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

FORM 10-Q

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

For the quarterly period ended March 31, 2021
OR

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

Commission file number: 001-38788

WATFORD

Watford Holdings Ltd.
(Exact Name of Registrant as Specified in its Charter)

Bermuda	**98-1155442**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

Waterloo House, 1st Floor
100 Pitts Bay Road, Pembroke HM 08, Bermuda
(Address of principal executive offices)

(441) 278-3455
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes ☒ No ☐

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

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐ Smaller reporting company ☐ Emerging growth company ☒

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☒

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

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

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common Shares	WTRE	Nasdaq Global Select Market
8½% Cumulative Redeemable Preference Shares	WTREP	Nasdaq Global Select Market

As of May 10, 2021, there were 19,924,220 common shares, $0.01 par value per share, of the registrant outstanding.

Watford Holdings Ltd.

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Explanatory note - Certain defined terms

Unless the context suggests otherwise, any reference in this report to:

- "ACGL" refers to Arch Capital Group Ltd. and its controlled subsidiaries;
- "Arch" refers to any one or more of the following direct or indirect subsidiaries of ACGL, as applicable in the context in which such term appears:
  - Arch Investment Management Ltd., or AIM, which manages the majority of our investment grade portfolio;
  - Arch Reinsurance Company, or ARC, which is a party to certain quota share agreements with one or more of our operating subsidiaries and a services agreement with Watford Holdings (U.S.) Inc.;
  - Arch Reinsurance Ltd., or ARL, which is a party to certain quota share agreements with one or more of our operating subsidiaries and owned approximately 10.2% of our outstanding common shares as of March 31, 2021;
  - Arch Underwriters Inc., or AUI, which manages the underwriting business of our U.S. operating subsidiaries;
  - Arch Underwriters Ltd., or AUL, which manages the underwriting business of our non-U.S. operating subsidiaries, including Watford Re;
- "HPS" refers to HPS Investment Partners, LLC (formerly known as Highbridge Principal Strategies, LLC), which manages our non-investment grade portfolio, as well as accounts in our investment grade portfolio;
- our "Investment Managers" refers to AIM, HPS or any other investment managers that manage our investment grade portfolio or our non-investment grade portfolio from time to time;
- "Watford," "we," "us" and "our" refers to Watford Holdings Ltd. and its subsidiaries;
- "Watford Holdings" refers to our company, Watford Holdings Ltd., a Bermuda exempted company;
- "Watford Re" refers to Watford Re Ltd., a Bermuda domiciled insurance company and a wholly-owned subsidiary of our company;
- "Watford Trust" refers to Watford Asset Trust I, a statutory trust organized under the laws of the State of Delaware;
- "WIC" refers to Watford Insurance Company, a New Jersey domiciled insurance company and a wholly-owned subsidiary of our company;
- "WICE" refers to Watford Insurance Company Europe Limited, a Gibraltar domiciled insurance company and a wholly-owned subsidiary of our company; and
- "WSIC" refers to Watford Specialty Insurance Company, a New Jersey domiciled insurance company and a wholly-owned subsidiary of our company.

In addition, unless the context suggests otherwise, any reference in this report to:

- "HoldCo" refers to Greysbridge Holdings Ltd., a newly formed entity of which ACGL will own approximately 40%, and funds managed by Warburg Pincus LLC and Kelso & Company will each own approximately 30%;

• “Merger” refers to the merger of Merger Sub with and into Watford Holdings pursuant to the Merger Agreement, with Watford Holdings surviving as a wholly-owned subsidiary of HoldCo;

• “Merger Agreement” refers to the Agreement and Plan of Merger, dated as of October 9, 2020, among Watford Holdings, ACGL and Merger Sub, as amended by Amendment No. 1 to Agreement and Plan of Merger, dated as of November 2, 2020, among Watford Holdings, ACGL and Merger Sub; and

• “Merger Sub” refers to Greysbridge Ltd., a newly formed entity that is a wholly-owned subsidiary of HoldCo.

Explanatory note - Proposed merger

On October 9, 2020, we announced that we had entered into (i) an Agreement and Plan of Merger with ACGL and Merger Sub pursuant to which, among other things, Merger Sub will merge with and into Watford Holdings, with Watford Holdings surviving as a wholly-owned subsidiary of ACGL, and (ii) a Voting and Support Agreement (or the Arch Voting Agreement) with ARL and Gulf Reinsurance Ltd., each a subsidiary of ACGL, pursuant to which, among other things, ARL and Gulf Reinsurance Ltd. agreed to vote all of the Company’s common shares and preference shares owned by them in favor of the Merger and to not transfer any such shares, subject to the conditions set forth in the Arch Voting Agreement. On November 2, 2020, we announced that we had entered into an amendment to the merger agreement with ACGL and Merger Sub to amend certain terms of the original merger agreement. ACGL assigned its interests and obligations in connection with this acquisition to HoldCo, a newly formed entity of which ACGL will own approximately 40%, and funds managed by Warburg Pincus LLC and Kelso & Company will each own approximately 30%.

On February 16, 2021, ARL sold an aggregate of 230,400 common shares to affiliates of Kelso & Company, or Kelso, and 230,400 common shares to an affiliate of Warburg Pincus LLC, Warburg Pincus, in each case, at a purchase price of $34.66 per common share which was the then current market price of the common shares (based on the closing sale price of the common shares on the Nasdaq Global Select Market on February 12, 2021) (such sales collectively referred to as the Arch Sales). In connection with the Arch Sales, the Company entered into a waiver to the Arch Voting Agreement with ARL and Gulf Reinsurance Ltd. in order to permit the Arch Sales to Kelso and Warburg Pincus. The Company also entered into Voting and Support Agreements with Kelso and Warburg Pincus, which are substantially similar to the Arch Voting Agreement and pursuant to which Kelso and Warburg Pincus agreed, among other things, to vote any common shares or preference shares owned by them (i) in favor of the adoption of the Merger Agreement and (ii) against any proposal or action that would reasonably be expected to impede or adversely affect in any material respect the merger or any of the other transactions contemplated by the Merger Agreement.

The Merger is expected to close in the first half of 2021, subject to customary closing conditions, including regulatory approval. Shareholder approval was obtained on March 30, 2021 at the Company's special general meeting.

Unless stated otherwise, all forward-looking information contained in this Quarterly Report on Form 10-Q does not take into account or give any effect to the impact of the Merger. For additional details regarding the Merger, see Part II Item 1A “Risk factors”, Part II Item 1 “Legal proceedings” and Part I Item 2 “Management’s discussion and analysis of financial condition and results of operations” of this Quarterly Report on Form 10-Q.

Part I. Financial information

Cautionary note regarding forward-looking statements

The Private Securities Litigation Reform Act of 1995 (or the PSLRA) provides a “safe harbor” for forward-looking statements. This report contains forward-looking statements that are intended to enhance the reader’s ability to assess our future financial and business performance. These statements are based on the beliefs and assumptions of our management, and are subject to risks and uncertainties. Generally, statements that are not about historical facts, including statements concerning our possible or assumed future actions or results of operations are forward-looking statements. Forward-looking statements include, but are not limited to, statements that represent our beliefs, expectations or estimates concerning future operations, strategies, financial results or performance, financings, investments, acquisitions, expenditures or other developments and anticipated trends and competition in the markets in which we operate. Forward-looking statements, for purposes of the PSLRA or otherwise, can also be identified by the use of forward-looking terminology such as “may,” “believes,” “intends,” “anticipates,” “plans,” “estimates,” “expects,” “should” or similar expressions.

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

◦ adverse general economic and market conditions, including those caused by pandemics, including the current global pandemic related to the novel coronavirus, or COVID-19, and government actions in response thereto;

◦ our limited operating history;

◦ fluctuations in the results of our operations;

◦ our ability to compete successfully with more established competitors;

◦ our losses exceeding our reserves;

◦ downgrades, potential downgrades or other negative actions by rating agencies, including the announcements by A.M. Best Company, or A.M. Best, that it has placed under review with negative implications status for our financial strength and credit ratings and Kroll Bond Rating Agency, or KBRA, that it has revised the outlook of our financial strength and credit ratings to negative;

◦ our dependence on key executives and inability to attract qualified personnel, or the potential loss of suitably qualified personnel as a result of Bermuda employment and immigration restrictions;

◦ our dependence on letter of credit facilities and borrowing facilities that may not be available on commercially acceptable terms;

◦ our potential inability to pay dividends or distributions;

◦ our potential need for additional capital in the future and the potential unavailability of such capital to us on favorable terms or at all;

◦ our dependence on clients’ evaluations of risks associated with such clients’ insurance underwriting;

◦ the suspension or revocation of our subsidiaries’ insurance licenses;

- Watford Holdings potentially being deemed an investment company under U.S. federal securities law;
- the potential characterization of us and/or any of our subsidiaries as a passive foreign investment company, or PFIC;
- our dependence on Arch for services critical to our underwriting operations;
- changes to our strategic relationship with Arch or the termination by Arch of any of our services agreements or quota share agreements;
- our dependence on HPS and AIM to implement our investment strategy;
- the termination by HPS or AIM of any of our investment management agreements;
- risks associated with our investment strategy being greater than those faced by competitors;
- changes in the regulatory environment;
- our potentially becoming subject to U.S. federal income taxation;
- our potentially becoming subject to U.S. withholding and information reporting requirements under the U.S. Foreign Account Tax Compliance Act, or FATCA, provisions;
- our ability to complete acquisitions and integrate businesses successfully;
- one or more closing conditions to the Merger, including certain regulatory approvals, may not be satisfied or waived, on a timely basis or otherwise, including that a governmental entity may prohibit, delay or refuse to grant approval for the consummation of the Merger;
- uncertainties regarding the proposed acquisition of Watford Holdings by HoldCo;
- our business may suffer as a result of uncertainty surrounding the proposed transaction with HoldCo, and there may be challenges with employee retention as a result of the proposed transaction with HoldCo;
- the proposed transaction with HoldCo may involve unexpected costs, liabilities or delays;
- legal proceedings that have been, and additional proceedings that may be, initiated against us or our directors related to the proposed transactions with HoldCo;
- an event, change or other circumstance may occur that could give rise to the termination of the Merger Agreement (including circumstances requiring us to pay HoldCo a termination fee pursuant to the Merger Agreement); and
- the other matters set forth under Item 1A “Risk factors,” Item 7 “Management’s discussion and analysis of financial condition and results of operations,” and other sections of the Company’s Annual Report on Form 10-K for the year ended December 31, 2020, Part II Item 1A “Risk factors” and Part I Item 2 “Management’s discussion and analysis of financial condition and results of operations” of this Form 10-Q as well as the other factors set forth in the Company’s other documents on file with the SEC and management’s response to any of the aforementioned factors.

Consequently, such forward-looking statements should be regarded solely as our current plans, estimates or belief as of the date of this report. All subsequent forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by these cautionary statements. The foregoing review of important factors should not be construed as exhaustive and should be read in conjunction with other cautionary statements that are included herein or elsewhere. We do not intend, and do not undertake, any obligation to update any forward-looking statements to reflect future events or circumstances after the date of this report.

Item 1. Consolidated financial statements

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

	(Unaudited) March 31, 2021	December 31, 2020
Assets		
Investments:		
Term loans, fair value option (Amortized cost: $815,305 and $890,996)	$ 790,186	$ 851,539
Fixed maturities, fair value option (Amortized cost: $546,878 and $477,548)	539,687	455,162
Short-term investments, fair value option (Cost: $477,084 and $412,762)	483,600	418,690
Equity securities, fair value option	67,295	64,994
Investments, fair value option	1,880,768	1,790,385
Fixed maturities, available for sale (Amortized cost: $616,054 and $638,075)	627,387	655,249
Equity securities, fair value through net income	63,758	53,207
Total investments (1)	2,571,913	2,498,841
Cash and cash equivalents	236,164	211,451
Accrued investment income	14,325	14,679
Premiums receivable (1)	252,523	224,377
Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses (1)	291,485	286,590
Prepaid reinsurance premiums (1)	113,180	122,339
Deferred acquisition costs, net (1)	62,224	53,705
Receivable for securities sold	68,076	37,423
Intangible assets	7,650	7,650
Funds held by reinsurers (1)	54,929	45,989
Other assets (1)	30,985	29,016
Total assets	$ 3,703,454	$ 3,532,060
Liabilities		
Reserve for losses and loss adjustment expenses (1)	$ 1,568,243	$ 1,519,583
Unearned premiums (1)	426,975	407,714
Losses payable (1)	48,415	59,397
Reinsurance balances payable (1)	77,041	63,269
Payable for securities purchased	50,265	16,916
Payable for securities sold short	34,589	21,975
Revolving credit agreement borrowings	250,579	211,640
Senior notes (1)	172,757	172,689
Amounts due to affiliates (1)	4,516	7,708
Investment management and performance fees payable (1)	12,012	21,641
Other liabilities (1)	28,645	35,786
Total liabilities	$ 2,674,037	$ 2,538,318
Commitments and contingencies		
Contingently redeemable preference shares (1)	52,421	52,398
Shareholders' equity		
Common shares ($0.01 par; shares authorized: 120 million; shares issued: 22,813,915 and 22,804,128)	228	228
Additional paid-in capital	899,761	899,491
Retained earnings (deficit)	144,441	103,554
Accumulated other comprehensive income (loss)	10,489	15,994
Common shares held in treasury, at cost (shares: 2,917,149 and 2,917,149)	(77,923)	(77,923)
Total shareholders' equity	976,996	941,344
Total liabilities, contingently redeemable preference shares and shareholders' equity	$ 3,703,454	$ 3,532,060

(1) See Note 12, "Transactions with related parties" for disclosure of related party amounts.

See Notes to Consolidated Financial Statements

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

	(Unaudited)	
	Three Months Ended March 31,	
	2021	2020
Revenues		
Gross premiums written (1)	$ 216,523	$ 234,902
Gross premiums ceded (1)	(37,212)	(48,202)
Net premiums written (1)	179,311	186,700
Change in unearned premiums (1)	(31,580)	(46,661)
Net premiums earned (1)	147,731	140,039
Other underwriting income (loss)	411	133
Interest income	25,798	37,824
Investment management fees - related parties (1)	(4,487)	(4,352)
Borrowing and miscellaneous other investment expenses	(2,354)	(5,669)
Net interest income	18,957	27,803
Realized and unrealized gains (losses) on investments	46,173	(290,502)
Investment performance fees - related parties (1)	(6,016)	—
Net investment income (loss)	59,114	(262,699)
Total revenues	207,256	(122,527)
Expenses		
Loss and loss adjustment expenses (1)	(118,794)	(110,676)
Acquisition expenses (1)	(35,135)	(28,367)
General and administrative expenses (1)	(7,292)	(7,139)
Interest expense (1)	(2,912)	(2,912)
Net foreign exchange gains (losses)	(475)	5,013
Transaction costs and other	(715)	—
Total expenses	(165,323)	(144,081)
Income (loss) before income taxes	41,933	(266,608)
Income tax expense	(8)	—
Net income (loss) before preference dividends	41,925	(266,608)
Preference dividends (1)	(1,038)	(1,171)
Net income (loss) available to common shareholders	$ 40,887	$ (267,779)
Earnings (loss) per common share:		
Basic	$ 2.06	$ (13.42)
Diluted	$ 2.05	$ (13.42)
Weighted average number of common shares used in the determination of earnings (loss) per share:		
Basic	19,892,886	19,951,932
Diluted	19,956,123	19,951,932

(1) See Note 12, “Transactions with related parties” for disclosure of related party amounts.

See Notes to Consolidated Financial Statements

WATFORD HOLDINGS LTD.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(U.S. dollars in thousands)

	(Unaudited)	
	Three Months Ended March 31,	
	2021	2020
Comprehensive income (loss)		
Net income (loss) available to common shareholders	$ 40,887	$ (267,779)
Other comprehensive income (loss) net of income tax:		
Available for sale investments:		
Unrealized holding gains (losses) arising during the period	(5,116)	(28,431)
Unrealized foreign currency gains (losses) arising during the period	620	(7,699)
Credit loss recognized in net income (loss)	412	563
Reclassification of net realized (gains) losses, included in net income (loss)	(1,345)	(2,405)
Unrealized holding gains (losses) of available for sale investments	(5,429)	(37,972)
Foreign currency translation adjustments	(76)	137
Other comprehensive income (loss) net of income tax	(5,505)	(37,835)
Comprehensive income (loss)	$ 35,382	$ (305,614)

See Notes to Consolidated Financial Statements

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

	(Unaudited) Three Months Ended March 31, 2021	2020
Common shares		
Balance at beginning of period	$ 228	$ 227
Common shares issued	—	—
Balance at end of period	228	227
Additional paid-in capital		
Balance at beginning of period	899,491	898,083
Common shares issued under share plans	225	250
Share-based compensation	45	360
Balance at end of period	899,761	898,693
Accumulated other comprehensive income (loss)		
Balance at beginning of period	15,994	5,629
Unrealized holding gains (losses) of available for sale investments:		
Balance at beginning of period	17,371	6,252
Unrealized holding gains (losses) of available for sale investments, net of reclassification adjustments	(5,429)	(37,972)
Balance at end of period	11,942	(31,720)
Currency translation adjustment:		
Balance at beginning of period	(1,377)	(623)
Currency translation adjustment	(76)	137
Balance at end of period	(1,453)	(486)
Balance at end of period	10,489	(32,206)
Common shares held in treasury, at cost		
Balance at beginning of period	(77,923)	(75,056)
Shares repurchased for treasury	—	(2,867)
Balance at end of period	(77,923)	(77,923)
Retained earnings (deficit)		
Balance at beginning of period	103,554	43,470
Cumulative effect of adoption of updated accounting guidance for credit losses at January 1, 2020	—	(428)
Net income (loss) before preference dividends	41,925	(266,608)
Preference share dividends paid and accrued	(1,038)	(1,171)
Balance at end of period	144,441	(224,737)
Total shareholders' equity	$ 976,996	$ 564,054

See Notes to Consolidated Financial Statements

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

	(Unaudited) Three Months Ended March 31, 2021	2020
Operating Activities		
Net income (loss) before preference dividends	$ 41,925	$ (266,608)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Net realized and unrealized (gains) losses on investments	(46,173)	290,502
Amortization of fixed assets	4	1
Share-based compensation	270	610
Changes in:		
Accrued investment income	356	(2,329)
Premiums receivable	(29,097)	(16,272)
Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses	(8,457)	(23,069)
Prepaid reinsurance premiums	9,158	4,007
Deferred acquisition costs, net	(9,103)	(7,995)
Reserve for losses and loss adjustment expenses	50,539	60,178
Unearned premiums	22,422	42,654
Reinsurance balances payable	14,277	(6,901)
Funds held with reinsurers	(8,829)	(2,868)
Other liabilities	(28,126)	(27,662)
Other items	(2,182)	(19,673)
Net Cash Provided By Operating Activities	6,984	24,575
Investing Activities		
Purchase of term loans	(105,440)	(86,702)
Purchase of fixed maturity investments	(554,618)	(328,927)
Purchase of short-term investments with maturities over three months	—	(36,119)
Proceeds from sale, redemptions and maturity of term loans	166,281	98,992
Proceeds from sales, redemptions and maturities of fixed maturity investments	546,187	215,719
Proceeds from sales, redemptions and maturities of short-term investments with maturities over three months	—	5,596
Net (purchases) sales of short-term investments with maturities less than three months	(64,138)	22,337
Purchases of equity securities	(6,180)	(6,388)
Proceeds from sales of equity securities	1,024	1,531
Net settlements of derivative instruments	(600)	2,336
Purchases of furniture, equipment and other assets	(14)	(2)
Net Cash Provided by (Used For) Investing Activities	(17,498)	(111,627)
Financing Activities		
Dividends paid on redeemable preference shares	(1,015)	(1,148)
Proceeds from borrowings	38,939	92,199
Purchases of common shares under share repurchase program	—	(2,867)
Net Cash Provided By (Used For) Financing Activities	37,924	88,184
Effects of exchange rate changes on foreign currency cash	(2,697)	(6,989)
Increase (decrease) in cash	24,713	(5,857)
Cash and cash equivalents, beginning of period	211,451	102,437
Cash and cash equivalents, end of period	$ 236,164	$ 96,580
Supplementary information		
Income taxes paid	$ 8	$ —
Interest paid	$ 1,810	$ 5,422
Non-cash exchange of investments	$ 15,328	$ 13,467

See Notes to Consolidated Financial Statements

1. Organization

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

As used herein, the terms “Company” or “Companies,” or “we,” “us” and “our,” collectively refer to the Parent and/or, as applicable, its subsidiaries. Watford Re is licensed as a Class 4 multi-line insurer under the Insurance Act 1978 of Bermuda, as amended, and related regulations (the “Insurance Act”) and is licensed to underwrite general business on an insurance and reinsurance basis. Through Watford Re, the Company primarily underwrites reinsurance on exposures worldwide.

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

In May 2018, WICE formed a branch in Romania and commenced underwriting operations in June 2018. WICE is a wholly-owned subsidiary of Watford Re. The Romanian branch ceased accepting new business from September 1, 2020.

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

The Company has engaged HPS Investment Partners, LLC (“HPS”), as Investment Manager of the assets in its non-investment grade portfolio pursuant to various investment management agreements. HPS invests the Company’s non-investment grade assets and a portion of its investment grade assets, subject to the terms of the applicable investment management agreements and the oversight of our senior management and board of directors. See Note 12, “Transactions with related parties” for further details.

The Company has engaged Arch Investment Management Ltd. (“AIM”), a Bermuda exempted company and a subsidiary of ACGL, as Investment Manager of assets in its investment grade portfolio pursuant to various investment management agreements. AIM manages the majority of the Company’s investment grade assets pursuant to the terms of the applicable investment management agreements and the oversight of our senior management and board of directors. See Note 12, “Transactions with related parties” for further details.

The results for the three months ended March 31, 2021 are not necessarily indicative of the results expected for the full calendar year.

2. Basis of presentation and significant accounting policies

There has been no material change to the Company’s significant accounting policies as described in its audited consolidated financial statements and the accompanying notes as of December 31, 2020 and 2019 and for each of the years in the periods ended December 31, 2020, 2019 and 2018, except as noted below.

(a) Basis of presentation

The unaudited interim consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP") on a basis consistent with reporting interim financial information in accordance with instructions to Form 10-Q and Article 10 of Regulation S-X under the Securities and Exchange Act of 1934, as amended. All significant intercompany transactions and balances have been eliminated on consolidation. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions. In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all adjustments (consisting of recurring accruals) necessary for a fair statement of results on an interim basis.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted; however management believes that the disclosures are adequate to make the information presented not misleading. These unaudited interim financial statements should be read in conjunction with the Company's audited consolidated financial statements and the accompanying notes for the years ended December 31, 2020, 2019 and 2018.

To facilitate comparison of information across periods, certain reclassifications have been made to prior period amounts to conform to the current period's presentation.

(b) Recent accounting pronouncements

Recently issued accounting standards not yet adopted

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740), Simplifying the Accounting for Income Taxes* ("ASU 2019-12"). ASU 2019-12 simplifies the accounting for income taxes by removing certain exceptions to the general principles in Topic 740. ASU 2019-12 will be effective for fiscal years beginning after December 31, 2021, and interim periods within fiscal years beginning after December 15, 2022. The Company has assessed the impact of the implementation of this ASU and considers the impact to be immaterial to the Company's consolidated financial statements and disclosures.

In March 2020, the FASB issued ASU 2020-04, *Reference Rate Reform (Topic 848),* ("ASU 2020-04"), and in January 2021, the FASB issued ASU 2021-01, *Reference Rate Reform (Topic 848),* Scope ("ASU 2021-01"). These ASUs provide practical expedients and exceptions for applying GAAP to contracts and transactions affected by reference rate reform if such contracts or transactions reference LIBOR or another reference rate expected to be discontinued. Amendments in this ASU for contract modifications may be applied as of March 12, 2020 through December 31, 2022. Once adopted, this ASU must be applied prospectively for all eligible contract modifications. The Company is currently assessing the impact the implementation of this ASU will have on its consolidated financial statements and disclosures, but does not believe that such impact will be material.

For additional information regarding accounting standards that the Company has not yet adopted, see Note 2, "Basis of presentation and significant accounting policies" in the Company's audited consolidated financial statements in Part II, Item 8 of the Company's Annual Report on Form 10-K for the year ended December 31, 2020.

3. Segment information

The Company reports results under one segment, referred to as the "underwriting segment." The underwriting segment captures the results of the Company's underwriting lines of business, which are comprised of specialty products on a worldwide basis. Lines of business include: (i) casualty reinsurance; (ii) property catastrophe reinsurance; (iii) other specialty reinsurance; and (iv) insurance programs and coinsurance.

The accounting policies of the underwriting segment are the same as those used for the preparation of the Company's consolidated financial statements.

The Company has a corporate function that includes certain general and administrative expenses related to corporate activities, interest expense (on the 6.5% senior notes due 2029), net foreign exchange gains (losses), income tax expense and items related to the Company's preference shares.

