's underwriting operations that vary with, and are directly related to, the successful acquisition or renewal of business are deferred and amortized over the period in which the related premiums are earned. Acquisition expenses, net of ceding commissions received from reinsurers, consist principally of commissions and premium taxes paid to obtain the Company's business.

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 2016 or 2015.

(c) Reinsurance Ceded

The accompanying consolidated statements of income (loss) reflect premiums and losses and loss adjustment expenses and acquisition costs, net of reinsurance ceded (see Note 4, "Reinsurance"). Ceded unearned premiums are reported as prepaid reinsurance premiums and estimated amounts of reinsurance

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

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. The portion of such commissions that will be earned in the future is deferred and reported as a reduction to acquisition costs. Reinsurance ceding commissions that represent a recovery of acquisition costs are recognized as a reduction to acquisition costs while the remaining portion is deferred.

(d) 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.

(e) 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 6, “Investment Information,” for further information about the investment portfolio.

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 (see Note 7, “Fair Value” for further details). 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.

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 net 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 “net 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” on the income statement. Performance fees, equal to 15% of income on the non-investment grade portfolio, are reflected in “investment performance fees” in the income statement.

(f) 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)

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

as the underlying contract originates from the Company's underwriting operations. See Note 9, "Derivative Instruments" for further details.

(g) 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 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 undiscounted basis. See Note 5, "Reserve for Losses and Loss Adjustment Expenses" for further details.

(h) Foreign Exchange

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. 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 net income (loss).

(i) 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.

(j) 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

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

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 10, "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. If the recognition threshold is not met, the Company records related interest and penalties in income tax expense.

(k) Recent Accounting Pronouncements

Issued and effective as of December 31, 2016

In February 2015, the FASB issued Accounting Standard Update 2015-02, *Consolidation (Topic 810) Amendments to the Consolidation Analysis* ("ASU 2015-02"). ASU 2015-02 requires management to evaluate whether limited partnerships and similar legal entities are variable interest entities (VIEs) or voting interest entities. ASU 2015-02 eliminates the presumption that a general partner should consolidate a limited partnership and affects the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related party relationships. ASU 2015-02 also provides a scope exception from consolidation guidance for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. The amendments in ASU 2015-02 are effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim period within those fiscal years. This pronouncement did not have a material impact on the Company's consolidated financial statements.

Issued but not yet effective as of December 31, 2016

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. For non-public reporters, the amendments are effective December 31, 2017. Early adoption is permitted. The Company will include the additional new disclosures in its consolidated financial statements as of and for the year ending December 31, 2017.

In January 2016, the FASB issued Accounting Standards Update ASU 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.

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

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.

In March 2016, the FASB issued Accounting Standards Update 2016-06, *Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments* (“ASU 2016-06”). ASU 2016-06 clarifies that determining whether the economic characteristics of a put or call are clearly and closely related to its debt host requires only an assessment of the four-step decision sequence outlined in FASB ASC paragraph 815-15-25-24. Additionally, entities are not required to separately assess whether the contingency itself is clearly and closely related. The ASU is effective for interim and annual periods in fiscal years beginning after December 15, 2016. The Company is assessing the impact the implementation of this standard will have on its consolidated financial statements.

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 currently evaluating the impact of this guidance on the Company’s consolidated financial statements.

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. The Company is currently evaluating the impact of this guidance on the Company’s consolidated financial statements.

In October 2016, the FASB issued Accounting Standards Update 2016-16, *Income Taxes - Intra-Entity Transfers of Assets Other than Inventory (Topic 740)*, was issued in the 2016 fourth quarter. The ASU will require companies to recognize the income tax effects of intercompany sales and transfers of assets other than inventory (e.g., intangible assets) in the period in which the transfer occurs. The ASU 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 will have on its consolidated financial statements and disclosures.