The following table provides summary information regarding premiums written and earned by line of business and net premiums written by underwriting location:

	Three Months Ended March 31,	
	2021	2020
	($ in thousands)	
Gross premiums written:		
Casualty reinsurance	$ 57,070	$ 83,818
Other specialty reinsurance	46,519	36,880
Property catastrophe reinsurance	13,410	9,832
Insurance programs and coinsurance	99,524	104,372
Total	$ 216,523	$ 234,902
Net premiums written:		
Casualty reinsurance	$ 57,016	$ 83,667
Other specialty reinsurance	39,468	35,484
Property catastrophe reinsurance	13,410	9,832
Insurance programs and coinsurance	69,417	57,717
Total	$ 179,311	$ 186,700
Net premiums earned:		
Casualty reinsurance	$ 47,138	$ 52,765
Other specialty reinsurance	35,203	35,364
Property catastrophe reinsurance	8,318	4,884
Insurance programs and coinsurance	57,072	47,026
Total	$ 147,731	$ 140,039
Net premiums written by underwriting location:		
United States	$ 30,030	$ 36,303
Europe	39,388	21,203
Bermuda	109,893	129,194
Total	$ 179,311	$ 186,700

4. Reinsurance

Through reinsurance agreements with Arch Reinsurance Ltd. (“ARL”) and Arch Reinsurance Company (“ARC”), which are subsidiaries of ACGL, as well as through other third-party 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:

	Three Months Ended March 31,	
	2021	2020
	($ in thousands)	
Premiums written		
Direct	$ 99,524	$ 104,372
Assumed	116,999	130,530
Ceded	(37,212)	(48,202)
Net	$ 179,311	$ 186,700
Premiums earned		
Direct	$ 101,414	$ 88,536
Assumed	97,779	99,529
Ceded	(51,462)	(48,026)
Net	$ 147,731	$ 140,039
Losses and loss adjustment expenses		
Direct	$ 71,593	$ 88,694
Assumed	77,546	74,720
Ceded	(30,345)	(52,738)
Net	$ 118,794	$ 110,676

The Company monitors the financial condition of its reinsurers and attempts to place coverages only with financially sound carriers. At March 31, 2021 and December 31, 2020, 100% of ceded loss and loss adjustment reserves were due from carriers which had an A.M. Best or Standard & Poor’s rating of “A-” or better.

At March 31, 2021 and December 31, 2020, approximately 46% and 44%, respectively, of the Company’s reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) were due from ARL and ARC, each of which have ratings of “A+” from A.M. Best. Although the Company has not experienced any material credit losses to date, an inability of its reinsurers to meet their obligations to it over the relevant exposure periods for any reason could have a material adverse effect on its financial condition and results of operations.

5. Reserve for losses and loss adjustment expenses

The following table represents an analysis of losses and loss adjustment expenses and a reconciliation of the beginning and ending reserve for losses and loss adjustment expenses for the three months ended March 31, 2021 and 2020.

	Three Months Ended March 31,	
	2021	2020
	($ in thousands)	
Gross reserve for losses and loss adjustment expenses at beginning of period	$ 1,519,583	$ 1,263,628
Unpaid losses and loss adjustment expenses recoverable	269,902	165,549
Net reserve for losses and loss adjustment expenses at beginning of period	1,249,681	1,098,079
Net incurred losses and loss adjustment expenses relating to losses occurring in:		
Current period	118,687	110,856
Prior years	107	(180)
Total net losses and loss adjustment expenses	118,794	110,676
Foreign exchange losses (gains)	(1,876)	(26,015)
Net paid losses and loss adjustment expenses relating to losses occurring in:		
Current period	(12,953)	(10,585)
Prior years	(58,526)	(62,585)
Total paid losses and loss adjustment expenses	(71,479)	(73,170)
Net reserve for losses and loss adjustment expenses at end of period	1,295,120	1,109,570
Unpaid losses and loss adjustment expenses recoverable	273,123	190,679
Gross reserve for losses and loss adjustment expenses at end of period	$ 1,568,243	$ 1,300,249

During the three months ended March 31, 2021, the Company recorded net unfavorable development on prior year loss reserves of $0.1 million. Net unfavorable development was experienced on insurance programs and coinsurance losses of $3.1 million and property catastrophe reinsurance losses of $2.1 million, offset by favorable development on casualty reinsurance losses of $2.9 million and other specialty reinsurance losses of $2.2 million.

During the three months ended March 31, 2020, the Company recorded net favorable development on prior year loss reserves of $0.2 million. Net favorable development was experienced on casualty reinsurance losses of $4.0 million, property catastrophe reinsurance losses of $0.5 million and other specialty reinsurance losses $0.1 million, offset by unfavorable development on insurance programs and coinsurance losses of $4.4 million.

6. Allowance for expected credit losses

Premiums Receivable

The following table presents the balances of premiums receivable, net of the allowance for expected credit losses, at March 31, 2021 and December 31, 2020, and changes in the allowance for expected credit losses for the three months ended March 31, 2021 and the twelve months ended December 31, 2020.

	At and For the Three Months Ended March 31, 2021		At and For the Twelve Months Ended December 31, 2020	
	Premiums Receivable, Net of Allowance	Allowance for Expected Credit Losses	Premiums Receivable, Net of Allowance	Allowance for Expected Credit Losses
	($ in thousands)			
Balance at beginning of period	$ 224,377	$ 156	$ 273,657	$ —
Cumulative effect of adoption of updated accounting guidance for credit losses at January 1, 2020		—		156
Current period change for expected credit losses		—		—
Write-offs charged against the allowance		—		—
Balance at end of period	$ 252,523	$ 156	$ 224,377	$ 156

Reinsurance Recoverables

The following table presents the balances of reinsurance recoverables, net of the allowance for expected credit losses, at March 31, 2021 and December 31, 2020, and changes in the allowance for expected credit losses for the three months ended March 31, 2021 and the twelve months ended December 31, 2020.

	At and For the Three Months Ended March 31, 2021		At and For the Twelve Months Ended December 31, 2020	
	Reinsurance Recoverables, Net of Allowance	Allowance for Expected Credit Losses	Reinsurance Recoverables, Net of Allowance	Allowance for Expected Credit Losses
	($ in thousands)			
Balance at beginning of period	$ 286,590	$ 305	$ 170,974	$ —
Cumulative effect of adoption of updated accounting guidance for credit losses at January 1, 2020		—		297
Current period change for expected credit losses		2		8
Write-offs charged against the allowance		—		—
Balance at end of period (1)	$ 291,485	$ 307	$ 286,590	$ 305

(1) As at March 31, 2021 and December 31, 2020, the allowance for credit losses is gross of deferred tax of $25 thousand.

7. Investment information

Available for Sale Investments

The following tables summarize the fair value of the Company's securities classified as available for sale as of March 31, 2021 and December 31, 2020:

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Allowance for Expected Credit Losses	Fair Value
			($ in thousands)		
March 31, 2021					
Fixed maturities:					
Corporate bonds	$ 197,849	$ 4,829	$ (1,287)	$ (395)	$ 200,996
U.S. government and government agency bonds	164,898	755	(243)	—	165,410
Non-U.S. government and government agency bonds	152,527	9,012	(875)	(207)	160,457
Asset-backed securities	83,515	779	(864)	—	83,430
Mortgage-backed securities	15,579	1	(259)	(6)	15,315
Municipal government and government agency bonds	1,686	93	—	—	1,779
Total investments, available for sale	$ 616,054	$ 15,469	$ (3,528)	$ (608)	$ 627,387

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Allowance for Expected Credit Losses	Fair Value
			($ in thousands)		
December 31, 2020					
Fixed maturities:					
U.S. government and government agency bonds	$ 201,114	$ 1,122	$ (22)	$ —	$ 202,214
Corporate bonds	188,473	9,176	(456)	(196)	196,997
Non-U.S. government and government agency bonds	146,594	10,837	(102)	—	157,329
Asset-backed securities	82,803	536	(3,081)	—	80,258
Mortgage-backed securities	17,405	5	(747)	—	16,663
Municipal government and government agency bonds	1,686	102	—	—	1,788
Total investments, available for sale	$ 638,075	$ 21,778	$ (4,408)	$ (196)	$ 655,249

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

	Less than 12 Months		12 Months or More		Total	
	Fair Value	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**
March 31, 2021			*($ in thousands)*			
Fixed maturities:						
U.S. government and government agency bonds	$ 89,559	$ (243)	$ —	$ —	$ 89,559	$ (243)
Corporate bonds	59,919	(1,386)	5,540	(296)	65,459	(1,682)
Asset-backed securities	12,330	(133)	35,767	(731)	48,097	(864)
Non-U.S. government and government agency bonds	39,805	(1,082)	—	—	39,805	(1,082)
Mortgage-backed securities	1,515	(3)	12,719	(262)	14,234	(265)
Total	$ 203,128	$ (2,847)	$ 54,026	$ (1,289)	$ 257,154	$ (4,136)
December 31, 2020						
Fixed maturities:						
Asset-backed securities	$ 48,790	$ (2,538)	$ 16,730	$ (543)	$ 65,520	$ (3,081)
Corporate bonds	19,862	(652)	—	—	19,862	(652)
Mortgage-backed securities	13,194	(671)	2,909	(76)	16,103	(747)
U.S. government and government agency bonds	15,492	(22)	—	—	15,492	(22)
Non-U.S. government and government agency bonds	14,296	(102)	—	—	14,296	(102)
Total	$ 111,634	$ (3,985)	$ 19,639	$ (619)	$ 131,273	$ (4,604)

At March 31, 2021, 68 positions out of a total of 140 positions were in an unrealized loss position. The unrealized loss position decreased during the three-month period from $4.6 million to $4.1 million. The reduction in the unrealized loss position can be attributed to overall market improvements, which primarily benefited asset-backed and mortgage-backed securities during the period. This was partially offset by a rise in yields, which negatively impacted corporate bonds and non-U.S. government bonds. The Company believes that such securities were temporarily impaired at March 31, 2021.

At December 31, 2020, 47 positions out of a total of 144 positions were in an unrealized loss position. The decrease in value can be attributed to the market movements resulting from the COVID-19 global pandemic, which primarily impacted the asset-backed securities during the year. The Company believes that such securities were temporarily impaired at December 31, 2020.

Allowance for expected credit losses

The allowance for expected credit losses on available for sale securities was $0.6 million and $0.2 million as of March 31, 2021 and December 31, 2020, respectively. The Company recognized changes in the allowance of $0.4 million, $0.6 million and $0.2 million for the three months ended March 31, 2021 and 2020 and the twelve months ended December 31, 2020, respectively. There were no write-offs charged against the allowance for the three months ended March 31, 2021 and 2020, or for the twelve months ended December 31, 2020. The change in allowance is recognized in “realized and unrealized gains (losses) on investments” in the Company’s consolidated statements of income (loss). There were no impairments of securities which the Company intends to sell or more likely than not will be required to sell.

The amortized cost and fair value of our fixed maturities classified as available for sale, summarized by contractual maturity as of March 31, 2021 and December 31, 2020 are shown in the following tables.

	March 31, 2021		
	Amortized Cost	Estimated Fair Value	% of Fair Value
		($ in thousands)	
Due in one year or less	$ 17,435	$ 17,906	2.9 %
Due after one year through five years	351,930	360,593	57.5 %
Due after five years through ten years	133,455	136,440	21.7 %
Due after ten years	14,140	13,703	2.2 %
Asset-backed securities	83,515	83,430	13.3 %
Mortgage-backed securities	15,579	15,315	2.4 %
Total investments, available for sale	$ 616,054	$ 627,387	100.0 %

	December 31, 2020		
	Amortized Cost	Estimated Fair Value	% of Fair Value
		($ in thousands)	
Due in one year or less	$ 27,469	$ 28,336	4.3 %
Due after one year through five years	367,343	378,427	57.8 %
Due after five years through ten years	123,253	132,165	20.2 %
Due after ten years	19,802	19,400	3.0 %
Asset-backed securities	82,803	80,258	12.2 %
Mortgage-backed securities	17,405	16,663	2.5 %
Total investments, available for sale	$ 638,075	$ 655,249	100.0 %

Fair Value Option and Fair Value Through Net Income

The following tables summarize the fair value of the Company's securities held as of March 31, 2021 and December 31, 2020, classified as fair value through net income or for which the fair value option was elected:

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		($ in thousands)		
March 31, 2021				
Term loan investments	$ 815,305	$ 11,286	$ (36,405)	$ 790,186
Fixed maturities:				
Corporate bonds	394,828	15,675	(7,115)	403,388
Asset-backed securities	150,365	2,436	(18,276)	134,525
Non-U.S. government and government agency bonds	1,419	82	—	1,501
U.S. government and government agency bonds	266	7	—	273
Short-term investments	477,084	6,517	(1)	483,600
Equities	49,045	23,079	(4,829)	67,295
Investments, fair value option	$ 1,888,312	$ 59,082	$ (66,626)	$ 1,880,768
Fair Value Through Net Income:				
Equities, fair value through net income	$ 72,866	$ 6,856	$ (15,964)	$ 63,758

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		($ in thousands)		
December 31, 2020				
Term loan investments	$ 890,996	$ 7,948	$ (47,405)	$ 851,539
Fixed maturities:				
Corporate bonds	313,212	17,772	(18,114)	312,870
Asset-backed securities	162,644	2,154	(24,290)	140,508
Non-U.S. government and government agency bonds	1,425	85	—	1,510
U.S. government and government agency bonds	267	7	—	274
Short-term investments	412,762	5,928	—	418,690
Equities	49,044	20,855	(4,905)	64,994
Investments, fair value option	$ 1,830,350	$ 54,749	$ (94,714)	$ 1,790,385
Fair Value Through Net Income:				
Equities, fair value through net income	$ 74,258	$ 5,126	$ (26,177)	$ 53,207

The amortized cost and fair value of our term loans, fixed maturities and short-term investments, excluding securities classified as available for sale, summarized by contractual maturity as of March 31, 2021 and December 31, 2020 are shown in the following tables.

	March 31, 2021		
	Amortized Cost	Estimated Fair Value	% of Fair Value
		($ in thousands)	
Due in one year or less	$ 498,680	$ 505,474	27.9 %
Due after one year through five years	731,977	718,449	39.6 %
Due after five years through ten years	440,795	438,017	24.2 %
Due after ten years	17,450	17,008	0.9 %
Asset-backed securities	150,365	134,525	7.4 %
Total	$ 1,839,267	$ 1,813,473	100.0 %

	December 31, 2020		
	Amortized Cost	Estimated Fair Value	% of Fair Value
		($ in thousands)	
Due in one year or less	$ 435,818	$ 440,003	25.5 %
Due after one year through five years	833,722	809,119	46.9 %
Due after five years through ten years	340,164	327,184	19.0 %
Due after ten years	8,958	8,577	0.5 %
Asset-backed securities	162,644	140,508	8.1 %
Total	$ 1,781,306	$ 1,725,391	100.0 %

Variable Interest Entities

In the normal course of its investing activities, the Company invests in limited partnerships, limited liability companies and other investment securities. Due to the legal forms of the entities and the fact that the investors lack the ability, through voting rights or similar rights, to make decisions that have a significant effect on the entities, such investments are considered variable interest entities. Since the Company lacks the ability to control the activities that most significantly impact the economic performance of these variable interest entities, the Company is not considered the primary beneficiary and does not consolidate these investments.

The activities of these entities are generally limited to holding and managing the underlying investments. The Company’s maximum exposure to loss with respect to these investments is limited to the investment carrying amounts reported as “other investments” in the Company’s consolidated balance sheet and any unfunded commitments. Realized and unrealized gains and losses from such investments are included in “realized and unrealized gains (losses) on investments” in the Company’s consolidated statements of income (loss).

The tables below summarize the credit quality of our total investments as of March 31, 2021 and December 31, 2020, as rated by Standard & Poor’s Financial Services, LLC, or Standard & Poor’s, Moody’s Investors Service, or Moody’s, Fitch Ratings Inc., or Fitch, Kroll Bond Rating Agency, or KBRA, or DBRS Morningstar, or DBRS, as applicable:

		Credit Rating (1)									
March 31, 2021	**Fair Value**	**AAA**	**AA**	**A**	**BBB**	**BB**	**B**	**CCC**	**CC**	**C**	**Not Rated**
	($ in thousands)										
Term loan investments	$ 790,186	$ —	$ —	$ —	$ 11,564	$ 34,507	$518,654	$174,552	$ 4,144	$1,283	$ 45,482
Fixed maturities:											
Corporate bonds	604,384	—	18,674	92,658	92,145	68,227	252,327	52,415	9,765	—	18,173
U.S. government and government agency bonds	165,683	—	165,683	—	—	—	—	—	—	—	—
Asset-backed securities	217,955	—	609	7,431	136,415	33,536	9,085	5,770	262	—	24,847
Mortgage-backed securities	15,315	—	—	1,516	13,799	—	—	—	—	—	—
Non-U.S. government and government agency bonds	161,958	—	161,958	—	—	—	—	—	—	—	—
Municipal government and government agency bonds	1,779	782	588	409	—	—	—	—	—	—	—
Total fixed income instruments	1,957,260	782	347,512	102,014	253,923	136,270	780,066	232,737	14,171	1,283	88,502
Short-term investments	483,600	143,441	187,807	99,140	49,494	—	3,163	555	—	—	—
Total fixed income instruments and short-term investments	2,440,860	144,223	535,319	201,154	303,417	136,270	783,229	233,292	14,171	1,283	88,502
Equities	131,053										
Total	$ 2,571,913	$144,223	$535,319	$201,154	$303,417	$136,270	$783,229	$233,292	$14,171	$1,283	$ 88,502

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

	Credit Rating (1)										
December 31, 2020	**Fair Value**	**AAA**	**AA**	**A**	**BBB**	**BB**	**B**	**CCC**	**CC**	**C**	**Not Rated**
	($ in thousands)										
Term loan investments	$ 851,539	$ —	$ —	$ —	$ 11,352	$ 19,486	$ 588,215	$ 185,221	$ 7,406	$ 2,727	$ 37,132
Fixed maturities:											
Corporate bonds	509,867	—	19,812	82,379	87,913	38,232	194,418	59,421	8,280	1,894	17,518
U.S. government and government agency bonds	202,488	—	202,488	—	—	—	—	—	—	—	—
Asset-backed securities	220,766	—	—	15,675	133,471	31,822	8,385	8,262	837	—	22,314
Mortgage-backed securities	16,663	—	—	2,092	14,571	—	—	—	—	—	—
Non-U.S. government and government agency bonds	158,839	—	158,839	—	—	—	—	—	—	—	—
Municipal government and government agency bonds	1,788	783	592	413	—	—	—	—	—	—	—
Total fixed income instruments	1,961,950	783	381,731	100,559	247,307	89,540	791,018	252,904	16,523	4,621	76,964
Short-term investments	418,690	89,519	168,700	108,905	47,891	—	3,186	489	—	—	—
Total fixed income instruments and short-term investments	2,380,640	90,302	550,431	209,464	295,198	89,540	794,204	253,393	16,523	4,621	76,964
Equities	118,201										
Total	$ 2,498,841	$ 90,302	$ 550,431	$ 209,464	$ 295,198	$ 89,540	$ 794,204	$ 253,393	$ 16,523	$ 4,621	$ 76,964

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

Fair value option

The Company elected to carry the majority of 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 Company’s consolidated statements of income (loss). The Company elected to use this option as investments are not necessarily held to maturity, and in order to address simplification and cost-benefit considerations.

Net investment income (loss)

The components of net investment income (loss) for the three months ended March 31, 2021 and 2020 were derived from the following sources:

	Three Months Ended March 31, 2021			
	Net Interest Income	Net Unrealized Gains (Losses)	Net Realized Gains (Losses)	Net Investment Income (Loss)
	($ in thousands)			
Net investment income (loss) by asset class:				
Term loan investments	$ 13,505	$ 14,338	$ 1,398	$ 29,241
Fixed maturities - Fair value option	9,768	16,317	5,623	31,708
Fixed maturities - Available for sale (1)	2,478	—	499	2,977
Short-term investments	47	38	(75)	10
Equities	—	2,300	—	2,300
Equities, fair value through net income (2)	—	10,063	(6,646)	3,417
Other (3)	—	1,415	903	2,318
Investment management fees - related parties	(4,487)	—	—	(4,487)
Borrowing and miscellaneous other investment expenses	(2,354)	—	—	(2,354)
Investment performance fees - related parties	—	—	—	(6,016)
	$ 18,957	$ 44,471	$ 1,702	$ 59,114

(1) Net realized gains (losses) from the fixed maturities available for sale portfolio consists of realized gains and realized losses of $1.2 million and $0.7 million, respectively. Realized losses include an allowance for expected credit losses on available for sale securities of $0.4 million for the three months ended March 31, 2021.

(2) Net interest income includes dividends for securities held in long and short positions.

(3) Other includes unrealized gains and unrealized losses for total return swaps.

	Three Months Ended March 31, 2020			
	Net Interest Income	Net Unrealized Gains (Losses)	Net Realized Gains (Losses)	Net Investment Income (Loss)
	($ in thousands)			
Net investment income (loss) by asset class:				
Term loan investments	$ 21,018	$ (155,233)	$ (8,145)	$ (142,360)
Fixed maturities - Fair value option	9,068	(89,675)	(1,244)	(81,851)
Fixed maturities - Available for sale (1)	4,660	—	2,180	6,840
Short-term investments	1,850	(3,440)	87	(1,503)
Equities	—	76	(39)	37
Equities, fair value through net income	377	(12,275)	868	(11,030)
Other investments	851	220	—	1,071
Other (2)	—	(25,129)	1,247	(23,882)
Investment management fees - related parties	(4,352)	—	—	(4,352)
Borrowing and miscellaneous other investment expenses	(5,669)	—	—	(5,669)
	$ 27,803	$ (285,456)	$ (5,046)	$ (262,699)

(1) Net realized gains (losses) from the fixed maturities available for sale portfolio consists of realized gains and realized losses of $3.3 million and $1.1 million, respectively. Realized losses include an allowance for expected credit losses on available for sale securities of $0.6 million for the three months ended March 31, 2020.

(2) Other includes unrealized gains and unrealized losses for total return swaps.

Pledged and restricted assets

For the benefit of certain Arch entities and other third parties that cede business to the Company, the Company is required to post and maintain collateral to support its potential obligations under reinsurance contracts written. This collateral can be in the form of either investment assets held in collateral trust accounts or letters of credit. Under its secured credit facilities, in order for the Company to have the bank issue a letter of credit to the Company's reinsurance contract counterparty, the Company must post investment assets or cash as collateral to the bank. In either case, the amounts remain restricted for the duration of the term of the trust or letter of credit, as applicable.

At March 31, 2021 and December 31, 2020, the Company held $2.0 billion in pledged assets in support of insurance and reinsurance liabilities as well as to collateralize the Company's secured credit facilities and investment derivatives. Included within total pledged assets, the Company held $7.7 million and $7.8 million, respectively, in deposits with U.S. regulatory authorities.

Non-cash investing activities

During the first quarter of 2021, $15.3 million of investments were converted or exchanged in non-cash transactions from fixed maturities or listed common stock equity positions to fixed maturities or unlisted common stock equity positions, as presented on the consolidated statements of cash flows.

During the first quarter of 2020, as a result of the restructuring of an investment position held by the Company, $13.5 million of term loans, held within "term loans, fair value option," were exchanged for $13.5 million of short-term investments held within "short-term investments, fair value option."

8. Fair value

Fair value hierarchy

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

The levels in the hierarchy are defined as follows:

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

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

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

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

Fair value measurements on a recurring basis

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

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

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

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

Of the $2.5 billion of net financial assets and liabilities measured at fair value at March 31, 2021, approximately $137.3 million, or 5.4%, were priced using non-binding broker-dealer quotes or modeled valuations. Of the $2.5 billion of net financial assets and liabilities measured at fair value at December 31, 2020, approximately $142.5 million, or 5.8%, were priced using non-binding broker-dealer quotes or modeled valuations.

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

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

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

Term Loans. Fair values are estimated by using quoted prices obtained from independent pricing services for term loan investments with similar characteristics, pricing models or matrix pricing. Such investments are generally classified within Level 2. The fair values for certain of the Company’s term loans are determined by the Investment Manager using quantitative and qualitative assessments such as internally modeled values, which are reviewed by the Company’s management. The modeled values are based on peer loans and comparison to industry-specific market data. 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 are generally determined through the use of pricing models (including option adjusted spread) which use spreads to determine the appropriate average life of the securities. These spreads are generally obtained from the new issue market, secondary trading and from broker-dealers who trade in the relevant security market. The pricing services also review prepayment speeds and other indicators, when applicable. As the significant inputs used in the pricing process for asset-backed securities are observable market inputs, the fair value of these securities are classified within Level 2.

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

U.S. Government and Government Agencies. Valuations are provided by independent pricing services, with all prices provided through index providers and pricing vendors. The Company determined that all U.S. Treasuries would be classified as Level 1 securities due to observed levels of trading activity, the high number of strongly correlated pricing quotes received on U.S. Treasuries and other factors. The fair values of U.S. government agency securities are generally determined using the spread above the risk-free yield curve. As the yields for the risk-free yield curve and the spreads for these securities are observable market inputs, the fair values of U.S. government agency securities are classified within Level 2.

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

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

Short-Term Investments. The Company determined that certain of its short-term investments, held in highly liquid money market-type funds, and equities would be included in Level 1 as their fair values are based on quoted market prices in active markets. The fair values of other short-term investments are generally determined using the spread above the risk-free yield curve and are classified within Level 2.

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

Underwriting 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. Refer to Note 9, “Derivative instruments” for more information.

Investment Derivative Instruments. The Company values the investment derivatives, including total return swaps and options, at fair value. As the underlying investments have observable inputs, the fair value of these securities are classified within Level 2. Refer to Note 9, “Derivative instruments” for more information.