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

4. Reinsurance

Through reinsurance agreements with ARL and Arch Reinsurance Company (“ARC”), subsidiaries of ACGL and 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:

	<u>2016</u>	<u>2015</u>
Premiums written		
Direct	\$ 66,807	\$ 12,106
Assumed	468,287	476,793
Ceded	<u>(21,306)</u>	<u>(22,940)</u>
Net	<u>\$ 513,788</u>	<u>\$ 465,959</u>
Premiums earned		
Direct	\$ 39,561	\$ 1,873
Assumed	448,181	416,762
Ceded	<u>(19,772)</u>	<u>(20,783)</u>
Net	<u>\$ 467,970</u>	<u>\$ 397,852</u>
Losses and Loss Adjustment Expenses		
Direct	\$ 26,230	\$ 1,179
Assumed	306,721	292,551
Ceded	<u>(11,370)</u>	<u>(16,071)</u>
Net	<u>\$ 321,581</u>	<u>\$ 277,659</u>

The Company monitors the financial condition of its reinsurers and attempts to place coverages only with substantial, financially sound carriers. At December 31, 2016 and 2015, a majority of the Company’s reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) were due from ARL, which had a rating of “A+” from A.M. Best Company. 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.

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

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, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
Gross reserve for losses and loss adjustment expenses at beginning of year	\$ 290,997	\$ 66,328
Unpaid losses and loss adjustment expenses recoverable	<u>11,571</u>	<u>2,705</u>
Net reserve for losses and loss adjustment expenses at beginning of year	<u>279,426</u>	<u>63,623</u>
Net incurred losses and loss adjustment expenses relating to losses occurring in:		
Current year	318,523	278,414
Prior years	<u>3,058</u>	<u>(755)</u>
Total net losses and loss adjustment expenses	<u>321,581</u>	<u>277,659</u>
Foreign exchange gains	(12,360)	(4,067)
Net paid losses and loss adjustment expenses relating to losses occurring in:		
Current year	(46,198)	(44,364)
Prior years	<u>(53,158)</u>	<u>(13,425)</u>
Total paid losses and loss adjustment expenses	<u>(99,356)</u>	<u>(57,789)</u>
Net reserve for losses and loss adjustment expenses at end of year	489,291	279,426
Unpaid losses and loss adjustment expenses recoverable	<u>21,518</u>	<u>11,571</u>
Gross reserve for losses and loss adjustment expenses at end of year	<u>\$ 510,809</u>	<u>\$ 290,997</u>

During 2016, the Company recorded net unfavorable development on prior year reserves of \$3.1 million due to a combination of medium and short-tail lines. During 2015, the Company recorded estimated net favorable development on prior year loss reserves of \$0.8 million, which were all from the favorable development in medium-tail lines.

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

6. Investment Information

The following table summarizes the fair value of the Company's securities held as at December 31, 2016 and 2015, for which the fair value option was elected:

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2016				
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 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	<u>\$ 1,925,212</u>	<u>\$ 43,273</u>	<u>\$ (44,936)</u>	<u>\$ 1,923,549</u>

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2015				
Term loan investments	\$ 813,867	\$ 617	\$ (52,322)	\$ 762,162
Fixed maturities:				
Corporate bonds	588,942	3,349	(55,523)	536,768
Asset backed securities	28,966	-	(3,522)	25,444
Non-U.S. government and government agency bonds	11,197	-	(4,501)	6,696
U.S. government and government agency bonds	115	-	(1)	114
Short-term investments	351,547	-	-	351,547
Total	<u>\$ 1,794,634</u>	<u>\$ 3,966</u>	<u>\$ (115,869)</u>	<u>\$ 1,682,731</u>

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

The amortized cost and fair value of our assets summarized by contractual maturity as of December 31, 2016, and 2015 were as follows:

	December 31, 2016		
	Amortized Cost	Estimated Fair Value	% of Fair Value
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 fixed maturities	<u>\$ 1,923,938</u>	<u>\$ 1,921,234</u>	<u>100.0%</u>

	December 31, 2015		
	Amortized Cost	Estimated Fair Value	% of Fair Value
Due in one year or less	\$ 356,216	\$ 354,448	21.1%
Due after one year through five years	547,716	508,645	30.2%
Due after five years through ten years	856,548	790,666	47.0%
Due after ten years	5,188	3,528	0.2%
Asset-backed securities	28,966	25,444	1.5%
Total fixed maturities	<u>\$ 1,794,634</u>	<u>\$ 1,682,731</u>	<u>100.0%</u>

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 primary reasons for electing the fair value option were to reflect economic events in earnings on a timely basis and address simplification and cost-benefit considerations.