The following tables present the Company's financial assets and liabilities measured at fair value by level as of March 31, 2021 and December 31, 2020:

		Fair Value Measurement Using:		
March 31, 2021	**Estimated Fair Value**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
		($ in thousands)		
Assets measured at fair value:				
Term loans	$ 790,186	$ —	$ 746,790	$ 43,396
Fixed maturities:				
Corporate bonds	604,384	—	603,395	989
U.S. government and government agency bonds	165,683	165,574	109	—
Asset-backed securities	217,955	—	217,955	—
Mortgage-backed securities	15,315	—	15,315	—
Non-U.S. government and government agency bonds	161,958	—	161,958	—
Municipal government and government agency bonds	1,779	—	1,779	—
Short-term investments	483,600	479,880	3,720	—
Equities	131,053	14,943	8,491	107,619
Other underwriting derivative assets	31	—	31	—
Investment derivative assets (1)	840	—	840	—
Total assets measured at fair value	$ 2,572,784	$ 660,397	$ 1,760,383	$ 152,004
Other underwriting derivative liabilities	$ —	$ —	$ —	$ —
Investment derivative liabilities (1)	176	—	176	—
Payable for securities sold short:				
U.S. government and government agency bonds	21,664	21,664	—	—
Corporate bonds	12,433	—	12,433	—
Equities	492	—	492	—
Total liabilities measured at fair value	$ 34,765	$ 21,664	$ 13,101	$ —

(1) Investment derivative assets and liabilities represent the fair value of total return swaps, which are recorded in "other assets" and "other liabilities" in the consolidated balance sheets as of March 31, 2021.

		Fair Value Measurement Using:		
December 31, 2020	**Estimated Fair Value**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
		($ in thousands)		
Assets measured at fair value:				
Term loans	$ 851,539	$ —	$ 801,660	$ 49,879
Fixed maturities:				
Corporate bonds	509,867	—	508,882	985
U.S. government and government agency bonds	202,488	202,378	110	—
Asset-backed securities	220,766	—	220,766	—
Mortgage-backed securities	16,663	—	16,663	—
Non-U.S. government and government agency bonds	158,839	—	158,839	—
Municipal government and government agency bonds	1,788	—	1,788	—
Short-term investments	418,690	415,014	3,676	—
Equities	118,201	624	13,025	104,552
Other underwriting derivative assets	25	—	25	—
Investment derivative assets (1)	255	—	255	—
Total assets measured at fair value	$ 2,499,121	$ 618,016	$ 1,725,689	$ 155,416
Investment derivative liabilities (1)	$ 1,117	$ —	$ 1,117	$ —
Payable for securities sold short:				
Corporate bonds	21,680	—	21,680	—
Equities	295	—	295	—
Total liabilities measured at fair value	$ 23,092	$ —	$ 23,092	$ —

(1) Investment derivative assets and liabilities represent the fair value of total return swaps, which are recorded in "other assets" and "other liabilities," respectively, in the consolidated balance sheets as of December 31, 2020.

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 following tables present 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 three months ended March 31, 2021 and 2020:

Three Months Ended March 31, 2021	Beginning Balance	Net Purchases (Sales)(1)	Net Unrealized Gains (Losses)(2)	Ending Balance
		($ in thousands)		
Term loans	$ 49,879	$ (6,786)	$ 303	$ 43,396
Corporate bonds	985	—	4	989
Equities	104,552	—	3,067	107,619
Total	$ 155,416	$ (6,786)	$ 3,374	$ 152,004

Three Months Ended March 31, 2020	Beginning Balance	Net Purchases (Sales)(1)	Net Unrealized Gains (Losses)(2)	Ending Balance
		($ in thousands)		
Term loans	$ 36,048	$ (74)	$ (29)	$ 35,945
Corporate bonds	933	32	—	965
Equities	108,591	3,277	(1,778)	110,090
Total	$ 145,572	$ 3,235	$ (1,807)	$ 147,000

(1) For the three months ended March 31, 2021, the net purchases (sales) consisted of calls and redemptions of $6.8 million of term loans. For the three months ended March 31, 2020, the net purchases (sales) consisted of purchases of $3.3 million of equities and $32.0 thousand of corporate bonds, partially offset by calls and redemptions of $74.0 thousand of term loans.

(2) 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).

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 March 31, 2021 and December 31, 2020 due to their respective short maturities. As these financial instruments are not actively traded, their respective fair values are classified within Level 2.

At March 31, 2021, the Company’s 6.5% senior notes were carried at cost, net of debt issuance costs, of $172.8 million and had a fair value of $189.3 million. The fair value of the senior notes was obtained from a third-party pricing service and was based on observable market inputs. As such, the fair values of the senior notes 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, such as discounted expected future cash flows, to determine the fair value of these assets when appropriate. There were no such triggering events or changes in circumstances as of March 31, 2021 and December 31, 2020. There were no additional assets measured at fair value on a non-recurring basis as of March 31, 2021 and December 31, 2020.

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. There were no such triggering events or changes in circumstances as of March 31, 2021 and December 31, 2020.

9. Derivative instruments

Underwriting Derivatives

The Company's underwriting strategy allows it to enter into government-sponsored enterprise credit-risk sharing transactions. These transactions are accounted for as derivatives. 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 are included in "other underwriting income (loss)" in the Company's consolidated statements of income (loss). The risk in force of these transactions is considered the notional amount.

As of March 31, 2021 and December 31, 2020, the Company posted $7.8 million and $9.2 million, respectively, in assets as collateral. These assets are included in "fixed maturities," which are recorded at fair value in the Company's consolidated balance sheets.

Investment Derivatives

The Company's investment strategy allows for the use of derivative securities. The Company invests in call options to manage specific market risks; such derivative instruments are recorded at fair value, and shown as part of "payable for securities sold short" on its consolidated balance sheets.

Additionally, the Company invests in put options to manage specific market risks; such derivative instruments are recorded at fair value, and shown as part of "equity securities" on its consolidated balance sheets.

The Company began investing in total return swaps ("swaps") during 2018, through a Master Confirmation of Total Return Swap Transactions agreement, and recognizes the swap derivatives at fair value. 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. At March 31, 2021 and December 31, 2020, the Company had collateral funds held by the counterparty of $67.7 million and $67.1 million, respectively, included in "short-term investments" in the Company's consolidated balance sheets.

The fair value of such options and swaps are based on observable inputs and classified in Level 2 of the valuation hierarchy. Realized and unrealized gains and losses from investment derivatives are included in "realized and unrealized gains (losses) on investments" in the Company's consolidated statements of income (loss).

The Company did not hold any derivatives designated as hedging instruments at March 31, 2021 and December 31, 2020.

The following table summarizes information on the fair values and notional amount of the Company's derivative instruments at March 31, 2021 and December 31, 2020:

	Estimated Fair Value			
	Asset Derivatives	**Liability Derivatives**	**Net Derivatives**	**Notional Amount (1)**
		($ in thousands)		
March 31, 2021				
Other underwriting derivatives	$ 31	$ —	$ 31	$ 33,116
Options	1,444	492	952	497,190
Total return swaps	840	176	664	112,182
Total	$ 2,315	$ 668	$ 1,647	$ 642,488
December 31, 2020				
Other underwriting derivatives	$ 25	$ —	$ 25	$ 39,165
Options (2)	796	296	500	491,803
Total return swaps	255	1,117	(862)	113,852
Total	$ 1,076	$ 1,413	$ (337)	$ 644,820

(1) The notional amount represents the absolute value of all outstanding contracts, consisting of long and short positions. As of March 31, 2021, the notional value of the long and short option positions were $248.9 million and $248.3 million, respectively. As of December 31, 2020, the notional value of the long and short option positions were $309.0 million and $182.8 million, respectively.

(2) The notional amount as at December 31, 2020 has been revised, which is not considered material to the previously issued consolidated financial statements.

The realized and unrealized gains and losses on the Company's derivative instruments are reflected in the consolidated statements of income (loss), as summarized in the following table:

	Three Months Ended March 31,	
	2021	**2020**
	($ in thousands)	
Underwriting derivatives:		
Other underwriting income (loss)	$ 411	$ 133
Investment derivatives:		
Net realized and unrealized gains (losses):		
Options	(2,386)	1,081
Total return swaps	2,318	(23,882)

10. Earnings per common share

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

	Three Months Ended March 31,	
	2021	2020
	($ in thousands except share and per share data)	
Numerator:		
Net income (loss) before preference dividends	$ 41,925	$ (266,608)
Preference dividends	(1,038)	(1,171)
Net income (loss) available to common shareholders	40,887	(267,779)
Denominator:		
Weighted average common shares outstanding - basic	19,892,886	19,951,932
Effect of dilutive common share equivalents:		
Weighted average non-vested restricted share units (1)(2)	63,237	—
Weighted average common shares outstanding - diluted (3)	19,956,123	19,951,932
Earnings (loss) per common share:		
Basic	$ 2.06	$ (13.42)
Diluted	$ 2.05	$ (13.42)

(1) The Company granted restricted share units to certain employees and directors. Non-vested restricted share units as of March 31, 2021 and March 31, 2020, were 95,302 and 131,276, respectively.

(2) The weighted average non-vested restricted share units of 13,727 are excluded from the calculation of diluted weighted average common shares outstanding for the three months ended March 31, 2020, due to a net loss reported. Refer to Note 17, “Share transactions” for further details.

(3) Warrants held by Arch and HPS were not included in the computation of diluted earnings because the exercise price of the warrants exceeded the market price of the common shares during the period and the exercise of the warrants would have been anti-dilutive. These warrants were not exercised and expired on March 25, 2020.

11. Income taxes

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

WICE is incorporated under the laws of Gibraltar and regulated by the Gibraltar Financial Services Commission (the “FSC”) under the Financial Services (Insurance Company) Act (the “Gibraltar Act”). In addition to its operations in Gibraltar, WICE operates a branch in Romania. The Romanian branch ceased accepting new business from September 1, 2020. The current rates of tax on applicable profits in Gibraltar and Romania are 10% and 16%, respectively. The open tax years that are potentially subject to examination are 2019 through 2021 in Gibraltar and 2018 through 2021 in Romania.

Watford Holdings (U.K.) Limited is incorporated in the United Kingdom and is subject to U.K. corporate income tax. The current U.K. corporate income tax rate is 19%. The open tax years that are potentially subject to examination by U.K. tax authorities are 2019 through 2021.

Watford Holdings (U.S.) Inc. is incorporated in the United States and files a consolidated U.S. federal tax return with its subsidiaries, WSIC, WIC and Watford Services Inc. The U.S. federal tax rate is 21%.

The open tax years that are potentially subject to examination by U.S. tax authorities are 2017 through 2021.

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 March 31, 2021 and December 31, 2020, the Company’s valuation allowance was $1.7 million and $1.5 million, respectively. After consideration of the valuation allowance, the Company had net deferred tax assets of $0.4 million as of March 31, 2021 and December 31, 2020.

After taking into account the impact of the change in the valuation allowance, the Company recognized income tax expense of $8 thousand and $Nil, respectively, in the consolidated statements of income (loss) during the three months ended March 31, 2021 and 2020.

The Company recognizes a tax benefit where it concludes that it is more likely than not that the tax benefit will be sustained on audit by the taxing authority based solely on the technical merits of the associated tax position. The Company records interest and penalties related to unrecognized tax benefits in the provision for income taxes. As of both March 31, 2021 and December 31, 2020, the Company’s total unrecognized tax benefits, including interest and penalties, were $Nil.

12. Transactions with related parties

In March 2014, ARL invested $100.0 million in the Company and acquired approximately 11% of its common equity.

AUL acts as the insurance and reinsurance manager for Watford Re and WICE while AUI acts as the insurance and reinsurance manager for WSIC and WIC, all under separate long-term services agreements. HPS manages the Company’s non-investment grade portfolio and a portion of the Company’s investment grade portfolio as Investment Manager and AIM manages a portion of the Company’s investment grade portfolio as Investment Manager, each under separate long-term services agreements. ARL and HPS were granted warrants to purchase additional common equity based on performance criteria; such warrants were unexercised and expired on March 25, 2020. In recognition of the sizable ownership interest, two senior executives of ACGL were appointed to the Company’s board of directors. The services agreements with AUL and AUI and the investment management agreements with HPS and AIM provide for services for an extended period of time with limited termination rights by the Company. In addition, these agreements allow for AUL, AUI and HPS to participate in the favorable results of the Company in the form of performance fees.

ACGL and affiliates

At March 31, 2021, ARL held approximately 10.2% of the Company’s common equity. Affiliates of ACGL held approximately 6.6% of the Company’s preference shares and $35 million in aggregate principal amount of the Company’s 6.5% senior notes due July 2, 2029.

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

The related balances presented in the consolidated statements of income (loss) for the three months ended March 31, 2021 and 2020 were as follows:

	Three Months Ended March 31,	
	2021	2020
	($ in thousands)	
Consolidated statements of income (loss) items:		
Interest expense	$ 582	$ 582
Preference dividends	69	78

Merger Agreement and Arch Voting Agreement

On October 9, 2020, the Company entered into an Agreement and Plan of Merger with ACGL and Greysbridge Ltd., a Bermuda exempted company limited by shares and wholly-owned subsidiary of ACGL ("Merger Sub"). On November 2, 2020, the Company entered into an amendment to the merger agreement with ACGL and Merger Sub (the original merger agreement as so amended, the "Merger Agreement") and ACGL assigned its rights under the Merger Agreement to Greysbridge Holdings Ltd. ("HoldCo"), a newly formed Bermuda exempted company limited by shares, of which ACGL will own approximately 40% and funds managed by Warburg Pincus LLC and Kelso & Company will each own approximately 30%. Pursuant to the merger agreement, as amended, Merger Sub will merge with and into the Company, with the Company surviving as a wholly-owned subsidiary of HoldCo, and each holder of the Company's common shares receiving consideration of $35.00 per common share and each issued and outstanding preference share of the Company remaining outstanding as a preference share of the surviving company and entitled to the same dividend and other relative rights, preferences, limitations and restrictions as are now provided to the preference shares. Refer to Note 13, "Commitments and contingencies" for additional information.

At the time it entered into the merger agreement on October 9, 2020, the Company also entered into a voting and support agreement (the "Arch Voting Agreement") with ARL and Gulf Reinsurance Ltd., another subsidiary of ACGL, pursuant to which each of ARL and Gulf Reinsurance Ltd. committed to vote all of its shares in favor of the merger and to not transfer any such shares, subject to the conditions set forth in the Arch Voting Agreement.

On February 16, 2021, ARL sold an aggregate of 230,400 common shares to affiliates of Kelso & Company ("Kelso") and 230,400 common shares to an affiliate of Warburg Pincus LLC ("Warburg Pincus"), in each case, at a purchase price of $34.66 per common share, which was the then current market price of the common shares, based on the closing sale price of the common shares on the Nasdaq Global Select Market on February 12, 2021 (such sales collectively, the "Arch Sales"). Subsequent to the Arch Sales, ARL held approximately 10.3% of the Company's outstanding common shares, a decrease from 12.6% as of December 31, 2020. In connection with the Arch Sales, on February 16, 2021, the Company entered into a waiver to the Arch Voting Agreement with ARL and Gulf Reinsurance Ltd. in order to permit the Arch Sales to Kelso and Warburg Pincus.

The Company also entered into voting and support Agreements with Kelso and Warburg Pincus, which are substantially similar to the Arch Voting Agreement and pursuant to which the parties agreed, among other things, to vote any common shares or preference shares owned by them (i) in favor of the adoption of the Merger Agreement and (ii) against any proposal or action that would reasonably be expected to impede or adversely affect in any material respect the merger or any of the other transactions contemplated by the Merger Agreement. Shareholder approval was obtained on March 30, 2021 at the Company's special general meeting.

AUL and AUI

Watford Re and WICE entered into services agreements with AUL. WSIC and WIC entered into services agreements with AUI. AUL and AUI provide services related to the management of the underwriting portfolio for a term ending in December 2025. The services agreements perpetually renew automatically in five-year increments unless either the Company or Arch gives notice to not renew at least 24 months before the end of the then-current term.

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

In return for their services, AUL and AUI receive fees from the Companies, including an underwriting fee and profit commission, as well as reimbursement for the services of the Designated Employees and reimbursements for an allocated portion of the expenses related to seconded employees, plus other expenses incurred on behalf of the Company. A profit commission is earned for each underwriting year where the performance meets defined thresholds within the service agreements.

The related AUL and AUI fees and reimbursements incurred in the consolidated statements of income (loss) for the three months ended March 31, 2021 and 2020 were as follows:

	Three Months Ended March 31,	
	2021	2020
	($ in thousands)	
Consolidated statements of income (loss) items:		
Acquisition expenses (1)	$ 7,813	$ 6,563
General and administrative expenses	1,027	988
Total	$ 8,840	$ 7,551

(1) For the three months ended March 31, 2021 and 2020, the Company incurred profit commission fees due to Arch of $0.8 million and $Nil, respectively, included within acquisition expenses above.

Reinsurance transactions with ACGL affiliates

The Company reinsures ARL and other ACGL subsidiaries and affiliates for property and casualty risks on a quota share basis. ACGL cedes business to the Company pursuant to inward retrocession agreements the Company's operating subsidiaries have entered into with ACGL. Pursuant to these inward retrocession agreements, the Company pays a ceding fee based on the business ceded and the terms of the applicable retrocession agreement. Such fees, in addition to origination fees, are reflected in "acquisition expenses" on the Company's consolidated statements of income (loss).

The related consolidated statements of income (loss) for the three months ended March 31, 2021 and 2020 were as follows:

	Three Months Ended March 31,	
	2021	2020
	($ in thousands)	
Consolidated statements of income (loss) items:		
Gross premiums written	$ 72,376	$ 81,348
Net premiums earned	57,461	58,785
Losses and loss adjustment expenses	45,194	46,541
Acquisition expenses (1)	14,876	13,853

(1) Acquisition expenses relating to the ACGL inward quota share agreements referred to above. For the three months ended March 31, 2021 and 2020, the Company incurred ceding fees to Arch, in aggregate, of $4.2 million and $4.0 million, respectively, under these inward retrocession agreements.

Separately, the Company's operating subsidiaries have entered into outward quota share retrocession or reinsurance agreements with ACGL subsidiaries. Specifically, each of Watford Re and WICE has entered into a separate outward quota share retrocession or reinsurance agreement with ARL, and each of WSIC and WIC has entered into a separate outward quota share reinsurance agreement with ARC.

The related consolidated statements of income (loss) for the three months ended March 31, 2021 and 2020 for the outward retrocession transactions were as follows:

	Three Months Ended March 31,	
	2021	2020
	($ in thousands)	
Consolidated statements of income (loss) items:		
Gross premiums ceded	$ (24,555)	$ (19,828)
Net premiums earned	(23,676)	(19,788)
Losses and loss adjustment expenses	(17,810)	(15,815)
Acquisition expenses (1)	(5,245)	(4,537)

(1) Acquisition expenses relating to the ACGL outward quota share agreements referred to above.

The related consolidated balance sheet account balances as of March 31, 2021 and December 31, 2020 were as follows:

	March 31, 2021	December 31, 2020
	($ in thousands)	
Consolidated balance sheet items:		
Total investments	$ 734,218	$ 744,998
Premiums receivable	106,211	84,155
Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses	134,839	126,294
Prepaid reinsurance premiums	65,084	64,074
Deferred acquisition costs, net	17,978	19,010
Funds held by reinsurers	29,681	31,639
Other assets - prepaid expenses	4,052	3,991
Reserve for losses and loss adjustment expenses	701,586	712,478
Unearned premiums	124,623	113,724
Losses payable	37,419	54,028
Reinsurance balances payable	49,270	41,812
Senior notes	34,551	34,538
Amounts due to affiliates	4,516	7,708
Other liabilities - contingent commissions	5,190	4,416
Contingently redeemable preference shares	3,470	3,468

AIM

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

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

The related consolidated statements of income (loss) for the three months ended March 31, 2021 and 2020 were as follows:

	Three Months Ended March 31,	
	2021	2020
	($ in thousands)	
Consolidated statements of income (loss) items:		
Investment management fees - related parties	$ 228	$ 253

Enstar Group Limited Voting Agreement

At March 31, 2021, Cavello Bay Reinsurance Limited ("Cavello Bay"), a wholly-owned subsidiary of Enstar Group Limited ("Enstar"), held 1,815,858 common shares, or 9.1% of the Company's outstanding common shares. On November 2, 2020, Enstar, Cavello Bay, ACGL and the Company entered into a voting and support agreement pursuant to which Cavello Bay committed to vote all of its shares in favor of the merger. Shareholder approval was obtained on March 30, 2021 at the Company's special general meeting.

HPS

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

In return for its investment services, HPS receives a management fee, a performance fee and allocated operating expenses. The management fee is calculated at an annual rate of 1.0% of the aggregate net asset value of the assets that are managed by HPS for the first $1.5 billion in net asset value, and 0.75% of the aggregate net value of assets exceeding $1.5 billion, payable quarterly in arrears. For purposes of calculating the management fees, net asset value is determined by HPS in accordance with the investment management agreements and is measured before reduction for any management fees, performance fees or any expense reimbursement and is adjusted for any non-routine intra-month withdrawals. The Company has also agreed to reimburse HPS for certain expenses related to the management of the Company's investment portfolios as set forth in the investment management agreements.

The base performance fee is equal to 10% of the Income (as defined in the investment management agreements relating to Watford Re, WICE and Watford Trust) or Aggregate Income (as defined in the investment management agreements relating to WSIC and WIC), as applicable, if any, on the assets managed by HPS, calculated and payable as of each fiscal year-end and the date on which the investment management agreements are terminated and not renewed, and HPS is eligible to earn an additional performance fee equal to 25% of any Excess Income (as defined in the investment management agreements) in excess of a net 10% return to Watford after deduction for paid and accrued management fees and base performance fees, with the total performance fees not to exceed 17.5% of the Income or Aggregate Income, as applicable. No performance fees will be paid to HPS if the high water mark (as described in the investment management agreements with HPS) is not met.

During 2019, the Company invested $28.7 million in a limited partnership as part of HPS's investment strategy. HPS acts as the general partner and manager of the limited partnership. During 2020, the Company fully redeemed its investment in the limited partnership. The management fees and performance fees on the limited partnership will be subject to the existing fee structure of the existing investment management agreement between the Company and HPS, as discussed above.

The related consolidated statements of income (loss) for the three months ended March 31, 2021 and 2020, and consolidated balance sheet account balances for HPS management fees and performance fees as of March 31, 2021 and December 31, 2020 were as follows:

	Three Months Ended March 31,	
	2021	**2020**
	($ in thousands)	
Consolidated statements of income (loss) items:		
Investment management fees - related parties	$ 4,259	$ 4,099
Investment performance fees - related parties	6,016	—
	$ 10,275	$ 4,099

	March 31,	December 31,
	2021	**2020**
	($ in thousands)	
Consolidated balance sheet items:		
Investment management and performance fees payable	$ 12,012	$ 21,641

<u>*Artex*</u>

In 2015, WICE and AUL entered into an insurance management services agreement with Artex Risk Solutions (Gibraltar) Limited, or Artex, pursuant to which Artex provides services to WICE relating to management, secretarial, governance, underwriting, claims, reinsurance, financial management, investment, regulatory, compliance, risk management and Solvency II. In addition, two principals of Artex have been appointed directors of WICE. In exchange for these services, the Company pays Artex fees based on WICE’s gross premiums written, subject to a minimum amount of £150,000 per annum and a maximum amount of £400,000 per annum, in each case subject to an inflation increase on an annual basis. The insurance management services agreement may be terminated by either Artex or WICE upon twelve months prior written notice; provided that the agreement is subject to earlier termination by WICE or Artex upon the occurrence of certain events.

The table below provides the aggregate fees the Company paid to Artex under the insurance management services agreement for the three months ended March 31, 2021 and 2020.

	Three Months Ended March 31,	
	2021	**2020**
	($ in thousands)	
Fees paid to Artex under insurance management services agreement	$ 138	$ 86

For the three months ended March 31, 2021 and 2020, the Company paid no fees to Arch under this insurance management services agreement.

13. Commitments and contingencies

Concentrations of credit risk

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

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

The Company’s reinsurance recoverables, and prepaid reinsurance premiums, net of reinsurance balances payable, resulting from reinsurance agreements entered into with ARL and ARC as of March 31, 2021 and December 31, 2020 amounted to $150.7 million and $148.6 million, respectively. ARL and ARC have “A+” credit ratings from A.M. Best.

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

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

The Company’s investment portfolios are managed in accordance with investment guidelines that include standards of diversification, which limit the allowable holdings of any single issuer. There were no investments in any entity in excess of 10% of the Company’s shareholders’ equity at March 31, 2021 and December 31, 2020, other than cash and cash equivalents held in operating and investment accounts with financial institutions with credit ratings between “A” and “AA-.”

Lloyds letter of credit facility

On May 15, 2020, Watford Re renewed its letter of credit facility with Lloyds Bank Corporate Markets Plc, New York Branch (the “Lloyds Facility”). The Lloyds Facility amount is $100.0 million and was renewed through to May 16, 2021. Under the renewed Lloyds Facility, the Company may request an increase in the facility amount, up to an aggregate of $50.0 million. The principal purpose of the Lloyds Facility is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which the Company has entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from the Company as required under insurance regulations in the United States. The amount of letters of credit issued is driven by, among other things, the timing and payment of catastrophe losses, loss development of existing reserves, the payment pattern of such reserves, the further expansion of the Company’s business and the loss experience of such business. When issued, the letters of credit are secured by certificates of deposit or cash. In addition, the Lloyds Facility also requires the maintenance of certain covenants, with which the Company was in compliance at March 31, 2021 and December 31, 2020. At such dates, the Company had $49.5 million and $47.9 million, respectively, in restricted assets as collateral for outstanding letters of credit issued from the Lloyds Facility, which were secured by certificates of deposit. These collateral amounts are reflected as short-term investments in the Company’s consolidated balance sheets.

Unsecured letter of credit facility

On September 17, 2020, Watford Re renewed and amended its 364-day letter of credit agreement with Lloyds Bank Corporate Markets Plc and BMO Capital Markets Corp. (the “Unsecured Facility”). The Unsecured Facility amount was reduced from $100.0 million to $50.0 million, and will be automatically extended for a period of one year unless canceled or not renewed by either counterparty prior to expiration. The principal purpose of the Unsecured Facility is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which the Company has entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from the Company as required under insurance regulations in the United States. The amount of letters of credit issued is driven by, among other things, the timing and payment of catastrophe losses, loss development of existing reserves, the payment pattern of such reserves, the further expansion of the Company’s business and the loss experience of such business. The Unsecured Facility requires the maintenance of certain covenants, as well as the making of certain representations and warranties that are customary for facilities of this type. At March 31, 2021 and December 31, 2020, the Company had $48.1 million and $49.9 million, respectively, in outstanding letters of credit issued from the Unsecured Facility, and was in compliance with all covenants contained in the Unsecured Facility requirements.

Bank of America secured credit facility

On November 30, 2017, Watford Re amended and restated its $800.0 million secured credit facility (the “Secured Facility”) with Bank of America, N.A., which expires on November 30, 2021. On August 27, 2020, Watford Re elected to reduce the borrowing capacity from $800.0 million to $640.0 million, and on November 9, 2020, further reduced the borrowing capacity from $640.0 million to $440.0 million, under the terms of the amended and restated agreement. The purpose of the Secured Facility is to provide borrowings, backed by Watford Re’s investment portfolios.

In addition, the Secured Facility allows for Watford Re to issue up to $220.0 million, reduced from $400.0 million as of August 27, 2020, and from $320.0 million as of November 9, 2020, in evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which the Company has entered into reinsurance arrangements. At March 31, 2021, Watford Re had $155.7 million and $28.2 million in borrowings and outstanding letters of credit, respectively. At December 31, 2020, Watford Re had $155.7 million and $28.2 million in borrowings and outstanding letters of credit, respectively. At March 31, 2021 and December 31, 2020, Watford Re was in compliance with all covenants contained in the Secured Facility.

Custodian bank facilities

As of March 31, 2021 and December 31, 2020, Watford Re had $94.9 million and $56.0 million, respectively, in borrowings from its custodian banks to purchase investment securities. As of March 31, 2021, the total borrowed amount of $94.9 million included 4.8 million Euros, or EUR, (U.S. dollar equivalent of $5.7 million) to purchase EUR-denominated securities. The Company pays interest based on LIBOR or the Overnight Bank Funding Rate (“OBFR”), plus a margin and the borrowed amount is payable upon demand. The foreign exchange gain or loss on revaluation on the non-U.S. dollar-denominated borrowed funds is included as a component of “net foreign exchange gains (losses)” included in the Company’s consolidated statements of income (loss).

The custodian banks require the Company to hold cash and investments on deposit, or in an investment account with respect to the borrowed funds. At March 31, 2021 and December 31, 2020, the Company was required to hold $167.9 million and $96.3 million, respectively, in such deposits and investment accounts.

Investment commitments

As of March 31, 2021 and December 31, 2020, the Company had unfunded commitments of $1.7 million and $3.9 million, respectively, relating to term loans within its investment portfolios.

Acquisition commitments

In 2020, the Company entered into an agreement to acquire Axeria IARD, a property and casualty insurance company based in France. The Company committed to acquiring 100% of the capital stock of Axeria IARD from the APRIL group. The transaction was completed on April 9, 2021. Refer to Note 19, “Subsequent events” for more information.

Proposed merger

On October 9, 2020, the Company entered into an Agreement and Plan of Merger (the “Original Merger Agreement”) with ACGL and Merger Sub. Further, on November 2, 2020, the Company entered into Amendment No. 1 to the Original Merger Agreement (the Original Merger Agreement, as amended by such Amendment No. 1, the “Merger Agreement”) with ACGL and Merger Sub, and ACGL assigned its interests and obligations under the Merger Agreement to HoldCo. ACGL remains contractually responsible for the performance of its obligations under the Merger Agreement.

Pursuant to the Merger Agreement, Merger Sub will merge with and into the Company, with the Company surviving as a wholly-owned subsidiary of HoldCo (the “Merger”). At the effective time of the Merger, holders of the Company’s common shares will be entitled to receive consideration of $35.00 in cash for each common share they own. The Company's preference shares will remain outstanding following the effective time of the Merger and will be entitled to the same dividend and other rights and preferences as are now provided to the preference shares. The Merger is expected to close in the first half of 2021, subject to customary closing conditions, including regulatory approval. Shareholder approval was obtained on March 30, 2021 at the Company's special general meeting.

If the Merger Agreement is terminated under specified circumstances, including if: (i) Watford terminates prior to receipt of shareholder approval in order to enter into a definitive written agreement providing for a superior proposal, or (ii) HoldCo terminates prior to the shareholders meeting to approve the Merger Agreement and after the Company’s board has acted in a way that constitutes an adverse recommendation change, the Company will be required to pay HoldCo a termination fee of $28.1 million.

14. Leases

The Company has entered into a lease agreement for real estate that is used for office space in the ordinary course of business. The lease is accounted for as an operating lease, whereby the lease expense is recognized on a straight-line basis over the term of the lease.

The lease includes an option to extend or renew the lease term. The exercise of the renewal option is at the Company’s discretion. The operating lease liability includes lease payments related to options to extend or renew the lease term if the Company is reasonably certain of exercising those options. Such options relating to the extension or renewal of the lease term are not included in the operating lease liability at this time.

Lease expense is included in “general and administrative expenses” in the Company’s consolidated statements of income (loss). Additional information regarding the Company’s real estate operating lease is as follows.

	Three Months Ended March 31,	
	2021	2020
	($ in thousands)	
Lease cost:		
Operating lease	$ 64	$ 62
Other information on operating lease:		
Cash payments included in the measurement of lease liability reported in operating cash flows	71	71
Right-of-use assets (1)	654	908
Operating lease liability (2)	654	908
Weighted average discount rate	3.9 %	3.9 %
Weighted average remaining lease term in years	2.5 years	3.5 years

(1) Included in “other assets” on the Company’s consolidated balance sheet.

(2) Included in “other liabilities” on the Company’s consolidated balance sheet.

The following tables present the contractual maturity of the Company’s lease liability:

	March 31, 2021	December 31, 2020
	($ in thousands)	
Remainder of 2021	212	283
2022	283	283
2023	189	189
Total undiscounted lease payments	684	755
Less: present value adjustment	(30)	(36)
Operating lease liability	654	719

15. Senior notes

The Company’s 6.5% senior notes due July 2, 2029 are the Parent’s senior unsecured and unsubordinated obligations and rank equally with all of the other existing and future obligations of the Parent that are unsecured and unsubordinated. Interest on the senior notes is paid semi-annually in arrears on each January 2 and July 2, which commenced on January 2, 2020. The senior notes may be redeemed by the Company at any time, in whole or in part, prior to July 2, 2024, at “make-whole” redemption price, subject to the Bermuda Monetary Authority (“BMA”) requirements. After July 2, 2024, the senior notes are redeemable, in whole or in part, at a redemption price equal to 100% of the principal amount, subject to BMA requirements. The indenture governing the senior notes contains certain customary covenants, including those related to the punctual payment of interest and principal amounts due. The Company was in compliance with such covenants at March 31, 2021 and December 31, 2020.

As of March 31, 2021, the carrying amount of the senior notes was $172.8 million, presented net of unamortized debt issuance costs of $2.2 million. As of December 31, 2020, the carrying amount of the senior notes was $172.7 million, presented net of unamortized debt issuance costs of $2.3 million.

16. Contingently redeemable preference shares

The Company has 2,145,202 8½% Cumulative Redeemable Preference Shares (the “preference shares”) outstanding with a par value of $0.01 per share and a liquidation preference of $25.00 per share. Holders of the preference shares are entitled to receive, if declared by the board of directors, quarterly cash dividends on the last day of March, June, September and December of each year.

Dividends on the preference shares accrue from (and including) June 30, 2019 (the “Floating Rate Period”), at a floating rate per annum (the “Floating Rate”) equal to three-month U.S. dollar LIBOR *plus* a margin of 667.85 basis points; provided, that, if, at any time, the three-month U.S. dollar LIBOR shall be less than 1%, then the three-month U.S. dollar LIBOR for purposes of calculating the Floating Rate at the time of such calculation shall be 1%. The preference shares may be redeemed by the Company on or after June 30, 2019 or at the option of the preference shareholders at any time on or after June 30, 2034 at the liquidation price of $25.00 per share. Because the redemption features are not solely within the control of the Company, the preference shares have been recorded as mezzanine equity on the Company’s consolidated balance sheets in accordance with applicable accounting guidance. Preference share dividends, including the accretion of the discount and issuance costs, are included in “preference dividends” in the Company’s consolidated statements of income (loss).

For the three months ended March 31, 2021 and 2020, dividends paid on the preference shares totaled $1.0 million and $1.1 million, respectively.

The following table presents a reconciliation of the preference shares for the three months ended March 31, 2021 and 2020:

	Three Months Ended March 31,	
	2021	2020
	($ in thousands)	
Preference shares:		
Balance at the beginning of the period	$ 52,398	$ 52,305
Accretion discount and issuance costs on remaining preference shares	23	23
Balance at the end of the period	$ 52,421	$ 52,328

17. Share transactions

Share-based compensation

The 2018 Stock Incentive Plan (the “2018 Plan”) provides for the issuance of restricted share units, performance units, restricted shares, performance shares, share options and share appreciation rights and other equity-based awards to the Company’s employees and directors. The 2018 Plan authorizes the issuance of 907,315 common shares and will terminate on March 28, 2029. As of March 31, 2021, 678,437 shares were available for future issuance.

During the first quarter of 2020, the Company granted an aggregate of 63,591 restricted share units and common shares to certain officers, other employees and directors. On the grant date of March 1, 2020, the fair value of the restricted share units and common shares was approximately $23.00 per share. Of the total restricted share units and common shares granted, 14,675 were vested and fully expensed, including 10,870 common shares issued. The remaining 48,916 restricted share units are being amortized over a three-year vesting period, being the requisite service period. During the first quarter of 2021, the Company issued 9,787 common shares related to the restricted share units granted on March 1, 2020. There were no forfeitures or expired awards during the first quarter of 2021 or 2020.

The effect of compensation cost arising from share-based payment awards on the Company’s consolidated statements of income (loss), within “general and administrative expenses”, for the three months ended March 31, 2021 and 2020, was $0.3 million and $0.6 million, respectively, including an accelerated expense recognition for retirement eligible employees.

Share repurchase program

In the first quarter of 2020, the board of directors of the Parent authorized the Company's investment in its common shares through a share repurchase program under which the Company may repurchase up to $50 million of its outstanding common shares (the "current share repurchase program"). During the first quarter of 2020, the Company purchased 127,744 shares at an average price per share of $22.42 under the current share repurchase program.

As of March 31, 2021, approximately $47.1 million of unused share repurchase capacity remained available under the current share repurchase program. Since the inception of the share repurchase programs through March 31, 2021, the Company has repurchased a total of 2.9 million shares. At March 31, 2021, the shares are held in treasury, at an aggregate cost of $77.9 million (excluding transaction costs).

Repurchases of the Company's common shares and other share-based transactions are recorded at cost and result in a reduction of the Company's shareholders' equity in its consolidated balance sheets. The Company does not anticipate making any further repurchases under its current share repurchase program as a result of its pending acquisition by HoldCo.

18. 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. Certain lawsuits challenging the Merger have been filed and remained ongoing as of the date of this Report. As of March 31, 2021, the Company was not a party to any other litigation or arbitration, which is expected by management to have a material adverse effect on the Company's results of operations or financial condition and liquidity.

19. Subsequent events

On April 9, 2021, the Company completed its acquisition of 100% of the capital stock of Axeria IARD, a property and casualty insurance company based in France, from the APRIL Group. The total consideration paid was €45.1 million.

Item 2. Management's discussion and analysis of financial condition and results of operations

The following discussion and analysis of our financial condition and results of operations contains forward-looking statements, which involve inherent risks and uncertainties. All statements other than statements of historical fact are forward-looking statements. These statements are based on our current assessment of risks and uncertainties. Actual results may differ materially from those expressed or implied in these statements and, therefore, undue reliance should not be placed on them. Important factors that could cause actual events or results to differ materially from those indicated in such statements are discussed elsewhere in this report, including the sections entitled Part I "Financial information - Cautionary note regarding forward-looking statements" and Part II Item 1A "Risk factors."

This discussion and analysis should be read in conjunction with our consolidated financial statements and notes thereto included in Part I Item 1 "Consolidated financial statements" of this report. Tabular amounts are in U.S. dollars in thousands, except share amounts, unless otherwise noted.

Overview

We are a global property and casualty, or P&C, insurance and reinsurance company with approximately $1.2 billion in capital as of March 31, 2021, comprised of $172.8 million of senior notes, $52.4 million of contingently redeemable preference shares and $977.0 million of common shareholders' equity. Through operations in Bermuda, the United States and Europe, we write insurance and reinsurance on a worldwide basis. Our objective is to deliver attractive returns to shareholders by combining disciplined underwriting with superior investment management. Our strategy combines a diversified, casualty-focused underwriting portfolio, accessed through our multi-year, renewable strategic underwriting management relationship with Arch, with a disciplined investment strategy comprised primarily of non-investment grade corporate credit assets, managed by HPS. In addition, we have a services arrangement with AIM and other Investment Managers to manage our investment grade portfolio.

While we are positioned to provide a full range of P&C lines, we focus on writing specialty lines of business. We believe that our experienced management team, our relationship with Arch and our strong capital base have enabled us to successfully compete and establish a meaningful presence in the insurance and reinsurance markets in which we participate.

We seek to generate an attractive return on average equity across the relevant insurance and investment cycles. We opportunistically seek to underwrite new lines that fit our return profile while maintaining a disciplined underwriting approach.

Current outlook

The outbreak of COVID-19 began significantly impacting the U.S. and global markets during the 2020 first quarter and the pandemic has continued to cause unprecedented economic volatility and disruption globally throughout 2020 and 2021. We remain committed to the safety of our employees, including restricting travel and instituting a work from home policy. These actions have helped prevent a major disruption to our operations or our ability to service our clients.

The impact of the COVID-19 global pandemic on the worldwide economy has changed some aspects of our outlook. There could be elevated claims activity in certain lines of business and growth in written premium may be harder to achieve in a recessionary economy. At this time, there continues to be significant uncertainty surrounding the ultimate number of insurance claims and scope of damage resulting from this pandemic. Our estimates across our insurance and reinsurance lines of business are based on currently available information derived from modeling techniques, claims information obtained from our clients and brokers, a review of relevant contracts with potential exposure to the pandemic and estimates of reinsurance recoverables. These estimates include losses related only to claims incurred as of March 31, 2021. Actual losses from these events may vary materially from the estimates due to several factors, including the inherent uncertainties in making such determinations and the evolving nature of this pandemic. In spite of these challenges, we will continue to look for opportunities to find acceptable books of business to underwrite without sacrificing underwriting discipline and will continue to focus on writing medium to long tail business. The severity, duration and long-term impacts of the COVID-19 global pandemic are difficult to predict, but we remain committed to our clients and the markets we serve.

We believe that we are relatively less exposed to COVID-19 global pandemic-related underwriting losses than many industry peers. For example, we have either no, or de minimis, premium writings in life, accident and health, event cancellation, trade credit, travel or pandemic specific coverages that respond directly to COVID-19 global pandemic-related losses. With regard to the potential exposure to business interruption losses, we write a limited amount of commercial property exposure, mainly emanating from our property catastrophe line of business. Our estimated ultimate loss for COVID-19 global pandemic related business interruption losses in our property catastrophe line of business is $5.5 million as of March 31, 2021. We continue to monitor our potential COVID-19 global pandemic exposures across all our lines of business.

We believe that mortgage insurance may potentially be affected by the COVID-19 global pandemic. We write U.S. mortgage risk predominately through a government sponsored enterprise (or “GSE”) credit risk transfer program and have international mortgage exposure through certain reinsurance contracts. Most of our exposure is for mortgages that were originated prior to 2018. Based upon an internal actuarial review, we increased our loss provision in 2020 to account for a potential increase in defaults in our mortgage insurance portfolio.

We believe the casualty lines most likely to be adversely affected by the COVID-19 global pandemic are workers' compensation, professional liability and medical malpractice. To date, we have recognized a nominal IBNR provision in our loss reserves for COVID-19 global pandemic-related casualty losses, as well as reductions in IBNR for certain casualty lines in which COVID-19 induced reductions in economic activity had a corresponding reduction in the frequency of claims.

Conversely, we believe the insurance and reinsurance market environment is showing signs of noticeable price improvement. Primary rates in most casualty lines, apart from workers’ compensation, continue to be strong, albeit, we believe, partly in response to higher perceived social inflation. Property catastrophe reinsurance rates are up meaningfully, retrocession capacity is shrinking, and ceding commissions have reduced modestly on some proportional casualty treaties. We believe the factors supporting a continued favorable pricing environment include the low interest rate environment, multiple years of significant catastrophe events, and signs of weakness in the adequacy of prior period loss reserves for some industry participants.

Against this backdrop and taking into account the proposed Merger, we are selectively growing our business in areas that we believe present attractive opportunities and meet our risk and return criteria. We continue to see good growth opportunities in the insurance market. In particular, our insurance underwriting platforms in the United States and Europe continued their growth in net premiums during in the first quarter of 2021 versus the comparable prior year quarter. Further we seek to grow our footprint in Europe with the acquisition of Axeria IARD.

We also see opportunities on the reinsurance side in general liability, commercial auto liability and other casualty lines. Our current underwriting portfolio has concentrations in general liability, professional liability, multi-line, workers’ compensation and motor product lines through reinsurance of third-party cedants and retrocessions from Arch.

Our outsourced business model

We have engaged Arch and HPS to perform certain services for us that are essential to the results of our operations, and have entered into long-term, renewable contracts with each in order to ensure continued access to these services. For our underwriting operations, Arch provides underwriting services including sourcing and evaluating underwriting opportunities as well as related services such as claims-handling, loss control, exposure management, portfolio management, modeling, statistical, actuarial and administrative support services, in each case, subject to our underwriting and operational guidelines and the oversight of our senior management and board of directors. With regard to our investments, HPS manages our non-investment grade portfolio while AIM manages the largest portion of our investment grade portfolio, in each case subject to compliance with our investment guidelines and the oversight of our senior management and board of directors. We outsource these functions in order to cost-effectively leverage the respective expertise and strong market positions of our trusted partners. Through our association with Arch, we access Arch's worldwide platform on a variable cost basis, thus avoiding the fixed expense of maintaining a multi-line platform for our underwriting operations. Similarly, we believe that the terms of service and structure of the compensation we pay to HPS and AIM provide benefits to us both in terms of cost-effective access to the expertise required to execute our investment strategy and in aligning interests.

Natural catastrophe risk

While we are more casualty-focused and assume less catastrophe exposure than many of our peers, we do underwrite a limited amount of natural catastrophe risk in order to balance and diversify our underwriting portfolio. We carefully monitor our natural catastrophe risk globally for all perils and regions where we believe our underwriting portfolio might have significant exposure.

Recently, Arch has been increasing its writings in this line in response to an improving rate environment and, as a result, our premiums have grown in proportion.

Limited operating history and comparability of results

We were incorporated in July 2013 and completed our initial funding and began underwriting business in the first quarter of 2014. Our initial underwriting activities focused on writing reinsurance. In 2015, we began our insurance business in connection with the establishment of our U.S. and European insurance platforms. As a result, we have a limited operating history and, given our underwriting and investment strategies, are exposed to volatility in our results of operations that may not be apparent from a review of our historical results. Period-to-period comparisons of our results of operations may not be meaningful. In addition, the amount of premiums written may vary from year to year and period to period as a result of any number of factors, including changes in market conditions and our view of the long-term profit potential of individual lines of business.

Financial measures and ratios

Our management and board of directors use financial indicators and ratios in evaluating our performance and measuring the overall growth in value generated for our common shareholders. The key financial measures that we believe are meaningful in analyzing our performance are: underwriting income (loss), combined ratio, adjusted underwriting income (loss), adjusted combined ratio, net interest income, net interest income yield on average net assets (including the non-investment grade portfolio and investment grade portfolio components thereof), net investment income (loss), net investment income return on average net assets, net investment income return on average total investments (excluding accrued investment income) (including the non-investment grade portfolio and investment grade portfolio components thereof), book value per diluted common share, growth in book value per diluted common share and return on average equity.

The table below shows the key performance indicators for the three months ended March 31, 2021 and 2020:

	Three Months Ended March 31,	
	2021	2020
	($ in thousands, except percentages and per share data)	
Key underwriting metrics:		
Underwriting income (loss)	$ (13,490)	$ (6,143)
Combined ratio	109.1 %	104.4 %
Adjusted underwriting income (loss)	$ (10,299)	$ (3,014)
Adjusted combined ratio	107.0 %	102.2 %
Key investment return metrics:		
Net interest income	$ 18,957	$ 27,803
Net interest income yield on average net assets (1)	0.8 %	1.4 %
Non-investment grade portfolio (1)	1.1 %	1.7 %
Investment grade portfolio (1)	0.2 %	0.5 %
Net investment income (loss)	$ 59,114	$ (262,699)
Net investment income return on average net assets (1)	2.6 %	(13.0)%
Non-investment grade portfolio (1)	3.7 %	(17.4)%
Investment grade portfolio (1)	0.3 %	0.8 %
Net investment income return on average total investments (excluding accrued investment income) (2)	2.3 %	(10.1)%
Non-investment grade portfolio (2)	3.2 %	(14.9)%
Investment grade portfolio (2)	0.3 %	0.8 %
Key shareholders' value creation metrics:		
Book value per diluted common share (3)	$ 48.86	$ 28.21
Growth in book value per diluted share (3)	3.8 %	(35.1)%
Annualized return on average equity (4)	17.1 %	N.M.

N.M. Ratio is not meaningful.

(1) Net interest income yield on average net assets and net investment income return on average net assets are calculated by dividing net interest income, and net investment income (loss), respectively, by average net assets. Net assets is calculated as the sum of total investments, accrued investment income and receivables for securities sold, less revolving credit agreement borrowings, payable for securities purchased and payable for securities sold short. For the three-month period, average net assets is calculated using the averages of each quarterly period. However, for the investment grade portfolio component of these returns, the impact of the revolving credit agreement borrowings is not subtracted from net interest income, net investment income (loss), or the net assets calculation. The separate components of these returns (non-investment grade portfolio and investment grade portfolio) are non-U.S. GAAP financial measures. Refer to "-Reconciliation of non-U.S. GAAP financial measures" for a reconciliation of these components of our net interest income yield on average net assets and net investment income return on average net assets.

(2) Net investment income return on average total investments (excluding accrued investment income) is calculated by dividing net investment income by average total investments. For the three-month period, average total investments is calculated using the averages of each quarterly period. However, for the investment grade portfolio component of these returns, the impact of revolving credit agreement borrowings is not subtracted from net investment income. The separate components of these returns (non-investment grade portfolio and investment grade portfolio) are non-U.S. GAAP financial measures. Refer to "-Reconciliation of non-U.S. GAAP financial measures" for a reconciliation of these components of our net investment income return on average total investments (excluding accrued investment income).

(3) Book value per diluted common share is calculated by dividing total shareholders' equity by the number of diluted common shares outstanding at the end of each reporting period. Growth in book value per diluted common share is calculated as the percentage change in value of beginning and ending book value per diluted common share over the reporting period.

(4) Annualized return on average equity represents net income (loss) expressed as a percentage of average total shareholders' equity during the period. Annualized return on average equity for the three months ended March 31, 2021 is calculated by extrapolating the quarterly return on average equity over a twelve-month period. For the three-month period, the average total shareholders' equity is calculated as the average of the beginning and ending total shareholders' equity of each quarterly period. Due to the net realized and unrealized losses on investments, the annualized return on average equity calculation is not meaningful for the three months ended March 31, 2020. For the three months ended March 31, 2021 and 2020, the return on average equity was 4.3% and (37.3)%, respectively.

Underwriting income (loss)

Underwriting income (loss) is a non-U.S. GAAP financial measure. We define underwriting income (loss) as net premiums earned less loss and loss adjustment expenses, acquisition expenses and general and administrative expenses. Underwriting income (loss) is one of the ways we evaluate the performance of our underwriting segment, and does not include other underwriting income (loss), net investment income (loss), interest expense, net foreign exchange gains (losses), transaction and other costs, income tax expense (benefit) and preference dividends. Although these items are an integral part of our operations, with the exception of other underwriting income (loss), they are independent of the underwriting process and result, in large part, from general economic and financial market conditions. We include other underwriting income (loss) in our adjusted underwriting income (loss), as described in more detail below. See “-Reconciliation of non-U.S. GAAP financial measures” for a reconciliation of underwriting income to net income (loss) available to common shareholders.

Combined ratio

The combined ratio is calculated as the sum of loss and loss adjustment expenses, acquisition expenses and general and administrative expenses, divided by net premiums earned, or equivalently, as the sum of the loss ratio, acquisition expense ratio and general and administrative expense ratio. The combined ratio is a measure of underwriting profitability but does not include other underwriting income or net investment income earned on underwriting cash flows.