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

Net Investment Income

The components of net investment income for the years ended December 31, 2016 and 2015 were derived from the following sources:

	<u>2016</u>	<u>2015</u>
Net interest income		
Term loan investments	\$ 66,018	\$ 51,830
Fixed maturities	53,192	42,609
Short-term investments	2,441	94
Cash and cash equivalents	727	86
Investment management fees	(19,554)	(17,405)
Other investment fees	(13,005)	(4,356)
Total net interest income	<u>89,819</u>	<u>72,858</u>
Net realized investment gains (losses)		
Term loan investments	(15,298)	2,341
Fixed maturities	(1,422)	(477)
Short-term investments	(7,763)	(111)
Total net realized investment gains (losses)	<u>(24,483)</u>	<u>1,753</u>
Net unrealized investment gains (losses)		
Term loan investments	60,825	(40,823)
Fixed maturities	41,982	(43,195)
Short-term investments	1,278	928
Equities	1,041	-
Total net unrealized investment gains (losses)	<u>105,126</u>	<u>(83,090)</u>
Investment performance fees	(24,065)	-
Net investment income (loss)	<u>\$ 146,397</u>	<u>\$ (8,479)</u>

Pledged Assets

For certain ACGL entities and third party ceding companies, the Company maintains assets in trust accounts as collateral and letters of credit backed by cash and/or investments. See Note 12, “Commitments and Contingencies – Letter of Credit and Revolving Credit Facilities,” for further details. As at December 31, 2016 and 2015, the Company held \$547.9 million and \$316.5 million, respectively, in assets used for collateral in trusts. As at December 31, 2016 and 2015, the Company held \$65.9 million and \$65.6 million, respectively, in restricted assets as collateral for issued letters of credit. All the assets held are included in investments accounted for using the fair value option.

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

The following table summarizes the fair value of the assets used for collateral or guarantees as at December 31, 2016 and 2015:

	<u>December 31, 2016</u>	<u>December 31, 2015</u>
Assets used for collateral or guarantees:		
Short-term investments	\$ 275,391	\$ 266,032
U.S. government and government agency bonds	192,053	114
Corporate bonds	<u>146,352</u>	<u>115,944</u>
Total fair value of assets held for collateral or guarantees	<u>\$ 613,796</u>	<u>\$ 382,090</u>

The Company is required to maintain assets on deposit, which primarily consists of fixed maturities, with various regulatory authorities to support its insurance and reinsurance operations. The Company's insurance and reinsurance subsidiaries maintain assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies and also have investments in segregated portfolios primarily to provide collateral or guarantees for letters of credit to third parties. The following table details the value of the Company's restricted assets for December 31, 2016 and 2015:

	<u>December 31, 2016</u>	<u>December 31, 2015</u>
Assets used for collateral or guarantees:		
Affiliated transactions	\$ 358,559	\$ 274,913
Third party agreements	248,686	107,063
Deposits with U.S. regulatory authorities	<u>6,551</u>	<u>114</u>
Total fair value of assets held for collateral or guarantees	<u>\$ 613,796</u>	<u>\$ 382,090</u>

7. 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

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

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

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

In certain circumstances, when fair values are unavailable from these independent pricing sources, quotes are obtained directly from broker-dealers who are active in the corresponding markets. Such quotes are subject to the validation procedures noted above. Of the \$1.8 billion and \$1.7 billion of financial assets net of liabilities measured at fair value at December 31, 2016 and 2015, respectively, approximately \$131.4 million and \$116.9 million, or 7.1% and 7.1% were priced using non-binding broker-dealer quotes.

The Company reviews its securities measured at fair value and discusses the proper classification of such investments with the Investment Manager 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

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

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 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.

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

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

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, 2016 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 included in Level 2 of the valuation hierarchy.

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.

The following table presents the Company's financial assets measured at fair value by level as at December 31, 2016 and 2015:

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

December 31, 2016	Estimated Fair Value	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:				
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 bonds	4,313	-	4,313	-
Short-term investments	374,480	372,355	-	2,125
Equities	2,315	-	2,315	-
Receivable for securities sold:				
Term loans	1,326	-	1,326	-
Other underwriting derivative assets	154	-	154	-
Total	\$ 1,925,029	\$ 569,297	\$ 1,259,614	\$ 96,118
Liabilities measured at fair value:				
Payable for securities purchased:				
Term loans	\$ 42,922	\$ -	\$ 42,922	\$ -
Payable for securities sold short:				
Corporate bonds	26,551	-	26,551	-
Non-U.S. government and government agencies	6,606	-	6,606	-
Total	\$ 76,079	\$ -	\$ 76,079	\$ -

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

December 31, 2015	Estimated Fair Value	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:				
Term loans	\$ 762,162	\$ -	\$ 718,399	\$ 43,763
Fixed maturities:				
Corporate bonds	536,768	-	514,600	22,168
Asset backed securities	25,444	-	25,444	-
Non-U.S. government and government agencies	6,696	-	6,696	-
U.S. government and government agency bonds	114	114	-	-
Short-term investments	351,547	351,547	-	-
Receivable for securities sold:				
Term loans	34,095	-	34,095	-
Other underwriting derivative assets	1	-	-	1
Total	<u>\$ 1,716,827</u>	<u>\$ 351,661</u>	<u>\$ 1,299,234</u>	<u>\$ 65,932</u>
Liabilities measured at fair value:				
Payable for securities purchased:				
Term loans	\$ 33,062	\$ -	\$ 33,062	\$ -
Payable for securities sold short:				
Corporate bonds	24,460	-	24,460	-
Non-U.S. government and government agencies	6,123	-	6,123	-
Other underwriting derivative liabilities	239	-	-	239
Total	<u>\$ 63,884</u>	<u>\$ -</u>	<u>\$ 63,645</u>	<u>\$ 239</u>

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 2016 and 2015, there were no transfers between Level 1 and Level 2.

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 the year ending December 31, 2016 and 2015:

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

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

	Beginning Balance January 1, 2015	Purchases (Sales)	Net Unrealized Gains (Losses) ⁽¹⁾⁽²⁾	Net Unrealized Foreign Exchange Gains (Losses)	Ending Balance December 31, 2015
Term loans	\$ -	\$ 45,073	\$ (1,310)	\$ -	\$ 43,763
Corporate bonds	23,475	-	1,101	(2,408)	22,168
Other underwriting derivatives	-	-	(238)	-	(238)
	<u>\$ 23,475</u>	<u>\$ 45,073</u>	<u>\$ (447)</u>	<u>\$ (2,408)</u>	<u>\$ 65,693</u>

- (1) 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).
- (2) Realized and unrealized gains or losses on other 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 9, "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, 2016 and 2015, 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.

8. Borrowings to Purchase Investments

On June 2, 2015, Watford Re entered into an \$800 million secured credit facility (the "Secured Facility") with Bank of America, N.A. The purpose of the Secured Facility is to provide borrowings, backed by Watford Re's investment portfolio. The Secured Facility expires on June 2, 2018. Borrowings on the Secured Facility may be made at a variable rate based on LIBOR or an alternative base rate at the option of Watford Re. As of December 31, 2016 and 2015, Watford Re had borrowed approximately \$256.6 million and \$430.4 million respectively. As of December 31, 2016 and 2015, the borrowed funds are collateralized with approximately \$773.9 million and \$665.9 million, respectively, of invested assets held in trust. Watford Re has deferred initial issuance costs relating to the borrowings of \$8.8 million and is subsequently amortizing the deferred issuance costs over the term of the borrowing arrangements.

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

During 2016 and 2015, Watford Re borrowed approximately \$2.2 million and €4.4 million (\$4.8 million) from its custodian bank to purchase U.S. and Euro denominated securities. Watford Re pays interest based on 3 month LIBOR plus a margin and the borrowed amount is payable upon demand. As at December 31, 2016 and 2015, the borrowed funds are collateralized with \$3.0 million and \$7.0 million, respectively, of invested assets. The foreign exchange gain or loss on revaluation on the borrowed Euro denominated funds is included as a component of foreign exchange gains and losses included in the consolidated statements of net income (loss).

As at December 31 2016 and 2015, Watford Re had total revolving credit agreement borrowings of \$258.9 million and \$435.3 million, respectively, which consist of the Secured Facility and borrowings from the custodian bank as discussed above.

During 2016 and 2015, interest expense incurred on the Secured Facility and borrowings from the custodian bank was \$14.0 million and \$3.3 million, respectively. The interest expense incurred is included as a component of net interest income in the Company's consolidated statements of income (loss).

As of December 31, 2016 and 2015, the fair value of the Company's outstanding borrowings approximated their carrying value.