Adjusted underwriting income (loss)

Adjusted underwriting income (loss) is a non-U.S. GAAP financial measure. We define adjusted underwriting income (loss) as underwriting income (loss) plus other underwriting income (loss) less certain corporate expenses. Adjusted underwriting income (loss) is one of the ways we evaluate the performance of our underwriting segment. We include other underwriting income (loss), as our underwriting strategy allows us to enter into government-sponsored enterprise credit-risk sharing transactions. Certain corporate expenses are generally comprised of costs associated with the ongoing operations of the holding company, such as compensation of certain executives, and costs associated with the initial setup of subsidiaries. See “-Reconciliation of non-U.S. GAAP financial measures” for a reconciliation of adjusted underwriting income to net income (loss) available to common shareholders.

Adjusted combined ratio

Adjusted combined ratio is a non-U.S. GAAP financial measure. The adjusted combined ratio is calculated as the sum of loss and loss adjustment expenses, acquisition expenses and general and administrative expenses less certain corporate expenses, divided by the sum of net premiums earned and other underwriting income (loss). This ratio is a measure of our underwriting and operational profitability but does not include certain corporate expenses or net investment income earned on underwriting cash flows. Certain corporate expenses are generally comprised of costs associated with the ongoing operations of the holding company, such as compensation of certain executives, and costs associated with the initial setup of subsidiaries. See “-Reconciliation of non-U.S. GAAP financial measures” for a reconciliation of our adjusted combined ratio to our combined ratio.

Net interest income and net investment income (loss)

Net interest income and net investment income (loss) are important contributors to our financial results. These key investment metrics are impacted by the performance of our Investment Managers as well as the state of the overall financial markets.

Net interest income yield on average net assets

Net interest income yield on average net assets is calculated by dividing net interest income by average net assets. Net assets is calculated as the sum of total investments, accrued investment income and receivables for securities sold, less revolving credit agreement borrowings, payable for securities purchased and payable for securities sold short. Net interest income yield on average net assets is a key indicator by which we measure the performance of our Investment Managers.

Net investment income return on average net assets

Net investment income return on average net assets is calculated by dividing net investment income (loss) by average net assets. Net assets is calculated as the sum of total investments, accrued investment income and receivables for securities sold, less revolving credit agreement borrowings, payable for securities purchased and payable for securities sold short. Net investment income return on average net assets is a key indicator by which we measure the performance of our Investment Managers.

Net investment income return on average total investments (excluding accrued investment income)

Net investment income return on average total investments (excluding accrued investment income) is calculated by dividing net investment income (loss) by average total investments. Net investment income return on average total investments (excluding accrued investment income) is a key indicator by which we measure the performance of our Investment Managers.

Non-investment grade portfolio and investment grade portfolio components of certain of our investment metrics

In order to provide further detail regarding our key investment metrics, we also present the non-investment grade portfolio and investment grade portfolio components of our net interest income yield on average net assets, net investment income return on average net assets and net investment income return on average total investments (excluding accrued investment income). In the calculation of the investment grade portfolio component of our net interest income yield on average net assets and net investment income return on average net assets, the impact of the revolving credit agreement borrowings is not subtracted from net interest income, net investment income (loss) or the net assets calculation. The separate components of these returns are non-U.S. GAAP financial measures. See "-Reconciliation of non-U.S. GAAP financial measures" for a reconciliation of these components of our net interest income yield on average net assets, net investment income return on average net assets and net investment income return on average total investments (excluding accrued investment income).

Growth in book value per diluted common share

Book value per diluted common share is calculated by dividing total shareholders' equity by the number of diluted common shares outstanding at the end of each reporting period. We calculate growth in book value per diluted common share as the percentage change in value of beginning and ending book value per diluted share over the reporting period. Book value per diluted common share is impacted by, among other factors, our underwriting results, our investment returns and our share repurchase activity, which has an accretive or dilutive impact on book value per diluted common share depending on the purchase price.

We measure our long-term financial success by our ability to compound growth in book value per diluted common share at an attractive rate of return. We believe that long-term growth in book value per diluted common share is the most comprehensive measure of our success because it includes all underwriting, operating and investing results.

Return on average equity

Return on average equity is net income (loss) expressed as a percentage of average total shareholders' equity during the period and is used to measure profitability. Our goal is to generate an attractive long-term return on our common shareholders' equity.

Comment on non-U.S. GAAP financial measures

Throughout this report, we present our operations in the way we believe will be the most meaningful and useful to investors, analysts, rating agencies and others who will use our financial information in evaluating the performance of our company. This presentation includes the use of underwriting income (loss), adjusted underwriting income (loss), adjusted combined ratio and the separate components of our investment returns (non-investment grade investment portfolio and investment grade investment portfolio). The presentation of these metrics constitutes non-U.S. GAAP financial measures as defined by applicable SEC rules. We believe that this presentation enables investors and other users of our financial information to analyze our performance in a manner similar to how management analyzes performance. We also believe that this presentation follows industry practice and, therefore, allows the equity analysts and certain rating agencies that follow us and the insurance industry as a whole, as well as other users of our financial information to compare our performance with our industry peer group. See "-Reconciliation of non-U.S. GAAP financial measures" for reconciliations of such measures to the most directly comparable U.S. GAAP financial measures, in accordance with applicable SEC rules.

Components of our results of operations

Revenues

We derive our revenues from two principal sources:

- premiums from our insurance and reinsurance lines of business; and
- income from investments.

Premiums from our insurance and reinsurance lines of business are directly related to the number, type, size and pricing of contracts we write. Premiums are earned over the contract period in proportion to the period of risk covered which is typically 12 to 24 months.

Income from our investments is comprised of interest income and net realized and unrealized gains (losses), less investment related expenses as described below.

Expenses

Our expenses consist primarily of the following:

- loss and loss adjustment expenses;
- acquisition expenses;
- general and administrative expenses;
- investment related expenses; and
- interest expense.

Loss and loss adjustment expenses are a function of the amount and type of contracts and policies we write and of the loss experience of the underlying coverage. Loss and loss adjustment expenses are based on an actuarial analysis of the estimated losses, including losses incurred during the period and changes in estimates from prior periods. Depending on the nature of the contract, loss and loss adjustment expenses may be paid over a period of years.

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

General and administrative expenses consist of salaries and benefits and related costs, legal and accounting fees, travel and client entertainment, fees relating to our letter of credit facilities, information technology, occupancy, the cost of employees made available to us by Arch under the services agreements, and other general operating expenses.

Investment-related expenses primarily consist of management and performance fees we pay to our Investment Managers, as well as interest and other expenses on borrowings from our credit facilities when used to finance a portion of our investments. Effective January 1, 2020, to the extent the aggregate net asset value of the HPS-managed non-investment grade portfolio assets exceeds $1.5 billion, the management fee is calculated at a blended annual rate equal to (i) 1.0% of the initial $1.5 billion in net asset value plus (ii) seventy-five basis points (0.75%) of the excess of aggregate net asset value over $1.5 billion, subject to a minimum blended management fee rate of eighty-five basis points (0.85%) on the aggregate net asset value of the HPS-managed non-investment grade portfolio assets. In addition, on an annual basis, subject to then-applicable high water marks, HPS receives a base performance fee equal to 10% of the income generated on the non-investment grade portfolio, and is eligible to earn an additional performance fee equal to 25% of any such investment income in excess of a net 10% return to us after deduction for paid and accrued management fees and base performance fees, with the total performance fees not to exceed 17.5% of the Income (as defined in the investment management agreements relating to Watford Re, WICE and Watford Trust) or Aggregate Income (as defined in the investment management agreements relating to WSIC and WIC), as applicable.

We have also engaged HPS to manage a portion of our investment grade portfolio as a separate managed account. We pay HPS a management fee equal to 0.60% per annum on the assets in the separate managed account. We also pay AIM monthly asset management fees related to the assets it manages for us. We are not obligated to pay performance fees to any of the Investment Managers managing our investment grade portfolios. We include the HPS non-investment grade portfolio base management fee and the AIM investment grade portfolio management fee in “investment management fees - related parties” in our consolidated statements of income (loss), and as management fees are accrued and paid to HPS in connection with its management of a portion of our investment grade portfolio, we will include such fees therein as well. We include interest and other expenses on borrowings in “borrowing and miscellaneous other investment expenses” in our consolidated statements of income (loss). The HPS non-investment grade portfolio performance fee, if applicable, is shown on a separate line in our consolidated statements of income (loss).

Interest expense consists of interest incurred on the $175.0 million aggregate principal amount of 6.5% senior notes due July 2, 2029, or the senior notes, that we issued on July 2, 2019. Interest on the senior notes is paid semi-annually in arrears on each January 2 and July 2, which commenced on January 2, 2020.

Reportable segment

We report results under one segment, which we refer to as our “underwriting segment.” Our underwriting segment captures the results of our underwriting lines of business, which are comprised of specialty products on a worldwide basis. We also have a corporate function that includes accelerated expense for the unamortized original issue discount and underwriting fees relating to the partial redemption of our 8½% cumulative redeemable preference shares, or the preference shares, and interest expense on our senior notes as well as certain operating expenses related to corporate activities referred to as certain corporate expenses. Certain corporate expenses are generally comprised of costs associated with the ongoing operations of the holding company, such as compensation of certain executives, and costs associated with the initial setup of subsidiaries (refer to "- Reconciliation of non-U.S. GAAP financial measures" for a discussion about certain corporate expenses).

Other recent developments

On April 9, 2021, we completed the acquisition of 100% of the capital stock of Axeria IARD, a property and casualty insurance company based in France, from the APRIL Group. The total consideration paid was €45.1 million.

Consolidated results - for the three months ended March 31, 2021 and 2020

The following table summarizes our results of operations for the three months ended March 31, 2021 and 2020:

	Three Months Ended March 31,		
	2021	% Change	2020
		($ in thousands)	
Gross premiums written	$ 216,523	(7.8)%	$ 234,902
Gross premiums ceded	(37,212)		(48,202)
Net premiums written	179,311	(4.0)%	186,700
Net premiums earned	147,731	5.5 %	140,039
Loss and loss adjustment expenses	(118,794)		(110,676)
Acquisition expenses	(35,135)		(28,367)
General and administrative expenses (1)	(7,292)		(7,139)
Underwriting income (loss) (2)	(13,490)	119.6 %	(6,143)
Other underwriting income (loss)	411		133
Interest income	25,798		37,824
Investment management fees - related parties	(4,487)		(4,352)
Borrowing and miscellaneous other investment expenses	(2,354)		(5,669)
Net interest income	18,957		27,803
Realized and unrealized gain (loss) on investments	46,173		(290,502)
Investment performance fees - related parties	(6,016)		—
Net investment income (loss)	59,114	N.M.	(262,699)
Interest expense	(2,912)		(2,912)
Net foreign exchange gains (losses)	(475)		5,013
Transaction costs and other	(715)		—
Income tax (expense) benefit	(8)		—
Net income (loss) before preference dividends	41,925		(266,608)
Preference dividends	(1,038)		(1,171)
Net income (loss) available to common shareholders	$ 40,887	N.M.	$ (267,779)

N.M. - Percentage change is not meaningful.

	Three Months Ended March 31,		
	2021	Change	2020
		($ in thousands)	
Loss ratio	80.4 %	1.4 %	79.0 %
Acquisition expense ratio	23.8 %	3.5 %	20.3 %
General & administrative expense ratio	4.9 %	(0.2)%	5.1 %
Combined ratio	109.1 %	4.7 %	104.4 %
Adjusted underwriting income (loss)(2)	$ (10,299)		$ (3,014)
Adjusted combined ratio (2)	107.0 %	4.8 %	102.2 %
Annualized return on average equity (3)	17.1 %		N.M.

N.M. Ratio is not meaningful.

(1) General and administrative expenses include certain corporate expenses. Refer to “Reconciliation of non-U.S. GAAP financial measures-Reconciliation of the adjusted combined ratio,” for a discussion of these certain corporate expenses.

(2) Underwriting income (loss), adjusted underwriting income (loss) and the adjusted combined ratio are non-U.S. GAAP financial measures. Refer to “Reconciliation of non-U.S. GAAP financial measures” for a reconciliation of our underwriting income (loss) to net income (loss) available to common shareholders in accordance with U.S. GAAP, a reconciliation of our adjusted underwriting income (loss) to underwriting income (loss) and a reconciliation of our adjusted combined ratio to our combined ratio.

(3) Annualized return on average equity represents net income (loss) expressed as a percentage of average total shareholders' equity during the period. Annualized return on average equity for the three months ended March 31, 2020 is calculated by extrapolating the quarterly return on average equity over a twelve-month period. For the three-month period, the average total shareholders' equity is calculated as the average of the beginning and ending total shareholders' equity of each quarterly period. Due to the net realized and unrealized losses on investments, the annualized return on average equity calculation is not meaningful for the three months ended March 31, 2020. For the three months ended March 31, 2021 and 2020, the return on average equity was 4.3% and (37.3)%, respectively.

Results for the three months ended March 31, 2021 versus 2020:

The net income attributable to common shareholders was $40.9 million in the 2021 first quarter, compared to net loss attributable to common shareholders of $267.8 million in the 2020 first quarter. The 2021 first quarter net income was driven by an increase in net investment income, offset in part by an increase in underwriting losses, an increase in net foreign exchange losses and transaction costs related to the Merger.

The net investment income was $59.1 million in the 2021 first quarter, compared to a net investment loss of $262.7 million in the 2020 first quarter. The net investment income was driven by realized and unrealized gains of $46.2 million in the 2021 first quarter, compared to realized and unrealized losses of $290.5 million in the 2020 first quarter.

The 2021 first quarter underwriting loss was $13.5 million, compared to an underwriting loss of $6.1 million in the 2020 first quarter. The 2021 first quarter loss ratio was 80.4%, 1.4 points higher than the 2020 first quarter. The 2021 first quarter acquisition expense ratio was 23.8%, 3.5 points higher than the 2020 first quarter. The increase in the loss ratio was driven by $8.9 million, or 6.0 points of losses associated with the 2021 U.S. winter storms. The increase in the acquisition expense ratio was due to the prior year acquisition ratio being depressed as a result of the loss sensitive commission decreases arising from our mortgage business. In addition, we recorded lower loss ratios in certain portions of our insurance motor business driven by reduced loss activity in the 2021 first quarter, as a result of the COVID-19 global pandemic. A portion of this decrease in losses was offset by loss sensitive commission increases, which adversely impacted the acquisition ratio.

The prior year loss reserve development for both the 2021 and 2020 first quarters was essentially flat, with a net adverse development of $0.1 million and a net favorable development of $0.2 million, respectively.

The 2021 first quarter general and administrative expense ratio was 4.9%, 0.2 points lower than the prior year quarter. The decrease year-over-year can be attributed to lower professional fees, office expenses and bank fees, offset in part by higher compensation, taxes and insurance expenses.

Premiums

Our underwriting segment captures the results of our underwriting lines of business, which are comprised of specialty products on a worldwide basis. Our four major lines of business are described as follows:

- *Casualty reinsurance:* coverage provided to ceding company clients on third-party liability and workers' compensation exposures, primarily on a treaty basis. Business written includes coverages such as: executive assurance, medical malpractice liability, other professional liability, workers' compensation, excess and umbrella liability and excess auto liability.

- *Other specialty reinsurance:* coverage provided to ceding company clients for personal and commercial auto (other than excess auto liability), mortgage, surety, accident and health, workers' compensation catastrophe, agriculture, marine and aviation.

- *Property catastrophe reinsurance:* protects ceding company clients for most catastrophic losses that are covered in the underlying policies. Perils covered may include hurricane, earthquake, flood, tornado, hail and fire, and coverage for other perils on a case-by-case basis. Property catastrophe reinsurance provides coverage on an excess of loss basis when aggregate losses and loss adjustment expense from a single occurrence of a covered peril exceed the retention specified in the contract.

- *Insurance programs and coinsurance:* targeting program managers and/or coinsurers with unique expertise and niche products offering primary and excess general liability, umbrella liability, professional liability, workers' compensation, personal and commercial automobile, inland marine and property business with minimal catastrophe exposure.

Gross premiums written

Gross premiums written for the three months ended March 31, 2021 and 2020 were as follows:

	Three Months Ended March 31,					
	2021			2020		
	Amount		%	Amount		%
	($ in thousands)					
Casualty reinsurance	$	57,070	26.4 %	$	83,818	35.7 %
Other specialty reinsurance		46,519	21.5 %		36,880	15.7 %
Property catastrophe reinsurance		13,410	6.2 %		9,832	4.2 %
Insurance programs and coinsurance		99,524	46.0 %		104,372	44.4 %
Total	$	216,523	100.0 %	$	234,902	100.0 %

Results for the three months ended March 31, 2021 versus 2020:

Gross premiums written were $216.5 million for the three months ended March 31, 2021, compared to $234.9 million for the three months ended March 31, 2020, a decrease of $18.4 million, or 7.8%.

Casualty reinsurance gross premiums written decreased 31.9% over the prior year quarter, primarily due to a reduction in U.K. motor excess of loss writings.

Insurance programs and coinsurance gross premiums written decreased 4.6%, driven by lower gross written premiums on certain motor businesses, partially offset by increased U.K. multi-line exposures.

Other specialty reinsurance gross premiums written increased 26.1% over the prior year quarter primarily due to a new quota share on Lloyds syndicate business, offset in part by a reduction in motor writings.

Our property catastrophe reinsurance gross premiums written increased 36.4% over the prior year quarter. Our primary involvement in this line of business is a 7.5% quota share participation of ARL's world-wide property catastrophe excess of loss portfolio. Arch has increased its writings in this line in response to an improving rate environment and, as a result, our premiums have grown in proportion.

Premiums ceded

Premiums ceded were $37.2 million for the three months ended March 31, 2021, compared to $48.2 million for the three months ended March 31, 2020, a decrease of $11.0 million. Premiums ceded decreased during the period, driven by a reduction in the third-party reinsurance purchased for one large insurance program.

Net premiums written

Net premiums written for the three months ended March 31, 2021 and 2020 were as follows:

	Three Months Ended March 31,			
	2021		2020	
	Amount	%	Amount	%
	($ in thousands)			
Casualty reinsurance	$ 57,016	31.8 %	$ 83,667	44.8 %
Other specialty reinsurance	39,468	22.0 %	35,484	19.0 %
Property catastrophe reinsurance	13,410	7.5 %	9,832	5.3 %
Insurance programs and coinsurance	69,417	38.7 %	57,717	30.9 %
Total	$ 179,311	100.0 %	$ 186,700	100.0 %

Results for the three months ended March 31, 2021 versus 2020:

Net premiums written were $179.3 million for the three months ended March 31, 2021, compared to $186.7 million for the three months ended March 31, 2020, a decrease of $7.4 million or 4.0%. The 2021 first quarter decrease in net reinsurance premiums written was driven by the reduction of gross reinsurance premiums written in the casualty reinsurance line of business. Offsetting this decrease were increases in insurance programs and coinsurance, property catastrophe and other specialty reinsurance. Despite the reduction in gross premiums written described earlier, net premiums increased in the insurance programs and coinsurance line of business, as we decreased the amount ceded to third-party reinsurers on one program.

Net premiums earned

Net premiums earned for the three months ended March 31, 2021 and 2020 were as follows:

	Three Months Ended March 31,			
	2021		2020	
	Amount	%	Amount	%
	($ in thousands)			
Casualty reinsurance	$ 47,138	31.9 %	$ 52,765	37.7 %
Other specialty reinsurance	35,203	23.8 %	35,364	25.3 %
Property catastrophe reinsurance	8,318	5.6 %	4,884	3.5 %
Insurance programs and coinsurance	57,072	38.7 %	47,026	33.5 %
Total	$ 147,731	100.0 %	$ 140,039	100.0 %

Results for the three months ended March 31, 2021 versus 2020:

Net premiums earned were $147.7 million for the three months ended March 31, 2021 compared to $140.0 million for the three months ended March 31, 2020, an increase of $7.7 million or 5.5%. The increase in net premiums earned reflected the increase in net premiums written in insurance programs and coinsurance, and, to a lesser extent, property catastrophe reinsurance during the 2021 first quarter. This was partially offset by a reduction in casualty reinsurance, consistent with the reduction in net premiums written discussed above.

Loss ratio

The following table shows the components of our loss and loss adjustment expenses for the three months ended March 31, 2021 and 2020:

	Three Months Ended March 31,			
	2021		2020	
	Loss and Loss Adjustment Expenses	% of Earned Premiums	Loss and Loss Adjustment Expenses	% of Earned Premiums
	($ in thousands)			
Current year	$ 118,687	80.3 %	$ 110,856	79.1 %
Prior year development (favorable)/adverse	107	0.1 %	(180)	(0.1)%
Loss and loss adjustment expenses	$ 118,794	80.4 %	$ 110,676	79.0 %

Results for the three months ended March 31, 2021 versus 2020:

Our loss ratio was 80.4% for the three months ended March 31, 2021, compared to 79.0% for the three months ended March 31, 2020, an increase of 1.4 points. The increase in loss ratio was driven by $8.9 million, or 6.0 points of losses associated with the 2021 U.S. winter storms.

The prior year first quarter loss ratio was elevated as a result of the COVID-19 global pandemic losses arising from our mortgage business. A portion of these losses were contractually offset by loss sensitive commission decreases and are recorded as a benefit to the Company's acquisition expense ratio.

The prior year loss reserve development for both the 2021 and 2020 first quarters was essentially flat, with a net adverse development of $0.1 million and a net favorable development of $0.2 million, respectively.

Refer to Note 5, "Reserve for losses and loss adjustment expenses" to our consolidated financial statements in Part I Item 1 of this report for more information about our prior year reserve development.

Acquisition expense ratio

Results for the three months ended March 31, 2021 versus 2020:

Our acquisition expense ratio was 23.8% for the three months ended March 31, 2021, an increase of 3.5 points from the three months ended March 31, 2020. The change was primarily as a result of the prior year acquisition ratio being depressed due to the loss sensitive commission decreases arising from our mortgage business previously mentioned. In addition, we recorded lower loss ratios in certain portions of our insurance motor business driven by reduced loss activity in the 2021 first quarter, as a result of the COVID-19 global pandemic. A portion of this decrease in losses was offset by loss sensitive commission increases, which adversely affect the acquisition ratio. The remaining difference is attributable to changes in the mix of business.

General and administrative expense ratio

Results for the three months ended March 31, 2021 versus 2020:

Our general and administrative expense ratio was 4.9% for the three months ended March 31, 2021, compared to 5.1% for the three months ended March 31, 2020. The decrease year-over-year can be attributed to lower professional fees, office expenses and bank fees, offset in part by higher compensation, taxes and insurance expenses.

Combined ratio

Results for the three months ended March 31, 2021 versus 2020:

Our combined ratio was 109.1% for the three months ended March 31, 2021, compared to 104.4% for the three months ended March 31, 2020, an increase of 4.7 points. In the 2021 first quarter, there was a 1.4 point increase in the loss expense ratio and a 3.5 point increase in the acquisition expense ratio, offset in part by a 0.2 point decrease in the general and administrative expense ratio, as described above.

Investment results

The following table summarizes the components of total investment income:

	Three Months Ended March 31,	
	2021	**2020**
	($ in thousands)	
Interest income	$ 25,798	$ 37,824
Investment management fees - related parties	(4,487)	(4,352)
Borrowing and miscellaneous other investment expenses	(2,354)	(5,669)
Net interest income	18,957	27,803
Net realized gains (losses) on investments	1,702	(5,046)
Net unrealized gains (losses) on investments	44,471	(285,456)
Investment performance fees - related parties	(6,016)	—
Net investment income (loss)	$ 59,114	$ (262,699)
Net interest income yield on average net assets (1)	0.8 %	1.4 %
Non-investment grade portfolio (1)	1.1 %	1.7 %
Investment grade portfolio (1)	0.2 %	0.5 %
Net investment income return on average net assets (1)	2.6 %	(13.0)%
Non-investment grade portfolio (1)	3.7 %	(17.4)%
Investment grade portfolio (1)	0.3 %	0.8 %
Net investment income return on average total investments (excluding accrued investment income) (2)	2.3 %	(10.1)%
Non-investment grade portfolio (2)	3.2 %	(14.9)%
Investment grade portfolio (2)	0.3 %	0.8 %

(1) Net interest income yield on average net assets and net investment income return on average net assets are calculated by dividing net interest income, and net investment income (loss), respectively, by average net assets. Net assets is calculated as the sum of total investments, accrued investment income and receivables for securities sold, less revolving credit agreement borrowings, payable for securities purchased and payable for securities sold short. For the three-month period, average net assets is calculated using the averages of each quarterly period. However, for the investment grade portfolio component of these returns, the impact of the revolving credit agreement borrowings is not subtracted from net interest income, net investment income (loss), or the net assets calculation. The separate components of these returns (non-investment grade portfolio and investment grade portfolio) are non-U.S. GAAP financial measures. Refer to “-Reconciliation of non-U.S. GAAP financial measures” for a reconciliation of these components of our net interest income yield on average net assets and net investment income return on average net assets.

(2) Net investment income return on average total investments (excluding accrued investment income) is calculated by dividing net investment income by average total investments. For the three-month period, average total investments is calculated using the averages of each quarterly period. However, for the investment grade portfolio component of these returns, the impact of revolving credit agreement borrowings is not subtracted from net investment income. The separate components of these returns (non-investment grade portfolio and investment grade portfolio) are non-U.S. GAAP financial measures. Refer to “-Reconciliation of non-U.S. GAAP financial measures” for a reconciliation of these components of our net investment income return on average total investments (excluding accrued investment income).