9. Derivative Instruments

The Company's investment strategy allows for the use of derivative securities. The Company's derivative instruments are recorded on its consolidated balance sheets at fair value. Derivative assets are shown as part of other assets and the derivative liabilities are included in other liabilities on the consolidated balance sheets. All realized and unrealized contract gains and losses are reflected as a component of "realized and unrealized gain (loss) on investments" in the Company's consolidated statements of income (loss). The Company did not hold any put options as at December 31, 2016 and 2015.

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 2015, these transactions were classified in Level 3 of the valuation hierarchy based on inputs to the valuation methodology which were considered unobservable and significant to the fair value measurement. 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 2016 and those classified as Level 3 in 2015 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 2016 and 2015, the Company held \$187.4 million and \$59.2 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.

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

The following table summarizes information on the fair values and notional amount of the Company's derivative instruments at December 31, 2016 and 2015:

2016	Estimated Fair Value			Notional Amount ⁽¹⁾
	Asset Derivatives	Liability Derivatives	Net Derivatives	
Other underwriting derivatives	\$ 154	\$ -	\$ 154	\$ 102,258
Total	<u>\$ 154</u>	<u>\$ -</u>	<u>\$ 154</u>	<u>\$ 102,258</u>

2015	Estimated Fair Value			Notional Amount ⁽¹⁾
	Asset Derivatives	Liability Derivatives	Net Derivatives	
Other underwriting derivatives	\$ 1	\$ (239)	\$ (238)	\$ 130,495
Total	<u>\$ 1</u>	<u>\$ (239)</u>	<u>\$ (238)</u>	<u>\$ 130,495</u>

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

10. Income Taxes

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

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 2015 and 2016.

Watford Re and WICE will be subject to U.S. federal income tax only to the extent that they derive U.S. source income that is subject to U.S. withholding tax or income that is effectively connected with the conduct of a trade or business within the U.S. and are not exempt from U.S. tax under an applicable income tax treaty with the U.S. Watford Re and WICE will be subject to a withholding tax on dividends from U.S. investments and interest from certain U.S. payors (subject to reduction by any applicable income tax treaty). Watford Re and WICE intend to conduct their operations in a manner that will not cause them to be treated as engaged in a trade or business in the United States and, therefore, do not expect to be required to pay U.S. federal income taxes (other than U.S. excise taxes on insurance and reinsurance premium and withholding taxes on dividends and certain other U.S. source investment income). However, because there is uncertainty as to the activities which constitute being engaged in a trade or business within the United States, there can be no assurances that the U.S. Internal Revenue Service will not contend successfully that Watford Re and WICE are engaged in a trade or business in the United States. If Watford Re and WICE were subject to U.S. income tax, the Company's shareholder's equity and earnings could be materially adversely affected.

Holdings U.S. is incorporated in the United States and files a consolidated U.S. federal tax return with its subsidiaries WSIC, WIC, and Watford Services Inc. ("Watford Services"). The U.S. federal tax rate is 35%. The open tax years that are potentially subject to examination by U.S. tax authorities are 2015 and 2016.

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

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

	<u>2016</u>	<u>2015</u>
Current income tax expense (benefit):		
United States	\$ 1	\$ -
Gibraltar	-	-
	<u>1</u>	<u>-</u>
Deferred income tax expense (benefit):		
United States	-	-
Gibraltar	-	-
	<u>-</u>	<u>-</u>
Total income tax expense (benefit)	<u>\$ 1</u>	<u>\$ -</u>

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

	<u>2016</u>	<u>2015</u>
Income (loss) before income taxes:		
Bermuda	\$ 148,742	\$ (12,917)
United States	(2,257)	(972)
Gibraltar	317	(77)
Total	<u>\$ 146,802</u>	<u>\$ (13,966)</u>

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

	<u>2016</u>	<u>2015</u>
Expected income tax expense (benefit) at Bermuda statutory rate:		
Foreign taxes at local expected rates	\$ (758)	\$ (348)
Other	(3)	-
Change in valuation allowance	762	348
Total income tax expense (benefit)	<u>\$ 1</u>	<u>\$ -</u>

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:

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

	<u>2016</u>	<u>2015</u>
Deferred income tax assets:		
Net operating loss	\$ 1,449	\$ 348
Unearned premium reserve	43	-
Loss reserves	4	-
Capitalized expenses	210	-
Goodwill and intangible assets	148	-
Deferred tax assets before valuation allowance	<u>1,854</u>	<u>348</u>
Valuation Allowance	(1,110)	(348)
Deferred tax assets net of valuation allowance	<u>744</u>	<u>-</u>
Deferred income tax liabilities:		
Deferred acquisition costs	(265)	-
Unrealized appreciation on investments	(479)	-
Total deferred tax liabilities	<u>(744)</u>	<u>-</u>
Net Deferred income tax assets (liabilities)	<u>\$ -</u>	<u>\$ -</u>

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, 2016 and 2015, the Company's valuation allowance was \$1.1 million and \$0.3 million, respectively. During the tax year ended December 31, 2016 the Company's valuation allowance increased by \$0.8 million. The valuation allowance primarily related to U.S. and Gibraltar operating loss carry-forwards. Under applicable law, the U.S. net operation loss carry-forwards begin to expire in 2035. The Gibraltar net operating loss carry-forwards do not expire.

FASB guidance regarding the accounting for uncertainty in income taxes prescribes a "more likely than not" threshold for the financial statement recognition of a tax position taken or expected to be taken in a tax return, assuming the relevant tax authority has full knowledge of all relevant information. The amount recognized represents the largest amount of tax benefit that is greater than 50% likely of being ultimately realized. A liability is recognized for any benefit claimed, or expected to be claimed, in a tax return in excess of the benefit recorded in the financial statements, along with any interest and penalty (if applicable) on the excess. The related interest and penalties are recorded in income tax expense.

As of December 31, 2016 and 2015, the Company did not have any tax benefits that did not meet the recognition threshold.

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 2016 and 2015, the Company incurred approximately \$4.0 million and \$3.5 million, respectively, of federal excise taxes. Such amounts are reflected as acquisition expenses in the Company's consolidated statements of income (loss).

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

11. Transactions with Related Parties

In March 2014, ARL, a Bermuda-based subsidiary of ACGL, 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 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 assets as investment manager and Arch IM manages the Company's investment grade assets as investment manager, each under separate long term services agreements. ACGL 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 the Parent's board of directors. The services agreements with AUL and AUI and the investment management agreements with HPS and Arch IM 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 Arch IM to participate in the favorable results of the Company in the form of performance fees.

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 reinsurance and insurance portfolios 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, the designated employees who serve as officers of the Companies and underwrite the reinsurance and insurance 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. All insurance and reinsurance contracts are bound by the Companies or by the Designated Employees on behalf of the Companies.

During the year ended December 31, 2016 and 2015, the Companies incurred \$10.6 million and \$5.7 million, respectively, in fees to AUL and AUI for services provided. The fee incurred in the year ended December 31, 2016 was recorded in acquisition expenses, net, and general and administrative expenses of \$7.3 million and \$3.3 million respectively. The fee incurred in the year ended December 31, 2015 was recorded in acquisition expenses, net, and general and administrative expenses of \$3.0 million and \$2.7 million, respectively in the consolidated statements of income (loss).

Watford Re, WICE and WSIC entered into investment management agreements with HPS pursuant to which HPS manages our non-investment grade portfolio for an initial term ending in December 2020. The investment management agreements perpetually renew automatically in five-year increments unless either the Company or HPS gives notice to not renew at least 24 months before the end of the then-current term. In return for its investment services, HPS receives a management fee, a performance fee and allocated operating expenses. The management fee is calculated as 1.5% of the net asset value under management, plus the portfolio profit (loss), as defined as interest, realized and unrealized gains (losses), less expenses. During the year ended December 31, 2016 and 2015, the Companies incurred \$16.3 million and \$16.0 million, respectively, in management fees to HPS. The performance fee is calculated as 15% of the "portfolio profit," if any, on the non-investment grade portfolio. Portfolio profit is net profit on the non-investment portfolio, net of management fees and expenses, but only after recouping previously un-recouped net losses. During the year ended December 31, 2016 and 2015, the Companies incurred \$24.1 million and \$Nil, respectively, in performance fees to HPS. The management fee is paid quarterly and the performance fee is calculated and payable as of each fiscal year-end. During the year ended December 31, 2016 and 2015, the Companies incurred \$40.4 million and \$16.0 million, respectively, in total fees to HPS. Such management fees and performance fees are included in "net interest income" and "investment performance fees," respectively, in the consolidated statements of income (loss).