Results for the three months ended March 31, 2021 versus 2020:

Net investment income was $59.1 million for the three months ended March 31, 2021 compared to net investment loss of $262.7 million for the three months ended March 31, 2020, an increase of $321.8 million. The 2021 first quarter net investment income return on average net assets was 2.6% as compared to (13.0)% for the 2020 first quarter.

The 2021 first quarter net investment return was driven by net realized and unrealized gains of $46.2 million, compared to net realized and unrealized losses of $290.5 million in the prior year quarter. The losses in the 2020 first quarter reflected investment market volatility caused by the economic shutdown mandated by governments around the world related to the COVID-19 global pandemic.

The net investment income for the three months ended March 31, 2021 included net interest income of $19.0 million, a decrease of 31.8% from the prior year quarter. The net interest income decrease over the prior period reflected a gradual shift to higher rated investments in our non-investment grade portfolio, a reduction in LIBOR and its impact on our investments in floating rate securities, and a reduction in prevailing interest rates period over period.

The 2021 first quarter non-investment grade portfolio net interest income yield was 1.1%, compared to 1.7% in the 2020 first quarter. The decrease in yield was attributable to a gradual shift to higher rated, lower yielding investments in our non-investment grade portfolio and a reduction in LIBOR and its impact on our investments in floating rate securities.

The non-investment grade portfolio net unrealized gains reported in the 2021 first quarter were $44.5 million, compared to net unrealized losses of $285.5 million in the 2020 first quarter. The net unrealized gains in the 2021 first quarter reflected slight spread tightening as well as idiosyncratic position movements. The net unrealized losses in the 2020 first quarter reflected investment market volatility caused by the economic dislocation resulting from the COVID-19 global pandemic.

The 2021 first quarter investment grade portfolio net interest income yield was 0.2%, compared to 0.5% in the 2020 first quarter. The reduction in net interest income yield was driven by a reduction in LIBOR and its impact on our investments in floating rate securities, and a reduction in prevailing interest rates during the year.

Transaction costs and other

During the 2021 first quarter, we incurred transaction costs of $0.7 million, which included various legal, advisory and other consulting costs associated with the Merger. We have incurred $4.8 million of such Merger transaction costs to date.

Growth in book value per diluted common share

Results for the three months ended March 31, 2021 versus 2020:

Book value per diluted common share was $48.86 as of March 31, 2021, compared to $47.08 per share as of December 31, 2020. The increase was driven by net income of $40.9 million and a net other comprehensive loss of $5.5 million.

Reconciliation of non-U.S. GAAP financial measures

Underwriting income (loss), adjusted underwriting income (loss), adjusted combined ratio and the non-investment grade portfolio and investment grade portfolio components of our investment returns (net interest income yield on average net assets, and net investment income return on average net assets and on average total investments (excluding accrued investment income), respectively) are non-U.S. GAAP financial measures. We use these measures, together with the GAAP financial statements, to provide information that assists with analyzing our performance. As a result, certain income and expense items are excluded from these measures in an effort to allow an effective analysis. With respect to expenses, we do not view certain operating expenses related to corporate activities, referred to as certain corporate expenses, as part of our underwriting activities. These expenses are generally comprised of costs associated with the ongoing operations of the holding company, such as compensation of certain executives and costs associated with the initial setup of subsidiaries. The following are descriptions of each of the non-U.S. GAAP financial measures used by us.

Underwriting income (loss) is useful in evaluating our underwriting performance, without regard to other underwriting income (losses), net investment income (losses), interest expense, net foreign exchange gains (losses), transaction and other costs, income tax expense (benefit) and preference dividends.

Adjusted underwriting income (loss) is useful in evaluating our underwriting performance, without regard to net investment income (losses), interest expense, net foreign exchange gains (losses), transaction and other costs, income tax expense (benefit), preference dividends and certain corporate expenses (which are described in more detail above). We define underwriting income (loss) as net premiums earned, less loss and loss adjustment expenses, acquisition expenses and general and administrative expenses, and we define adjusted underwriting income (loss) as underwriting income (loss) plus other underwriting income (loss) less certain corporate expenses. Our adjusted combined ratio is a key indicator of our profitability, without regard to certain corporate expenses. We calculate the adjusted combined ratio by dividing the sum of loss and loss adjustment expenses, acquisition expenses and general and administrative expenses less certain corporate expenses by the sum of net premiums earned and other underwriting income (loss).

The non-investment grade portfolio and investment grade portfolio components of our investment returns (net interest income yield on average net assets, and net investment income return on average net assets and on average total investments (excluding accrued investment income), respectively) are useful in evaluating our investment performance. The non-investment grade portfolio component of these investment returns reflect the performance of our investment strategy under HPS, which includes the use of leverage. The investment grade portfolio component of these investment returns reflect the performance of the investment portfolios that predominantly support our underwriting collateral.

We use underwriting income (loss), adjusted underwriting income (loss) and the adjusted combined ratio and the separate components of our returns (non-investment grade portfolio and investment grade portfolio) as internal performance measures in the management of our operations because we believe they give us and users of our financial information useful insight into our results of operations and our underlying business performance. Underwriting income (loss) and adjusted underwriting (income) loss should not be viewed as a substitute for net income (loss) calculated in accordance with U.S. GAAP, and our adjusted combined ratio should not be viewed as a substitute for our combined ratio. Furthermore, other companies may define these measures differently.

Reconciliation of underwriting income (loss) and adjusted underwriting income (loss)

Underwriting income (loss) reconciles to net income (loss) available to common shareholders, and adjusted underwriting income (loss) reconciles to underwriting income (loss) for the three months ended March 31, 2021 and 2020 as follows:

	Three Months Ended March 31,	
	2021	**2020**
	($ in thousands)	
Net income (loss) available to common shareholders	$ 40,887	$ (267,779)
Preference dividends	1,038	1,171
Net income (loss) before preference dividends	41,925	(266,608)
Income tax expense (benefit)	8	—
Interest expense	2,912	2,912
Net foreign exchange (gains) losses	475	(5,013)
Transaction costs and other	715	—
Net investment (income) loss	(59,114)	262,699
Other underwriting (income) loss	(411)	(133)
Underwriting income (loss)	(13,490)	(6,143)
Certain corporate expenses	2,780	2,996
Other underwriting income (loss)	411	133
Adjusted underwriting income (loss)	$ (10,299)	$ (3,014)

Reconciliation of the adjusted combined ratio

The adjusted combined ratio reconciles to the combined ratio for the three months ended March 31, 2021 and 2020 as follows:

	Three Months Ended March 31,					
	2021			2020		
	Amount	Adjustment	As Adjusted	Amount	Adjustment	As Adjusted
	($ in thousands)					
Losses and loss adjustment expenses	$ 118,794	$ —	$ 118,794	$ 110,676	$ —	$ 110,676
Acquisition expenses	35,135	—	35,135	28,367	—	28,367
General & administrative expenses (1)	7,292	(2,780)	4,512	7,139	(2,996)	4,143
Net premiums earned (1)(2)	147,731	411	148,142	140,039	133	140,172
Loss ratio	80.4 %			79.0 %		
Acquisition expense ratio	23.8 %			20.3 %		
General & administrative expense ratio (1)	4.9 %			5.1 %		
Combined ratio	109.1 %			104.4 %		
Adjusted loss ratio			80.2 %			79.0 %
Adjusted acquisition expense ratio			23.7 %			20.2 %
Adjusted general & administrative expense ratio			3.1 %			3.0 %
Adjusted combined ratio			107.0 %			102.2 %

(1) Adjustments include certain corporate expenses, which are deducted from general and administrative expenses, and other underwriting income (loss), which is added to net premiums earned.

(2) The adjustment to net premiums earned relates to “other underwriting income” from underwriting contracts accounted for as derivatives.

Reconciliation of the non-investment grade portfolio and investment grade portfolio components of our investment returns

The non-investment grade portfolio and the investment grade portfolio components of our investment returns for the three months ended March 31, 2021 and 2020 are as follows:

	Three Months Ended March 31, 2021				Three Months Ended March 31, 2020			
	Non-Investment Grade	Investment Grade	Cost of U/W Collateral (4)	Total	Non-Investment Grade	Investment Grade	Cost of U/W Collateral (4)	Total
				($ in thousands)				
Interest income	$ 23,293	$ 2,505	$ —	$ 25,798	$ 32,764	$ 5,060	$ —	$ 37,824
Investment management fees - related parties	(4,151)	(336)	—	(4,487)	(3,973)	(379)	—	(4,352)
Borrowing and miscellaneous other investment expenses	(1,909)	(329)	(116)	(2,354)	(2,591)	(225)	(2,853)	(5,669)
Net interest income	17,233	1,840	(116)	18,957	26,200	4,456	(2,853)	27,803
Net realized gains (losses) on investments	1,279	423	—	1,702	(7,225)	2,179	—	(5,046)
Net unrealized gains (losses) on investments (1)	44,489	(18)	—	44,471	(285,493)	37	—	(285,456)
Investment performance fees - related parties	(6,016)	—	—	(6,016)	—	—	—	—
Net investment income (loss)	$ 56,985	$ 2,245	$ (116)	$ 59,114	$ (266,518)	$ 6,672	$ (2,853)	$ (262,699)
Average total investments (excluding accrued investment income) (2)	$1,760,548	$774,829	$ —	$2,535,377	$1,790,337	$820,635	$ —	$2,610,972
Average net assets (3)	$1,558,811	$775,586	$(24,750)	$2,309,647	$1,530,825	$826,062	$(328,750)	$2,028,137
Net interest income yield on average net assets (3)	1.1 %	0.2 %		0.8 %	1.7 %	0.5 %		1.4 %
Net investment income return on average total investments (excluding accrued investment income) (2)	3.2 %	0.3 %		2.3 %	(14.9)%	0.8 %		(10.1)%
Net investment income return on average net assets (3)	3.7 %	0.3 %	(0.5)%	2.6 %	(17.4)%	0.8 %	(0.9)%	(13.0)%

(1) Net unrealized gains (losses) on investments excludes unrealized gains and losses from the available for sale portfolios, which are recorded in other comprehensive income.

(2) Net investment income return on average total investments (excluding accrued investment income) is calculated by dividing net investment income by average total investments. For the three-month period, average total investments is calculated using the average of the beginning and ending balance of each quarterly period. However, for the investment grade portfolio component of these returns, the impact of revolving credit agreement borrowings is not subtracted from net investment income.

(3) Net interest income yield on average net assets and net investment income return on average net assets are calculated by dividing net interest income, and net investment income (loss), respectively, by average net assets. For the non-investment grade component of investment returns and total investment returns, net assets is calculated as the sum of total investments, accrued investment income and receivables for securities sold, less total revolving credit agreement borrowings, payable for securities purchased and payable for securities sold short. However, for the investment grade portfolio component of these returns, the impact of the revolving credit agreement borrowings is not subtracted from net interest income, net investment income (loss), or the net assets calculation.

(4) The cost of underwriting collateral is calculated as the revolving credit agreement expenses for the investment grade portfolios divided by the average total revolving credit agreement borrowings for the investment grade portfolios during the period.

	As of March 31, 2021				As of March 31, 2020			
	Non-Investment Grade	Investment Grade	Borrowings for U/W Collateral	Total	Non-Investment Grade	Investment Grade	Borrowings for U/W Collateral	Total
				($ in thousands)				
Average total investments (excluding accrued investment income) - QTD	$ 1,760,548	$ 774,829	$ —	$ 2,535,377	$ 1,790,337	$ 820,635	$ —	$ 2,610,972
Average net assets - QTD	1,558,811	775,586	(24,750)	2,309,647	1,530,825	826,062	(328,750)	2,028,137
Total investments	$ 1,796,839	$ 775,074	$ —	$ 2,571,913	$ 1,718,421	$ 794,385	$ —	$ 2,512,806
Accrued Investment Income	12,053	2,272	—	14,325	12,312	4,032	—	16,344
Receivable for Securities Sold	65,671	2,405	—	68,076	22,329	4,460	—	26,789
Less: Payable for Securities Purchased	44,052	6,213	—	50,265	61,834	1,995	—	63,829
Less: Payable for Securities Sold Short	34,589	—	—	34,589	30,076	—	—	30,076
Less: Revolving credit agreement borrowings	225,829	—	24,750	250,579	247,736	—	328,750	576,486
Net assets	$ 1,570,093	$ 773,538	$ (24,750)	$ 2,318,881	$ 1,413,416	$ 800,882	$ (328,750)	$ 1,885,548
Non-investment grade borrowing ratio (1)	14.4 %				17.5 %			
Unrealized gains on investments	$ 65,643	$ 15,764	$ —	$ 81,407	$ 25,439	$ 15,086	$ —	$ 40,525
Unrealized losses on investments	(82,589)	(4,137)	—	(86,726)	(366,188)	(47,603)	—	(413,791)
Net unrealized gains (losses) on investments	$ (16,946)	$ 11,627	$ —	$ (5,319)	$ (340,749)	$ (32,517)	$ —	$ (373,266)

(1) The non-investment grade borrowing ratio is calculated as revolving credit agreement borrowings divided by net assets.

Critical accounting policies, estimates and recent accounting pronouncements

The preparation of consolidated financial statements in accordance with GAAP requires us to make many estimates and judgments that affect the reported amounts of assets, liabilities (including reserves), revenues and expenses, and related disclosures of contingent liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, insurance and other reserves, reinsurance recoverables and fair value measurements. We base our estimates on historical experience, where possible, and on various other assumptions that we believe to be reasonable under the circumstances, which form the basis for our judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Estimates and judgments for a relatively new company, like our company, are even more difficult to make than those made in a mature company since we have compiled relatively limited historical information through March 31, 2021. Actual results will differ from these estimates and such differences may be material.

The critical accounting policies that we believe affect significant estimates used in the preparation of our consolidated financial statements, as well as certain recent accounting pronouncements, are discussed under the heading “Management’s discussion and analysis of financial condition and results of operations-Critical accounting policies, estimates and recent accounting pronouncements” contained in our Annual Report on Form 10-K for the year ending December 31, 2020, updated, where applicable, in the notes accompanying our consolidated financial statements included in this report, including Note 2, “Basis of presentation and significant accounting policies”.

Financial condition, liquidity and capital resources

General

We are a holding company whose assets primarily consist of the shares in our subsidiaries. Generally, we depend on our available cash resources, dividends or other distributions from subsidiaries to make payments, including the payment of interest on our senior notes, dividends on our preference shares and operating expenses we may incur. During the three months ended March 31, 2021 and the year ended December 31, 2020, we received dividends of $1.0 million and $15.7 million, respectively, from Watford Re, our Bermuda operating subsidiary.

The ability of our regulated operating subsidiaries to pay dividends or make distributions is dependent on their ability to meet applicable regulatory standards. Under Bermuda law, Watford Re is required to maintain an enhanced capital requirement, or ECR, which must equal or exceed its minimum solvency margin (in other words, the amount by which the value of its general business assets must exceed its general business liabilities). Watford Re is also required 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. Watford Re is prohibited from declaring or paying any dividends during any financial year if it is not in compliance with each of its ECR, minimum solvency margin and minimum liquidity ratio. In any financial year, Watford Re is prohibited from declaring or paying dividends of more than 25% of its total statutory capital and surplus (as shown on its previous financial year’s statutory balance sheet) unless it files, at least seven days before payment of such dividends, with the Bermuda Monetary Authority, or the BMA, an affidavit attesting that a dividend would not cause Watford Re to fail to meet its relevant margins. As of December 31, 2020, as determined under Bermuda law, Watford Re had a statutory capital and surplus of $1.2 billion and was in compliance with its ECR, minimum solvency margin and minimum liquidity ratio. Accordingly, as of December 31, 2020, Watford Re was able to pay dividends of up to $296.0 million to us during 2021 without the requirement of filing such an affidavit with the BMA. Our compliance with the relevant margins is subject to ongoing monitoring of our statutory capital throughout 2021. In addition, Watford Re is prohibited, without prior approval of the BMA, from reducing by 15% or more its total statutory capital, as set out in its previous year’s statutory financial statements.

Our U.S. and Gibraltar insurance subsidiaries are subject to similar insurance laws and regulations in the jurisdictions in which they operate. The ability of these insurance subsidiaries to pay dividends or make distributions is also dependent on their ability to meet applicable regulatory standards.

Furthermore, the ability of our operating subsidiaries to pay dividends to us and to intermediate subsidiaries owned by us could be constrained by our dependence on financial strength ratings from independent rating agencies. Our ratings from these agencies depend to a large extent on the capitalization levels of our operating subsidiaries. We believe that we have sufficient cash resources and available dividend capacity to service our indebtedness, pay required dividends on our preference shares and satisfy other current outstanding obligations.

Financial condition

Shareholders' equity

2021 versus 2020: Total shareholders' equity was $977.0 million as of March 31, 2021, compared to $941.3 million as of December 31, 2020, an increase of $35.7 million or 3.8%. The increase in shareholders' equity was primarily driven by net investment income of $59.1 million, offset in part by an underwriting loss of $13.5 million, other comprehensive loss of $5.5 million, an interest expense of $2.9 million, preference dividends of $1.0 million and other transaction costs of $0.7 million.

Investment portfolios

The table below summarizes the credit quality of our total non-investment grade and investment grade portfolios as of March 31, 2021 and December 31, 2020, as rated by Standard & Poor's Financial Services, LLC, or Standard & Poor's, Moody's Investors Service, or Moody's, Fitch Ratings Inc., or Fitch, or Kroll Bond Rating Agency, or KBRA, DBRS Morningstar, or DBRS, as applicable:

		Credit Rating (1)									
March 31, 2021	**Fair Value**	**AAA**	**AA**	**A**	**BBB**	**BB**	**B**	**CCC**	**CC**	**C**	**Not Rated**
					($ in thousands)						
Non-Investment Grade Portfolio:											
Term loan investments	$ 790,186	$ —	$ —	$ —	$ 11,564	$ 34,507	$ 518,654	$ 174,552	$ 4,144	$ 1,283	$ 45,482
Corporate bonds	403,389	—	—	1,435	4,782	64,492	252,327	52,415	9,765	—	18,173
Asset-backed securities	134,524	—	—	—	66,101	28,459	9,085	5,770	262	—	24,847
Short-term investments	337,687	133,819	121,024	79,126	—	—	3,163	555	—	—	—
Total fixed income instruments and short-term investments	1,665,786	133,819	121,024	80,561	82,447	127,458	783,229	233,292	14,171	1,283	88,502
Equities	131,053										
Total Non-Investment Grade Portfolio	$ 1,796,839	$ 133,819	$ 121,024	$ 80,561	$ 82,447	$ 127,458	$ 783,229	$ 233,292	$ 14,171	$ 1,283	$ 88,502
Investment Grade Portfolio:											
Corporate bonds	$ 200,995	$ —	$ 18,674	$ 91,223	$ 87,363	$ 3,735	$ —	$ —	$ —	$ —	$ —
U.S. government and government agency bonds	165,683	—	165,683	—	—	—	—	—	—	—	—
Asset-backed securities	83,431	—	609	7,431	70,314	5,077	—	—	—	—	—
Mortgage-backed securities	15,315	—	—	1,516	13,799	—	—	—	—	—	—
Non-U.S. government and government agency bonds	161,958	—	161,958	—	—	—	—	—	—	—	—
Municipal government and government agency bonds	1,779	782	588	409	—	—	—	—	—	—	—
Short-term investments	145,913	9,622	66,783	20,014	49,494	—	—	—	—	—	—
Total Investment Grade Portfolio	$ 775,074	$ 10,404	$ 414,295	$ 120,593	$ 220,970	$ 8,812	$ —	$ —	$ —	$ —	$ —
Total	$ 2,571,913	$ 144,223	$ 535,319	$ 201,154	$ 303,417	$ 136,270	$ 783,229	$ 233,292	$ 14,171	$ 1,283	$ 88,502

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

December 31, 2020	Fair Value	AAA	AA	A	BBB	BB	B	CCC	CC	C	Not Rated
					Credit Rating (1)						
					($ in thousands)						
Non-Investment Grade Portfolio											
Term loan investments	$ 851,539	$ —	$ —	$ —	$ 11,352	$ 19,486	$ 588,215	$ 185,221	$ 7,406	$ 2,727	$ 37,132
Corporate bonds	312,620	—	—	—	—	31,089	194,418	59,421	8,280	1,894	17,518
Asset-backed securities	140,508	—	—	—	73,911	26,799	8,385	8,262	837	—	22,314
Short-term investments	301,390	83,308	124,830	89,577	—	—	3,186	489	—	—	—
Total fixed income instruments and short-term investments	1,606,057	83,308	124,830	89,577	85,263	77,374	794,204	253,393	16,523	4,621	76,964
Equities	118,201										
Total Non-Investment Grade Portfolio	$ 1,724,258	$ 83,308	$ 124,830	$ 89,577	$ 85,263	$ 77,374	$ 794,204	$ 253,393	$ 16,523	$ 4,621	$ 76,964
Investment Grade Portfolio											
Corporate bonds	$ 197,247	$ —	$ 19,812	$ 82,379	$ 87,913	$ 7,143	$ —	$ —	$ —	$ —	$ —
U.S. government and government agency bonds	202,488	—	202,488	—	—	—	—	—	—	—	—
Asset-backed securities	80,258	—	—	15,675	59,560	5,023	—	—	—	—	—
Mortgage-backed securities	16,663	—	—	2,092	14,571	—	—	—	—	—	—
Non-U.S. government and government agency bonds	158,839	—	158,839	—	—	—	—	—	—	—	—
Municipal government and government agency bonds	1,788	783	592	413	—	—	—	—	—	—	—
Short-term investments	117,300	6,211	43,870	19,328	47,891	—	—	—	—	—	—
Total Investment Grade Portfolio	$ 774,583	$ 6,994	$ 425,601	$ 119,887	$ 209,935	$ 12,166	$ —	$ —	$ —	$ —	$ —
Total	$ 2,498,841	$ 90,302	$ 550,431	$ 209,464	$ 295,198	$ 89,540	$ 794,204	$ 253,393	$ 16,523	$ 4,621	$ 76,964

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

The following tables summarize the composition of our non-investment grade and investment grade portfolios by sector as of March 31, 2021 and December 31, 2020:

	March 31, 2021								
	Total	**Financials**	**Health Care**	**Technology**	**Consumer Discretionary (1)**	**Industrials**	**Consumer Staples**	**Oil & Gas**	**All Other (2)**
	($ in thousands)								
Non-Investment Grade Portfolio:									
Term loan investments	$ 790,186	$ 133,545	$ 145,013	$ 149,263	$ 132,708	$ 115,863	$ 9,486	$ 28,808	$ 75,500
Corporate bonds	403,389	23,010	31,911	58,216	103,019	36,737	16,665	70,392	63,439
Equities - sector specific	114,689	66,679	22,982	3,291	9,734	3,207	3,368	2,086	3,342
Short-term investments - sector specific	3,720	—	557	—	—	—	—	—	3,163
Subtotal	1,311,984	223,234	200,463	210,770	245,461	155,807	29,519	101,286	145,444
Equities - non-sector specific	16,364								
Short-term investments - non-sector specific	333,967								
Asset-backed securities	134,524								
Total Non-Investment Grade Portfolio	$ 1,796,839	$ 223,234	$ 200,463	$ 210,770	$ 245,461	$ 155,807	$ 29,519	$ 101,286	$ 145,444
Investment Grade Portfolio:									
Corporate bonds	$ 200,995	$ 68,281	$ 10,565	$ 16,031	$ 27,381	$ 16,524	$ 26,906	$ 15,484	$ 19,823
Short-term investments	145,913								
U.S. government and government agency bonds	165,683								
Non-U.S. government and government agency bonds	161,958								
Asset-backed securities	83,431								
Mortgage-backed securities	15,315								
Municipal government and government agency bonds	1,779								
Total Investment Grade Portfolio	$ 775,074	$ 68,281	$ 10,565	$ 16,031	$ 27,381	$ 16,524	$ 26,906	$ 15,484	$ 19,823
Total Investments	$ 2,571,913	$ 291,515	$ 211,028	$ 226,801	$ 272,842	$ 172,331	$ 56,425	$ 116,770	$ 165,267

(1) As of March 31, 2021, the industry classifications were revised and, as such, the investments classified as "Consumer Services" in previous quarters are now classified as "Consumer Discretionary." The presentation of information as of December 31, 2020 has not been changed.

(2) Includes telecommunications, utilities, basic materials and real estate.

	December 31, 2020								
	Total	Financials	Health Care	Technology	Consumer Services	Industrials	Consumer Goods	Oil & Gas	All Other (1)
	($ in thousands)								
Non-Investment Grade Portfolio:									
Term loan investments	$ 851,539	$ 191,608	$ 162,255	$ 159,747	$ 79,477	$ 131,820	$ 24,079	$ 29,679	$ 72,874
Corporate bonds	312,620	26,565	23,929	53,493	81,990	21,899	18,759	34,955	51,030
Equities - sector specific	101,464	71,574	22,463	2,724	—	2,822	—	479	1,402
Short-term investments - sector specific	12,637		490	—	8,961	—	—	—	3,186
Subtotal	1,278,260	289,747	209,137	215,964	170,428	156,541	42,838	65,113	128,492
Equities - non-sector specific	16,737								
Short-term investments - non-sector specific	288,753								
Asset-backed securities	140,508								
Total Non-Investment Grade Portfolio	$ 1,724,258	$ 289,747	$ 209,137	$ 215,964	$ 170,428	$ 156,541	$ 42,838	$ 65,113	$ 128,492
Investment Grade Portfolio:									
Corporate bonds	$ 197,247	$ 55,430	$ 11,190	$ 17,863	$ 28,002	$ 13,989	$ 41,543	$ 14,473	$ 14,757
Short-term investments	117,300								
U.S. government and government agency bonds	202,488								
Non-U.S. government and government agency bonds	158,839								
Asset-backed securities	80,258								
Mortgage-backed securities	16,663								
Municipal government and government agency bonds	1,788								
Total Investment Grade Portfolio	$ 774,583	$ 55,430	$ 11,190	$ 17,863	$ 28,002	$ 13,989	$ 41,543	$ 14,473	$ 14,757
Total Investments	$ 2,498,841	$ 345,177	$ 220,327	$ 233,827	$ 198,430	$ 170,530	$ 84,381	$ 79,586	$ 143,249

(1) Includes telecommunications, utilities and basic materials.