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

Watford Re, WSIC, WICE, and WIC entered into investment management agreements with Arch IM pursuant to which Arch IM manages our investment grade portfolio. Each of the investment management agreements with Arch has an initial one-year term, which terms end on January 31, 2017, March 31, 2017, July 31, 2017 and July 31, 2017, respectively. Thereafter, the terms will continue to renew for successive one-year periods; provided, however, that either the Company or Arch IM may terminate any of the investment management agreements with Arch IM at any time upon 45 days prior written notice. In return for its investment services, Arch IM receives monthly asset management fees. During the years ended December 31, 2016 and 2015, the Companies incurred \$0.2 million and \$Nil, respectively, in asset management fees to Arch IM.

Certain directors and executive officers of ACGL along with HPS principals and management own common and preference shares of the Company.

The Company reinsures ARL and other ACGL entities for property and casualty risks on a quota share basis. The related consolidated statement of income (loss) and consolidated balance sheets account balances for these transactions for the years ended December 31, 2016 and 2015 were as follows:

	<u>2016</u>	<u>2015</u>
Consolidated statement of income (loss) items:		
Gross premiums written	\$ 338,937	\$ 326,634
Premiums ceded	13,817	22,073
Net premiums earned	290,994	252,842
Losses and Loss Adjustment Expenses	189,007	163,831
Net acquisition costs	101,009	84,833
Consolidated balance sheet items:		
Pledged cash and investments	358,559	274,913
Premiums receivable	137,252	104,041
Unpaid losses and loss adjustment expenses recoverable	15,157	11,571
Paid losses and loss adjustment expenses recoverable	2,902	2,564
Prepaid reinsurance premiums	8,763	10,475
Deferred acquisition costs	71,804	60,432
Reserve for losses and loss adjustment expenses	358,237	205,720
Unearned premiums	204,516	172,030
Reinsurance balances payable	10,352	13,328
Amounts due to affiliates	3,319	2,590
Losses payable	15,092	4,077

12. Commitments and Contingencies

Concentrations of Credit Risk

For the 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.

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

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 net reinsurance recoverables at December 31, 2016 and 2015 amounted to \$16.5 million and \$11.4 million, respectively, and resulted from reinsurance arrangements entered into with Arch Reinsurance Ltd., which has an “A+” credit rating from A.M. Best Company. 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 portfolio is 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 shareholder’s equity at December 31, 2016 and 2015 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, 2016, Watford Re renewed its letter of credit facility (the “Lloyds Facility”) with Lloyds Bank Plc, New York Branch. In 2015, the Lloyds Facility amount was reduced from \$200 million to \$100 million. The Lloyds Facility expires on May 19, 2017 and is expected to be renewed. The principal purpose of the Facility is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which Watford Re has entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from Watford Re 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 Watford Re’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 Watford Re was in compliance with at December 31, 2016 and 2015. At such dates, Watford Re had approximately \$65.9 million and \$65.6 million, respectively, in outstanding letters of credit, 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 June 2, 2015, Watford Re entered into an \$800 million secured credit facility (the “Secured Facility”) with Bank of America, N.A. The Secured Facility expires on June 2, 2018. The purpose of the Secured Facility is to provide borrowings, backed by Watford Re’s investment portfolio. In addition, the Secured Facility allows for Watford Re to issue, but not to exceed, \$400 million in evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which the Company has entered into reinsurance arrangements. As at December 31, 2016 and 2015, Watford Re had \$256.6 million and \$430.4 million in borrowings, and \$186.6 million and \$60.0 million in outstanding letters of credit, respectively. At December 31, 2016, Watford Re was in compliance with all covenants contained in the Secured Facility.

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

Leases and Purchase Obligations

At December 31, 2016, the future minimum rental commitments for the Company's operating lease are as follows:

	<u>2016</u>
2017	\$ 323
2018	323
2019	323
2020	323
2021	323
Thereafter	565
Total	<u>\$ 2,180</u>

The lease is for the rental of office space, with an expiration date of September 2, 2023. Rental expense was \$0.3 million for both the years ended December 31, 2016 and 2015.

Employment and Other Arrangements

During 2015 and 2014, the Company has entered into employment agreements with certain of its executive officers for periods extending up to March 2017. 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, 2016 and 2015, the Company had unfunded commitments of \$1.1 million and \$Nil, respectively, relating to term loans within its investment portfolio.