The fair value of our term loans, fixed maturities and short-term investments in our non-investment grade and investment grade portfolios, summarized by contractual maturity as of March 31, 2021 and December 31, 2020 were as follows:

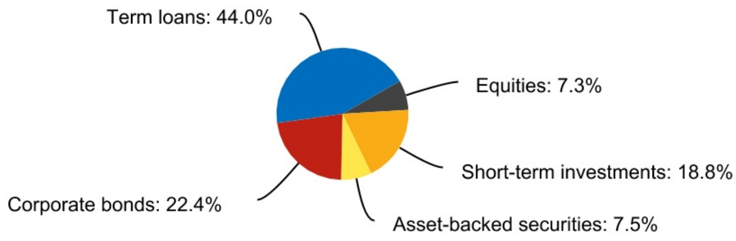
	Contractual Maturity					
March 31, 2021	**Fair Value**	**Due in One Year or Less**	**Due After One Through Two Years**	**Due After Three Through Five Years**	**Due After Five Through Ten Years**	**Due After Ten Years**
	($ in thousands)					
Non-Investment Grade Portfolio:						
Term loan investments	$ 790,186	$ 21,873	$ 112,578	$ 377,280	$ 278,455	$ —
Corporate bonds	403,389	—	21,874	204,944	159,563	17,008
Short-term investments	337,687	337,687	—	—	—	—
Subtotal	1,531,262	359,560	134,452	582,224	438,018	17,008
Asset-backed securities	134,524					
Equities	131,053					
Total Non-Investment Grade Portfolio	$ 1,796,839	$ 359,560	$ 134,452	$ 582,224	$ 438,018	$ 17,008
Investment Grade Portfolio:						
Corporate bonds	$ 200,995	$ 885	$ 41,736	$ 75,145	$ 69,526	$ 13,703
U.S. government and government agency bonds	165,683	644	143,984	14,786	6,269	—
Non-U.S. government and government agency bonds	161,958	16,378	31,010	53,926	60,644	—
Municipal government and government agency bonds	1,779	—	1,370	409	—	—
Short-term investments	145,913	145,913	—	—	—	—
Subtotal	676,328	163,820	218,100	144,266	136,439	13,703
Asset-backed securities	83,431					
Mortgage-backed securities	15,315					
Total - Investment Grade Portfolio	$ 775,074	$ 163,820	$ 218,100	$ 144,266	$ 136,439	$ 13,703
Total	$ 2,571,913	$ 523,380	$ 352,552	$ 726,490	$ 574,457	$ 30,711

December 31, 2020	Contractual Maturity					
	Fair Value	Due in One Year or Less	Due After One Through Two Years	Due After Three Through Five Years	Due After Five Through Ten Years	Due After Ten Years
	($ in thousands)					
Non-Investment Grade Portfolio:						
Term loan investments	$ 851,539	$ 21,035	$ 106,014	$ 465,153	$ 259,337	$ —
Corporate bonds	312,620	28	32,778	203,390	67,847	8,577
Short-term investments	301,390	301,390	—	—	—	—
Subtotal	1,465,549	322,453	138,792	668,543	327,184	8,577
Asset-backed securities	140,508					
Equities	118,201					
Total Non-Investment Grade Portfolio	$ 1,724,258	$ 322,453	$ 138,792	$ 668,543	$ 327,184	$ 8,577
Investment Grade Portfolio:						
Corporate bonds	$ 197,247	$ 4,290	$ 25,914	$ 67,785	$ 79,858	$ 19,400
U.S. government and government agency bonds	202,488	820	180,324	20,945	399	—
Non-U.S. government and government agency bonds	158,839	23,476	29,027	54,428	51,908	—
Municipal government and government agency bonds	1,788	—	1,375	413	—	—
Short-term investments	117,300	117,300	—	—	—	—
Subtotal	677,662	145,886	236,640	143,571	132,165	19,400
Asset-backed securities	80,258					
Mortgage-backed securities	16,663					
Total - Investment Grade Portfolio	774,583	$ 145,886	$ 236,640	$ 143,571	$ 132,165	$ 19,400
Total	$ 2,498,841	$ 468,339	$ 375,432	$ 812,114	$ 459,349	$ 27,977

Actual maturities may differ from contractual maturities because some borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

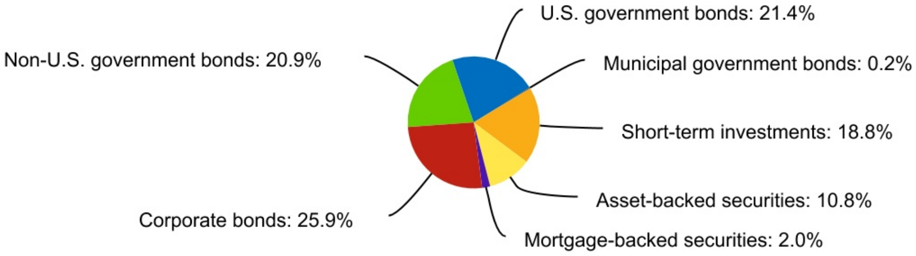
The following chart shows the composition of our non-investment grade and investment grade portfolios as of March 31, 2021:

Non-Investment Grade Portfolio as of March 31, 2021



Total: $1,796.8 million

Investment Grade Portfolio as of March 31, 2021



Total: $775.1 million

Liquidity and capital resources

Cash flows

Liquidity is a measure of our ability to access sufficient cash flows to meet the short-term and long-term cash requirements of our business operations. Our most significant source of operating cash flow is from premiums received from our insureds and reinsureds. Our underwriting operations provide liquidity in that premiums are received in advance, sometimes substantially in advance, of the time losses are paid. The period of time from the occurrence of a claim through the settlement of the resulting liability may extend many years into the future. We expect that our liquidity needs, including our anticipated insurance and reinsurance obligations and operating and capital expenditure needs, for at least the next 12 months, will be met by funds generated from underwriting activities and investment income, as well as by our balance of cash, short-term investments, proceeds on the sale or maturity of our investments and our credit facilities. For a discussion of the risks related to the potential future impacts of the COVID-19 global pandemic on our liquidity and capital resources, see Part II, Item 1A, “Risk Factors” in this report.

Our most significant operating cash outflow is for claim payments. Because the payment of claims occurs after the receipt of the premium, often years later, we invest the cash in various fixed income investments that earn interest. We also use cash to pay commissions to brokers, as well as to pay for ongoing operating expenses such as salaries, rent and taxes, interest expense on our senior notes and dividends on our preference shares. We have reinsurance agreements with Arch and others through which we cede a portion of our business. In purchasing reinsurance, we pay part of our premiums to reinsurers and collect cash back when our reinsurers reimburse us for losses subject to our reinsurance coverage.

The timing of our cash flows from operating activities can vary among periods due to the timing by which payments are made or received. Some of our payments and receipts, including loss settlements and subsequent reinsurance receipts, can be significant, so their timing can influence cash flows from operating activities in any given period.

Sources of liquidity include cash flows from operations, financing arrangements and routine sales of investments. The following table summarizes our cash flows from operating, investing and financing activities for the three months ended March 31, 2021 and 2020:

	Three Months Ended March 31,	
	2021	**2020**
	($ in thousands)	
Cash and cash equivalents provided by (used for):		
Operating activities	$ 6,984	$ 24,575
Investing activities	(17,498)	(111,627)
Financing activities	37,924	88,184
Effects of exchange rate changes on foreign currency	(2,697)	(6,989)
Change in cash and cash equivalents	$ 24,713	$ (5,857)

Results for the three months ended March 31, 2021:

- Cash provided by operating activities for the three months ended March 31, 2021 was lower than the same period in 2020. Operating cash flows reduced due to higher claim payments and reduced premium written and interest income received.
- Cash used for investing activities for the three months ended March 31, 2021 was lower than the same period in 2020, due to an increase in sales, redemptions and maturities, partially offset by an increase in purchases of fixed maturities in 2021.
- Cash was provided by financing activities for the three months ended March 31, 2021 was lower than the same period in 2020, driven by lower borrowings from the secured credit facility and custodian bank facilities.

Our investments in certain securities and loans may be illiquid due to contractual provisions or may prove to be illiquid in certain investment market conditions. Changes in general economic conditions could have a material adverse effect on the value and liquidity of the investments in our investment portfolios. The COVID-19 global pandemic has severely impacted the global economy and financial markets, which had a material adverse effect on our non-investment grade portfolio in 2020. The valuations of the portfolio have recovered and there has been a gradual shift towards higher rated investments. However, there continues to be uncertainty which could adversely impact our investment portfolios. If we require significant amounts of cash on short notice in excess of our anticipated cash requirements, we may have difficulty selling these investments in a timely manner or may be forced to sell or otherwise liquidate them at unfavorable values.

The primary goals of our asset liability management process are to satisfy insurance liabilities and maintain sufficient liquidity to cover fluctuations in projected liability cash flows, including our debt service obligations and payment of dividends on our preference shares. We do not explicitly implement an exact cash flow match in each period. However, the substantial degree by which the fair value of our investment portfolios exceeds the expected present value of the net underwriting liabilities, as well as the ongoing cash flow from premiums and contractual principal and interest payments received from our investment portfolios, strengthens our ability to fund the payment of claims and to service our other outstanding obligations without having to sell securities or loans at distressed prices. We believe that, generally, the combination of premium receipts and the expected principal and interest payments produced by our predominantly fixed income investment portfolios will adequately fund future claim payments and other liabilities when due.

Capital resources

In addition to the common shares and preference shares we issued in our initial funding, we have entered into credit facilities to support our business operations. Further, in July 2019, we issued our senior notes and used the net proceeds from the issuance to redeem 76.34% of our then outstanding preference shares. We believe that we hold sufficient capital to allow us to continue our business operations and execute our strategy, as well as to comply with all applicable statutory regulations.

We monitor our capital adequacy on a regular basis and will seek to adjust our capital base (up or down) according to the needs of our business. As part of our capital management program, we may seek to raise additional capital or may seek to return capital to our shareholders through share repurchases, cash dividends or other methods (or a combination of such methods). Any such determination will be at the discretion of our board of directors and will be dependent upon our profits, financial requirements and other factors, including legal restrictions, rating agency requirements and such other factors as our board of directors deems relevant.

In the first quarter of 2020, our board of directors authorized a share repurchase program, which allows us to make repurchases of up to $50 million of our common shares from time to time in open market or privately negotiated transactions. During the first quarter of 2020, we repurchased 127,744 common shares at an average price of $22.42 per share for an aggregate cost of $2.9 million. With the onset of the COVID-19 global pandemic, we temporarily halted repurchases under the program following the first quarter of 2020, and we did not repurchase any of our common shares during the remainder of 2020. As of March 31, 2021, approximately $47.1 million of unused share repurchase capacity remained available under the program. However, we do not anticipate making any further repurchases under the share repurchase program as a result of our entry into the Merger Agreement, which generally prohibits us from repurchasing our shares as well as certain other securities prior to the consummation of the Merger or the earlier termination of the Merger Agreement. Accordingly, at the present time, we do not expect to repurchase common shares, declare or pay dividends on our common shares or otherwise return capital to our common shareholders for the foreseeable future.

The following table summarizes our consolidated capital position:

	March 31, 2021		December 31, 2020	
	Amount	**% of Total Capital**	**Amount**	**% of Total Capital**
	($ in thousands)			
Debt:				
Senior notes	$ 172,757	14.4 %	$ 172,689	14.8 %
Shareholders’ equity:				
Preference shares	52,421	4.3 %	52,398	4.5 %
Shareholders’ equity	976,996	81.3 %	941,344	80.7 %
Total shareholders’ equity	1,029,417	85.6 %	993,742	85.2 %
Total capital available to Watford	$ 1,202,174	100.0 %	$ 1,166,431	100.0 %

The future capital requirements of our business will depend on many factors, including our ability to write new business successfully and to establish premium rates and reserves at levels sufficient to cover losses. Our ability to underwrite is largely dependent upon the quality of our claims paying and financial strength ratings as evaluated by independent rating agencies. In particular, we require (1) sufficient capital to maintain our financial strength ratings, as issued by ratings agencies, at a level considered necessary by management to enable our key operating subsidiaries to compete; (2) sufficient capital to enable our underwriting subsidiaries to meet the capital adequacy tests mandated by regulatory agencies in Bermuda, the United States and other key markets; and (3) sufficient letter of credit and other credit facilities to enable Watford Re to post regulatory and commercially required letters of credit and other forms of collateral that are necessary for it to write business. For more information regarding the current status of our ratings, see “-Ratings” below.

To the extent that our existing capital is insufficient to fund our future operating requirements or maintain such ratings, we may need to raise additional funds through financings or limit our growth. However, we can provide no assurance that, if needed, we would be able to obtain additional funds through financing on satisfactory terms or at all. Adverse developments in the financial markets, such as disruptions, uncertainty or volatility in the capital and credit markets may result in realized and unrealized capital losses that could have a material adverse effect on our results of operations, financial position and our businesses, and may also limit our access to capital required to operate our business.

If we are not able to obtain adequate capital, our business, results of operations and financial condition could be adversely affected, which could include, among other things, the following possible outcomes: (1) potential downgrades in the financial strength ratings assigned by ratings agencies to our operating subsidiaries, which could place those operating subsidiaries at a competitive disadvantage compared to higher-rated competitors; (2) reductions in the amount of business that our operating subsidiaries are able to write in order to meet capital adequacy-based tests enforced by regulatory agencies; and (3) any resultant ratings downgrades could, among other things, affect our ability to write business and increase the cost of bank credit and letters of credit. In addition, under certain of the reinsurance agreements assumed by our reinsurance operations, upon the occurrence of a ratings downgrade or other specified triggering event with respect to our reinsurance operations, such as a reduction in surplus by specified amounts during specified periods, our ceding company clients may be provided with certain rights, including, among other things, the right to terminate the subject reinsurance agreement and/or to require that our reinsurance operations post additional collateral.

We have a total of 2,145,202 preference shares issued and outstanding, with dividends accruing at a floating rate. The holders of our preference shares have the option, at any time on or after June 30, 2034, to redeem their preference shares at the liquidation price of $25.00 per share. We have the right to redeem any or all of our remaining preference shares at the original purchase price of $25.00 per share at any time. The preference shares are listed on the Nasdaq Global Select Market.

On July 2, 2019, we completed a private offering of $175.0 million in aggregate principal amount of our 6.5% senior notes due July 2, 2029. The aggregate principal amount was in line with our then-current limit on Tier 3 capital credit under the BMA’s regulatory framework. Interest on our senior notes is paid semi-annually in arrears on each January 2 and July 2, which commenced on January 2, 2020. Affiliates of ACGL purchased $35.0 million in aggregate principal amount of our senior notes. The $172.3 million net proceeds from the offering were used to redeem a portion of our outstanding preference shares.

As a result of the issuance of our senior notes and the redemption of our preference shares, we incur interest expenses and a reduction of preference dividends, with the cumulative effect resulting in substantial savings in our combined interest and preference dividend expense.

In addition to the capital provided by the sale of our common shares, preference shares and senior notes, we may depend on external sources of financing to support our underwriting activities, such as bank credit facilities providing loans and/or letters of credit, as well as additional note issuances. As noted above, additional equity or debt financing, if available at all, may be on terms that are unfavorable to us. In the case of equity financings, dilution to our shareholders could result, and, in any case, such securities might have rights, preferences and privileges that are senior to those of our outstanding securities.

Ratings

Our operating subsidiaries, Watford Re, WICE, WIC and WSIC, each carry a financial strength rating of “A-” (Excellent) from A.M. Best. A.M. Best assigns 16 ratings to insurance companies, which currently range from “A++” (Superior) to “F” (In Liquidation). “A-” (Excellent) is the fourth highest rating issued by A.M. Best. The “A-” (Excellent) rating is assigned to insurers that have, in A.M. Best’s opinion, an excellent ability to meet their ongoing obligations to policyholders. Each of our operating subsidiaries also carries a financial strength rating of “A” from KBRA. KBRA assigns 22 ratings to insurance companies, which currently range from “AAA” to “D.” The “A” rating, KBRA’s sixth highest rating category, is assigned to insurers for which, in KBRA’s opinion, the insurer’s financial condition is sound and the entity is likely to meet its policyholder obligations under difficult economic, financial and business conditions. These respective ratings are intended to provide an independent opinion of an insurer’s ability to meet its obligation to policyholders and neither is an evaluation directed at investors.

The financial strength ratings assigned by A.M. Best and KBRA, respectively, have an impact on the ability of Watford Re to attract reinsurance clients, and also on the ability of our insurance subsidiaries to attract and retain program administrators, agents, brokers and insureds. The A.M. Best “A-” (Excellent) rating and KBRA “A” rating obtained by Watford Re, WICE, WIC, and WSIC are each consistent with our business plan and allow us to actively pursue relationships with the types of cedants, program administrators, agents, brokers and insureds targeted in our marketing plan.

In response to the unrealized, adverse mark-to-market impact on the valuation of our investment portfolios caused by the economic shutdown related to the COVID-19 global pandemic, A.M. Best and KBRA issued press releases noting potential future rating actions. In particular, on May 1, 2020, A.M. Best announced that it had placed the “A-” financial strength ratings of our operating subsidiaries “under review with negative implications.” In addition, A.M. Best also placed “under review with negative implications” the long-term issuer credit rating of “BBB-” and the long-term issuer credit rating of “BB” on our cumulative contingently-redeemable preference shares. On November 19, 2020, A.M. Best announced that it had maintained its “under review with negative implications” status for the “A-” financial strength rating of our operating subsidiaries. The designation of being “under review with negative implications” indicates that a previously-published rating has the potential for a near-term change (typically within six months) due to a recent event or abrupt change in the financial condition of the entity to which the rating applies. The rating remains under review until A.M. Best is able to determine the implications of the circumstances that facilitated the under review status, before making its final opinion. In addition, on June 17, 2020, after previously putting our ratings on “watch” status following the COVID-19 global pandemic-related impact to our investment portfolios, KBRA reaffirmed the “A” insurance financial strength ratings of our operating subsidiaries and revised the outlook for all of our ratings to negative. Further, following and as a result of our announcement that we had entered into the Merger Agreement, on October 9, 2020, KBRA announced that it had placed all of our ratings on “watch developing” status.

Underwriting, natural and man-made catastrophic events

The broader P&C insurance and reinsurance market in which we operate has long been subject to market cycles. “Soft” markets occur when the supply of insurance capital in a given market or territory is greater than the amount of insurance capital necessary to meet the coverage needs of the insureds in that market. When this occurs, insurance prices tend to decline and policy terms and conditions become more favorable to the insured. Conversely, there are periods when there is not enough insurance capital in the market to meet insureds’ needs, leading to a “hard” market during which insurance prices generally rise and policy terms and conditions become more favorable to the insurer.

In general, notwithstanding the prevailing global economic uncertainty related to the COVID-19 global pandemic, the current insurance and reinsurance market environment overall remains extremely competitive but is starting to show signs of hardening. Over the past several years, the industry has witnessed a gradual rate softening in response to a surplus of industry capital and a number of years of benign catastrophe activity. While the insurance and reinsurance market historically has been subject to pricing and capacity cycles, the overall market has not experienced true cyclicality in the period since the inception of our operations in 2014. However, due to recent property catastrophe losses, higher perceived social inflation, the reduction in risk free rates, and the uncertainty for the P&C business created by the COVID-19 global pandemic, pricing on certain product lines are firming and becoming more attractive on a risk adjusted basis.

In recent years, there have been certain product lines that have experienced a favorable hardening, such as U.K. and European motor insurance. The rates for these particular lines have been rising as a result of several years of higher than expected losses, as well as regulatory changes impacting loss costs. As rates and commensurate risk-adjusted returns have risen, we have increased our writings in those lines.

Since the formation of WICE, we have grown our U.K. motor insurance business. Gross premiums written generated by WICE for the three months ended March 31, 2021 and 2020 were $54.3 million and $51.7 million, respectively. The majority of such premiums relate to U.K. motor insurance.

We target a medium- to long-term, lower volatility underwriting portfolio with tightly managed natural catastrophe exposure in order to reduce the likelihood that our capital and/or liquidity position would be adversely affected by a catastrophe event. We seek to limit our modeled net PML, for property catastrophe exposures for each peak peril and peak zone from a modeled 1-in-250 year occurrence to no more than 10% of our total capital, which is less than most of our principal reinsurance competitors. As of March 31, 2021, our largest modeled peak peril and zone net occurrence PML was 4.1% of our total capital. Our conscious effort to limit our catastrophe exposure is designed to lower the volatility of our overall underwriting portfolio and to provide greater certainty as to future claims-related payout patterns and timing. Our casualty-focused underwriting portfolio’s payout pattern is slower than that of most competitors due to the longer tail lines of business we write, and that slower payout pattern provides us with the potential for greater investment income on those premiums.

While we seek to limit our exposure to catastrophic events to a level we believe is acceptable, given the liquidity profile of our underwriting portfolio and investment portfolios, we do assume meaningful aggregate exposures to natural and man-made catastrophic events. Catastrophes can be caused by various events, including hurricanes, floods, windstorms, earthquakes, hailstorms, tornadoes, explosions, severe winter weather, fires, droughts and other natural disasters. Catastrophes can also cause losses in non-property business such as workers’ compensation or general liability. In addition to the general nature of the risks inherent in writing property business, we believe that economic and geographic trends affecting insured property, including inflation, property value appreciation and geographic concentration, tend to generally increase the size of losses from catastrophic events over time.

We monitor our exposure to catastrophic events, including earthquake and wind and periodically reevaluate the estimated PML for such exposures. Our estimated PML is determined through the use of modeling techniques, but such estimate does not represent our total potential loss for such exposures. Net PML estimates are net of expected reinsurance recoveries, before income tax and before excess reinsurance reinstatement premiums. Such modeled loss estimates are reflective of the zone indicated and not the entire portfolio. Since hurricanes and windstorms can affect more than one zone and make multiple landfalls, our loss estimates include clash estimates from other zones. Our loss estimates do not represent our maximum exposures and it is highly likely that our actual incurred losses would vary materially from the modeled estimates. There can be no assurances that we will not suffer pre-tax losses greater than 10% of total capital from one or more catastrophic events due to several factors, including the inherent uncertainties in estimating the frequency and severity of such events and the margin of error in making such determinations resulting from potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques or as a result of a decision to change the percentage of shareholders' equity exposed to a single catastrophic event. In addition, our actual losses may increase if our reinsurers fail to meet their obligations to us or the reinsurance protections purchased by us are exhausted or are otherwise unavailable. Depending on business opportunities and the mix of business that may comprise our underwriting portfolio, we may seek to adjust our self-imposed limitations on PML for catastrophe-exposed business.

For more information regarding our current outlook related to the impact of the COVID-19 global pandemic on the insurance and reinsurance industry and our business, see "-Current outlook" above.

Contractual obligations and commitments

Lloyds letter of credit facility

On May 15, 2020, Watford Re renewed its letter of credit facility with Lloyds Bank Corporate Markets Plc, New York Branch (the "Lloyds Facility"). The Lloyds Facility amount is $100.0 million and was renewed through to May 16, 2021. Under the renewed Lloyds Facility, we may request an increase in the facility amount, up to an aggregate of $50.0 million. The principal purpose of the Lloyds Facility is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which we have entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from us 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 our 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, with which we were in compliance as of March 31, 2021 and December 31, 2020. At such dates, we had approximately $49.5 million and $47.9 million, respectively, in restricted assets as collateral for outstanding letters of credit issued from the Lloyds Facility, which were secured by certificates of deposit. These collateral amounts are reflected as short-term investments in our consolidated balance sheets.

Unsecured letter of credit facility

On September 17, 2020, Watford Re renewed and amended its 364-day letter of credit agreement with Lloyds Bank Corporate Markets Plc and BMO Capital Markets Corp. (the "Unsecured Facility"). The Unsecured Facility amount was reduced from $100.0 million to $50.0 million, and will be automatically extended for a period of one year unless canceled or not renewed by either counterparty prior to expiration. The principal purpose of the Unsecured Facility is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which we have entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from us 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 our business and the loss experience of such business. The Unsecured Facility requires the maintenance of certain covenants, as well as the making of certain representations and warranties that are customary for facilities of this type. At March 31, 2021 and December 31, 2020, we had $48.1 million and $49.9 million, respectively, in outstanding letters of credit issued from the Unsecured Facility, and were in compliance with the Unsecured Facility requirements.