13. Shareholder's Equity

Common Shares

The authorized share capital of the Company consists of 1,000,000 common shares, par value of \$1.00 per share, at December 31, 2016 and 2015. The issued share capital of the Company consists of 1,000,000 common shares, par value of \$1.00 per share at December 31, 2016 and 2015.

14. 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 2016 and 2015, the Company expensed approximately \$0.2 million and \$0.1 million, respectively, related to these retirement plans.

15. Legal Proceedings

The Company, in common with the insurance industry in general, is subject to litigation and arbitration in the normal course of its business. As of December 31, 2016, the Company was not a party to any litigation or arbitration which is expected by management to have a material adverse effect on the Company's results of operations and financial condition and liquidity.

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

16. Statutory Information

Bermuda

Under The Insurance Act 1978, as amended, and related regulations of Bermuda (the “Insurance Act”), Watford Re 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 (“MSM”) and enhanced capital requirement (“ECR”) pertaining to its general business. At December 31, 2016 and 2015, 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, 2016 and 2015, 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. Under the BSCR model, Watford Re’s required statutory capital and surplus is referred to as the ECR. The ECR is equal to the higher of the MSM or the BSCR model. The BSCR for relevant insurers for the year ended December 31, 2016 will not be filed with the BMA until April 30, 2017. Following receipt of the submission of Watford Re’s ECR, the BMA has the authority to impose additional capital requirements or capital add-ons, if it deems necessary. If an insurer fails to maintain or meet its ECR, the BMA may take various degrees of regulatory action. As of December 31, 2016 and 2015, Watford Re met its ECR.

The BSCR will be 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.

Statutory accounting differs from U.S. GAAP in the reporting of certain items such as acquisition costs, deferred income taxes and prepaid expenses. The statutory capital and surplus for Watford Re at December 31, 2016 and 2015 was \$1.081 billion and \$964.4 million, respectively. As noted above, the BSCR will not be filed with the BMA until April 30, 2017. The MSM as at December 31, 2016 is \$252.7 million. The minimum required statutory capital and surplus as at December 31, 2015 is \$490.2 million, which is the higher of the MSM and ECR.

Watford Re may declare dividends subject to it continuing to meet its 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, 2016, Watford Re could pay dividends in 2017 of approximately \$270.3 million without providing an affidavit to the BMA.

The Bermuda Companies Act 1981 (the “Companies Act”) 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 is restricted with respect to the payment of dividends. Based on this restriction, Watford Re is prohibited, without prior approval of the BMA, from reducing by 15% or more its

WATFORD RE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

prior year statutory capital. During 2016 and 2015, Watford Re paid \$19.3 million and \$19.3 million, respectively, in dividends to the Parent based on the solvency and capital requirements in 2016 and 2015.

Gibraltar

WICE is licensed by the FSC under 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 FSC as outlined in the Gibraltar Act and in accordance with Gibraltar Generally Accepted Accounting Practice.

Statutory accounting differs from U.S. GAAP in the reporting of certain items, such as investment income and expenses, realized and unrealized gains (losses) on investments. The required statutory capital and surplus for WICE at December 31, 2016 and 2015 was \$5.4 million and \$5.5 million, respectively. The statutory capital and surplus for WICE at December 31, 2016 and 2015 was \$15.3 million and \$11.4 million, respectively.

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. 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.

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 US. WSIC and WIC can declare a maximum of \$6.5 million and \$2.1 million, respectively, of dividends during 2017, without prior approval from the New Jersey Commissioner of Insurance.

The statutory policyholders' surplus for WISC at December 31, 2016 and 2015 was \$65.1 million and \$59.5 million, respectively. The minimum required statutory policyholders' surplus, referred to as authorized control level risk-based capital, for WSIC at December 31, 2016 and 2015 was \$3.1 million and \$90 thousand respectively.

The statutory policyholders' surplus for WIC at December 31, 2016 was \$20.7 million. The minimum required statutory policyholders' surplus, referred to as authorized control level risk-based capital, for WIC at December 31, 2016 was \$716 thousand.

17. Subsequent Events

The Company has completed its subsequent events evaluation for the period subsequent to the balance sheet date of December 31, 2016 through April 28, 2017, the date the consolidated financial statements were available to be issued, and concluded that there are no subsequent events requiring recognition or disclosure.