Bank of America secured credit facility

On November 30, 2017, Watford Re amended and restated its $800.0 million secured credit facility (the “Secured Facility”) with Bank of America, N.A. through Watford Trust, which had originally been entered into in June 2015. On November 9, 2020, Watford Re elected to reduce the borrowing capacity to $440.0 million, under the terms of the amended and restated agreement. Watford Re owns all of the beneficial interests of Watford Trust. The Secured Facility expires on November 30, 2021 and is backed by a portion of Watford Re’s non-investment grade portfolio which has been transferred to Watford Trust and which continues to be managed by HPS pursuant to an investment management agreement between HPS and Watford Trust. The purpose of the Secured Facility is to provide borrowing capacity, including for the purchase of loans, securities and other assets and to distribute cash or any such loans, securities or other assets to Watford Re. Pursuant to this Secured Facility, the bank assigns borrowing or letter of credit capacity (or “advance rate”) for each eligible asset type held in the trust. Under our credit agreement, advance rates range from 100% for cash and 80% for certain first-lien loans to 40% for certain small-issue unsecured bonds.

Borrowings under the Secured Facility may be made at LIBOR or an alternative base rate at our option, in either case plus an applicable margin. The applicable margin varies based on the applicable base rate and, in the case of LIBOR rate borrowings, the currency in which the borrowing is denominated. In addition, the Secured Facility allows for us to issue up to $220.0 million in evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which we have entered into reinsurance arrangements. We pay a fee on each letter of credit equal to the amount available to be drawn under such letter of credit multiplied by an applicable percentage. The applicable percentage varies based on the currency in which the letter of credit is denominated.

The borrowings and outstanding letters of credit from the Secured Facility were as follows:

	March 31, 2021	December 31, 2020
	($ in thousands)	
Borrowings to purchase investments	$ 130,937	$ 130,937
Borrowings for underwriting collateral	24,750	24,750
Total secured credit facility borrowings	155,687	155,687
Outstanding letters of credit	28,156	28,156

The Secured Facility contains various affirmative and negative covenants. As of March 31, 2021 and December 31, 2020, Watford Re was in compliance with all covenants contained in the Secured Facility.

Custodian bank facilities

As of March 31, 2021 and December 31, 2020, we had borrowings of $94.9 million and $56.0 million, respectively, from our custodian banks to purchase investment securities. We pay interest based on LIBOR or the Overnight Bank Funding Rate (“OBFR”), plus a margin and the borrowed amount is payable upon demand. As of March 31, 2021, the total borrowed amount of $94.9 million included

4.8 million Euros, or EUR, (U.S. dollar equivalent of $5.7 million) to purchase EUR-denominated securities. We pay interest based on 3-month LIBOR plus a margin and the borrowed amount is payable upon demand. The foreign exchange gain or loss on revaluation on the non-U.S. dollar-denominated borrowed funds is included as a component of foreign exchange gains (losses) included in the consolidated statements of income (loss).

The custodian banks require us to hold cash and investments on deposit, or in an investment account with respect to the borrowed funds. At March 31, 2021 and December 31, 2020, we were required to hold $167.9 million and $96.3 million, respectively, in such deposits and investment accounts.

Senior notes

On July 2, 2019, we completed a private offering of $175.0 million in aggregate principal amount of our 6.5% senior notes, due July 2, 2029. Interest on the senior notes is paid semi-annually in arrears on each January 2 and July 2, which commenced on January 2, 2020. The senior notes are Watford Holding’s senior unsecured and unsubordinated obligations and rank equally with all of the other existing and future obligations of Watford Holdings that are unsecured and unsubordinated. We may redeem the senior notes at any time, in whole or in part, prior to July 2, 2024, at “make-whole” redemption price, subject to BMA requirements. The senior notes are redeemable, in whole or in part, at a redemption price equal to 100% of the principal amount, subject to BMA requirements, at any time after July 2, 2024. At March 31, 2021, the carrying amount of the senior notes was $172.8 million, presented net of unamortized debt issuance costs of $2.2 million. At December 31, 2020, the carrying amount of the senior notes was $172.7 million, presented net of unamortized debt issuance costs of $2.3 million.

Master confirmation of total return swap transactions

On August 13, 2018, Watford Re executed a Master Confirmation of Total Return Swap Transactions (the “Master TRS”) with Credit Suisse International (“CSI”) under the ISDA Master Agreement between Watford Re and CSI dated as of April 24, 2014. Under the Master TRS, we can from time to time execute total return swap transactions referencing loan obligations. The purpose of the Master TRS is to allow us to obtain leveraged exposure to loan obligations in a cash efficient manner. Since each transaction will be confirmed separately, the Master TRS is uncommitted and does not have a maximum facility size. Each confirmed transaction executed under the Master TRS will expire on the earlier of (i) the repayment date of the underlying reference loan or (ii) the date specified in the confirmation, which cannot be later than 360 days after the date of the confirmation, provided that each transaction will automatically extend for a further 360 days unless certain events have occurred. Under the terms of the Master TRS, we are required to post collateral to CSI under our ISDA Credit Support Annex with CSI to support our obligations under each transaction. The collateral will comprise an initial amount, determined on a transaction-by-transaction basis, plus an amount calculated on the basis of the daily mark-to-market value of the transaction. Under each transaction, CSI will pay to us an amount equal to the amounts received by a lender of the specified principal amount under the relevant reference loan and, if the transaction is terminated before the loan is repaid, an amount based on the change in market value of the loan. We have the option to terminate any transaction at will, subject to paying a break fee, and CSI can terminate transactions if certain events occur, including the unavailability of market prices for the relevant loan, CSI being unable to hedge the relevant transaction or certain changes of law or regulation.

Pledged and restricted assets

For the benefit of certain Arch entities and other third parties that cede business to us, we are required to post and maintain collateral to support our potential obligations under reinsurance contracts that we write. This collateral can be in the form of either investment assets held in collateral trust accounts or letters of credit. Under our credit facilities, in order for us to have the bank issue a letter of credit to our reinsurance contract counterparty, we must post investment assets or cash as collateral to the bank. In either case, the amounts remain restricted for the duration of the term of the trust or letter of credit, as applicable. See Note 13, “Commitments and contingencies” in our consolidated financial statements in Part I, Item 1 of this report for further details.

As of March 31, 2021 and December 31, 2020, we held $2.0 billion and $2.0 billion, respectively, in pledged assets in support of insurance and reinsurance liabilities as well as to collateralize our credit facilities. Included within total pledged assets, we held $7.7 million and $7.8 million, respectively, in deposits with U.S. regulatory authorities.

The following table summarizes our assets pledged as collateral for credit and letter of credit facilities and total return swap transactions, assets held in trust for underwriting transactions and regulatory deposits as of March 31, 2021 and December 31, 2020:

	March 31, 2021	December 31, 2020
	($ in thousands)	
Total investments held in trust as collateral for underwriting transactions and regulatory deposits	$ 974,389	$ 988,145
Total investments pledged for Secured Facility	776,194	791,230
Total investments pledged for custodian banks	167,853	96,260
Total investments pledged for Lloyds Facilities	49,494	47,891
Total investments pledged for Master TRS	67,742	67,116

Contractual obligations and commitments

The following table illustrates our contractual obligations and commitments by due date as of March 31, 2021 and December 31, 2020:

	Payments Due by Period				
	Total	**Less Than One Year**	**One Year to Less Than Three Years**	**Three Years to Less Than Five Years**	**More Than Five Years**
			($ in thousands)		
March 31, 2021					
Estimated gross payments for losses and loss adjustment expenses (1)	$ 1,568,243	400,258	533,811	269,597	364,577
Interest payments on senior notes (2)	96,688	11,375	22,750	22,750	39,813
Senior notes (2)	175,000	—	—	—	175,000
Revolving credit agreement borrowings (3)	250,579	250,579	—	—	—
Operating lease obligations	684	283	401	—	—
Total	$ 2,091,194	$ 662,495	$ 556,962	$ 292,347	$ 579,390
December 31, 2020					
Estimated gross payments for losses and loss adjustment expenses (1)	$ 1,519,583	$ 383,168	$ 518,927	$ 264,563	$ 352,925
Interest payments on senior notes (2)	96,688	11,375	22,750	22,750	39,813
Senior notes (2)	175,000	—	—	—	175,000
Revolving credit agreement borrowings (3)	211,640	211,640	—	—	—
Operating lease obligations	755	283	472	—	—
Total	$ 2,003,666	$ 606,466	$ 542,149	$ 287,313	$ 567,738

(1) The estimated expected contractual commitments related to the reserves for loss and loss adjustment expenses are presented on a gross basis (not reflecting any corresponding reinsurance recoverable amounts that would be due to us). As of March 31, 2021, the modeled duration of our claims reserves was approximately 4.2 years.

(2) On July 2, 2019 we completed a private offering of $175.0 million aggregate principal amount of our 6.5% senior notes due July 2, 2029. Interest on the senior notes is paid semi-annually in arrears on each January 2 and July 2, which commenced on January 2, 2020.

(3) Revolving credit agreement borrowings include borrowings from our custodian bank to purchase securities, which is payable on demand. Therefore we have assumed that these payments will be made within one year, but payment may occur over a longer period of time.

Reserves for losses and loss adjustment expenses represent our best estimate of the ultimate cost of settling reported and unreported claims and related expenses. As discussed previously, the estimation of loss and loss expense reserves is based on various complex and subjective judgments. Actual losses and settlement expenses we are ultimately required to pay may deviate, perhaps substantially, from the reserve estimates reflected in our financial statements. Similarly, the timing for payment of our estimated losses is not fixed and is not determinable on an individual or aggregate basis. The assumptions used in estimating the payments due by period are based on industry and peer-group claims payment experience. Due to the uncertainty inherent in the process of estimating the timing of such payments, there is a risk that the amounts paid in any period can be significantly different than the amounts discussed above. Amounts discussed above are gross of anticipated amounts recoverable from reinsurers. Reinsurance balances recoverable on reserves for losses and loss adjustment expenses are reported separately as assets, instead of being netted with the related liabilities, since having purchased reinsurance does not discharge us of our liability to policyholders. Reinsurance balances recoverable on reserves for paid and unpaid losses and loss adjustment expenses as of March 31, 2021 and December 31, 2020 totaled $291.5 million and $286.6 million, respectively.

Inflation

The effects of inflation are considered implicitly in pricing our contracts and policies through the modeled components such as demand surge. Loss reserves are established to recognize likely loss settlements at the date payment is made. Those reserves inherently recognize the effects of inflation. The actual effects of inflation on our results cannot be accurately known, however, until claims are ultimately resolved.

Off-balance sheet arrangements

We are not party to any transaction, agreement or other contractual arrangement to which an entity unconsolidated with us is a party that management believes is reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

Item 3. Quantitative and qualitative disclosures about market risk

We believe we are principally exposed to the following types of market risk:

- foreign currency risk;
- interest rate risk;
- credit spread risk;
- credit risk;
- liquidity risk; and
- political risk.

Foreign currency risk

Underwriting contracts and policies

Foreign currency rate risk is the potential change in value, income and cash flow arising from adverse changes in foreign currency exchange rates. We have foreign currency exposure related to non-U.S. dollar denominated contracts and policies. Of our gross premiums written from inception, $1.8 billion, or 42.3%, were written in currencies other than the U.S. dollar. For these contracts, non-U.S. dollar assets generally offset liabilities in the same non-U.S. dollar currencies resulting in minimal net exposure. As of March 31, 2021 and December 31, 2020, net loss and loss adjustment expense reserves included $562.8 million and $537.0 million, respectively, in foreign currencies.

Investments

We are exposed to foreign currency risk through cash and investments in loans and securities denominated in foreign currencies. Foreign currency exchange rate risk is the potential for adverse changes in the U.S. dollar value of investments (long and short) and foreign currency derivative instruments, which we may employ from a risk management perspective, due to a change in the exchange rate of the foreign currency in which cash and financial instruments are denominated. As of March 31, 2021 and December 31, 2020, our total net long exposure to foreign denominated investments represented 13.4% and 13.6% of our total investment portfolios of $2.6 billion and $2.5 billion, respectively.

The following table summarizes the net impact that a 10% increase and decrease in the value of the U.S. dollar against select foreign currencies in which we have written contracts and policies would have had on the value of our shareholders' equity as of March 31, 2021 and December 31, 2020:

	March 31, 2021	December 31, 2020
	(U.S. dollars in thousands, except per share data)	
Assets, net of insurance liabilities, denominated in foreign currencies, excluding shareholders' equity and derivatives	$ 107,762	$ 72,082
Shareholders' equity denominated in foreign currencies (1)	(34,391)	(33,889)
Net assets denominated in foreign currencies	$ 73,371	$ 38,193
Pre-tax impact of a hypothetical 10% appreciation of the U.S. dollar against foreign currencies:		
Shareholders' equity	$ (7,337)	$ (3,819)
Book value per diluted common share	$ (0.37)	$ (0.19)
Pre-tax impact of a hypothetical 10% decline of the U.S. dollar against foreign currencies:		
Shareholders' equity	$ 7,337	$ 3,819
Book value per diluted common share	$ 0.37	$ 0.19

(1) Represents capital contributions held in the foreign currency of WICE.

Although we generally attempt to match the currency of our projected liabilities with investments in the same currencies, from time to time we may elect to over or underweight one or more currencies, which could increase our exposure to foreign currency fluctuations and increase the volatility of our shareholders' equity. Historical observations indicate a low probability that all foreign currency exchange rates would shift against the U.S. dollar in the same direction and at the same time and, accordingly, the actual effect of foreign currency rate movements may differ materially from the amounts set forth above.

Interest rate risk

Our investment portfolios include interest rate sensitive securities, such as corporate and sovereign debt instruments and asset-backed securities. One key market risk exposure for any debt instrument is interest rate risk. As interest rates rise, the market value of our fixed income portfolio may fall, and the opposite is generally true when interest rates fall. Based on historical observations, there is a low probability that all interest rate yield curves would shift in the same direction at the same time. Furthermore, at times interest rate movements in certain credit sectors exhibit a much lower correlation to changes in U.S. Treasury yields. Accordingly, the actual effect of interest rate movements may differ materially from the amounts set forth in the following tables.

The following table estimates the impact that a 50 basis point and 100 basis point increase or decrease in interest rates would have had on the value of our investment portfolios as of March 31, 2021 and December 31, 2020:

(U.S. dollars in millions)	Interest Rate Shift in Basis Points -100	-50	0	+50	+100
March 31, 2021					
Total fair value	$ 2,618	$ 2,595	$ 2,572	$ 2,550	$ 2,531
Change from base	1.8 %	0.9 %	— %	(0.9)%	(1.6)%
Change in unrealized value	$ 46	$ 23	$ —	$ (22)	$ (41)
December 31, 2020					
Total fair value	$ 2,546	$ 2,522	$ 2,499	$ 2,478	$ 2,459
Change from base	1.9 %	0.9 %	— %	(0.9)%	(1.6)%
Change in unrealized value	$ 47	$ 23	$ —	$ (21)	$ (40)

Credit spread risk

We invest in credit spread sensitive assets, primarily debt assets. We consider the effect of credit spread movements on the market value of our fixed maturity investments, short-term investments, and certain of our other investments and the corresponding change in market value. As credit spreads widen, the fair value of our fixed income investments falls, and the converse is also true. Based upon historical observations, there is a low probability that credit spreads would change in the same magnitude across asset classes, industries, credit ratings, jurisdictions and individual instruments. Accordingly, the actual effect of credit spread movements may differ materially from the amounts set forth in the following tables.

The following table summarizes the effect that an immediate, parallel shift in credit spreads in a static interest rate environment would have had on the value of our investment portfolios as of March 31, 2021 and December 31, 2020:

(U.S. dollars in millions)	Percentage Shift in Credit Spreads -50%	-10%	0	+10%	+50%
March 31, 2021					
Total fair value	$ 2,660	$ 2,593	$ 2,572	$ 2,548	$ 2,441
Change from base	3.4 %	0.8 %	— %	(0.9)%	(5.1)%
Change in unrealized value	$ 88	$ 21	$ —	$ (24)	$ (131)
December 31, 2020					
Total fair value	$ 2,600	$ 2,523	$ 2,499	$ 2,473	$ 2,362
Change from base	4.0 %	0.9 %	— %	(1.0)%	(5.5)%
Change in unrealized value	$ 101	$ 24	$ —	$ (26)	$ (137)

Credit risk

Underwriting contracts and policies

We are exposed to credit risk from our clients relating to premiums receivable under our contracts and policies, and the possibility that counterparties may default on their obligations to us. The risk of counterparty default is partially mitigated by the fact that any amount owed to us from an insurance or reinsurance counterparty would be netted against any losses we would pay in the future. We monitor the collectability of these premiums on a regular basis.

Investments

Our investment strategy is to invest primarily in the debt obligations of non-investment grade corporate issuers. We rely upon our Investment Managers to invest our funds in debt instruments that provide an attractive risk-adjusted return, but the value we ultimately receive from these debt instruments is dependent upon the performance of the issuers of such obligations. In addition, the securities and cash in our investment portfolios are held with several custodians and prime brokers, subjecting us to the related credit risk from the possibility that one or more of them may default on their obligations to us. Our Investment Managers regularly monitor the concentration of credit risk with each broker and if necessary, transfer cash or securities among brokers to diversify and mitigate our credit risk.

Liquidity risk

Certain of our investments are, or may become, illiquid. Disruptions in the credit markets may materially affect the liquidity of certain investments including our Level 3 (non-quoted) assets, which, as of March 31, 2021 and December 31, 2020, represented 5.9% and 6.2% of our total investments, respectively. If we require significant amounts of cash on short notice in excess of anticipated cash requirements, which could include the payment of claims expenses or to satisfy a requirement of rating agencies in a period of market illiquidity, certain of our investments may be difficult to sell in a timely manner and may have to be sold or otherwise liquidated for less than what may otherwise have been possible under normal market conditions.

Political risk

We are exposed to political risk to the extent that we underwrite business from entities located in foreign markets; we operate through subsidiaries located in Bermuda, the United States and Gibraltar, and to the extent that our Investment Managers trade securities or assets that are originated, listed or traded in various U.S. and foreign markets. The governments in any of these jurisdictions could impose restrictions, regulations or other measures which may have a material impact on our investment strategy, the value of our investments and our underwriting operations.

We do not currently write political risk coverage in our insurance or reinsurance contracts; however, changes in government law and regulation may impact our underwriting operations.

Item 4. Controls and procedures

Evaluation of Disclosure Controls and Procedures

In connection with the filing of this Quarterly Report on Form 10-Q, our management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of disclosure controls and procedures as defined in Rules 13a-15(b) and 15d-15(b) of the Exchange Act, as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective as of the end of and during the period covered by this report with respect to information being recorded, processed, summarized and reported within time periods specified in the SEC's rules and forms and with respect to timely communication to them and other members of management responsible for preparing periodic reports of all material information required to be disclosed in this report as it relates to Watford Holdings and its consolidated subsidiaries.

We continue to enhance our operating procedures and internal controls to effectively support our business and our regulatory and reporting requirements. Our management does not expect that our disclosure controls or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. As a result of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issuances and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgements in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons or by collusion of two or more people. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. As a result of the inherent limitations in a cost-effective control system, misstatement due to error or fraud may occur and not be detected. Accordingly, our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the disclosure controls and procedures are met.

Changes in Internal Controls over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the fiscal quarter ended March 31, 2021 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. We have not experienced any material impact to our internal controls over financial reporting despite the fact that employees of the Company and of our service providers have had to work from home during the COVID-19 global pandemic, though we will continue to assess the impact on the design and operating effectiveness of our internal controls.

Part II. Other information

Item 1. Legal proceedings

Two lawsuits challenging the Merger have been filed in the Supreme Court of the State of New York, New York County. The first action was filed on January 20, 2021, captioned Canh v. Watford Holdings Ltd., et al., No. 650415/2021 (N.Y. Sup. Ct.) (which we refer to as the "Canh Action"). The second action was filed on January 25, 2021, captioned Ciccotelli v. Watford Holdings Ltd., et al., No.650544/2021 (N.Y. Sup. Ct.) (which we refer to as the "Ciccotelli Action"). Both lawsuits name us and our directors as defendants.

The Canh Action is a putative shareholder class action. The plaintiff claims to be a shareholder of our company. He asserts that our directors breached their fiduciary duties in connection with the Merger by, among other things, (i) agreeing to the merger and allegedly failing to obtain maximum value for our company in connection therewith; and (ii) allegedly failing to disclose certain purportedly material information relating to the Merger. The plaintiff alleges that we aided and abetted the directors' purported breaches of fiduciary duty. The plaintiff seeks, among other relief: (i) an injunction barring the Merger and ordering our directors to obtain an un-specified different transaction "in the best interest" of our company and our shareholders; (ii) rescission or rescissory damages in the event the Merger is consummated; (iii) a declaration that the directors have breached their fiduciary duties; (iv) an order directing us and our directors to account for damages; and (v) costs and fees in connection with the lawsuit.

The Ciccotelli Action is brought solely on behalf of the named plaintiff, who claims to be a shareholder of our company. The plaintiff asserts that our directors breached their fiduciary duties by allegedly failing to disclose certain purportedly material information relating to the Merger. The plaintiff alleges that we aided and abetted the directors' purported breaches of fiduciary duty. The plaintiff seeks, among other relief: (i) a preliminary and permanent injunction barring the Merger and directing the defendants to disseminate additional information relating to the Merger; (ii) rescission or rescissory damages in the event the Merger is consummated; (iii) a declaration that the directors have breached their fiduciary duties; and (iv) costs and fees in connection with the lawsuit.

Other potential plaintiffs may also file additional lawsuits challenging the Merger. The outcome of Canh Action, the Ciccotelli Action, and any additional future litigation is uncertain. Such litigation, if not resolved, could prevent or delay completion of the Merger and result in substantial costs to us, including any costs associated with the indemnification of directors and officers. One of the conditions to the closing of the Merger is the absence of any law, injunction or order by any governmental entity enjoining or otherwise prohibiting the consummation of the Merger. Therefore, if a plaintiff were successful in obtaining an injunction prohibiting the consummation of the Merger on the agreed-upon terms, then such injunction may prevent the Merger from being completed, or from being completed within the expected timeframe. The defense or settlement of any lawsuit or claim that remains unresolved at the time the Merger is completed may adversely affect our business, financial condition, results of operations and cash flows.

In addition, we, in common with the insurance industry in general, are subject to litigation and arbitration in the normal course of our business. Except as described above, as of March 31, 2021, we were not a party to any litigation or arbitration which is expected by management to have a material adverse effect on our results of operations and financial condition and liquidity.

Item 1A. Risk factors

Investing in our securities involves risks. For a discussion of the these potential risks or uncertainties, please see Part I—Item 1A—"Risk Factors" and Part II—Item 7—"Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended December 31, 2020 filed with the SEC (or our 2020 Annual Report), and Part I—Item

2—“Management’s Discussion and Analysis of Financial Condition and Results of Operations” in this report, in each case as updated by our subsequent periodic filings with the SEC.

There have been no material changes from the risk factors previously disclosed in Part I—Item 1A, “Risk Factors” of our 2020 Annual Report.

Item 2. Unregistered sales of equity securities and use of proceeds

In the first quarter of 2020, our board of directors authorized a share repurchase program, which allows us to make repurchases of up to $50 million of our common shares from time to time in open market or privately negotiated transactions. For more information, see Part I Item 2 “Management’s discussion and analysis of financial condition and results of operations—Liquidity and capital resources—Capital resources.”

During the three months ended March 31, 2021, we did not repurchase any of our common shares under our share repurchase program and approximately $47.1 million of unused share repurchase capacity remained available under our share repurchase program. However, we do not anticipate making any further repurchases under the share repurchase program due to the pending acquisition by HoldCo. In particular, the Merger Agreement generally prohibits us from repurchasing our shares as well as certain other securities prior to the consummation of the Merger or the earlier termination of the Merger Agreement.

	Issuer Purchases of Common Shares			
Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plan or Program
Beginning dollar amount available to be repurchased				$ 47,136
1/1/2021 - 1/31/2021	—	$ —	—	—
2/1/2021 - 2/28/2021	—	—	—	—
3/1/2021 - 3/31/2021	—	—	—	—
Total	—	$ —	—	$ 47,136

Item 3. Defaults upon senior securities

None.

Item 4. Mine safety disclosures

None.

Item 5. Other information

None.

Item 6. Exhibit index

Exhibit Number	Exhibit Description	Incorporated by Reference: Form	Incorporated by Reference: Original Exhibit Number	Incorporated by Reference: Date Filed	Filed Herewith
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				X
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				X
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002				X
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002				X
101	The following financial information from Watford Holdings Ltd.'s Quarterly Report for the quarter ended March 31, 2021 formatted in XBRL: (i) Consolidated Balance Sheets at March 31, 2021 and December 31, 2020; (ii) Consolidated Statements of Income for the three months ended March 31, 2021 and 2020; (iii) Consolidated Statements of Comprehensive Income for the three months ended March 31, 2021 and 2020; (iv) Consolidated Statements of Changes in Shareholders' Equity for the three months ended March 31, 2021 and 2020; (v) Consolidated Statements of Cash Flows for the three months ended March 31, 2021 and 2020; and (vi) Notes to Consolidated Financial Statements.				
104	Cover Page Interactive Data File (embedded within the Inline XBRL document)				

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

		WATFORD HOLDINGS LTD.
		(REGISTRANT)
		/s/ Jonathan D. Levy
Date:	May 10, 2021	Jonathan D. Levy, Chief Executive Officer
Date:	May 10, 2021	/s/ Robert L. Hawley
		Robert L. Hawley, Chief Financial Officer

Certification
of Chief Executive Officer
Pursuant to Section 302 of the
Sarbanes-Oxley Act of 2002

I, Jonathan D. Levy, certify that:

1. I have reviewed this Quarterly report on Form 10-Q of Watford Holdings Ltd.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in the report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
    a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
    b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
    c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
    d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrants most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and to the audit committee of registrant's board of directors (or persons performing the equivalent functions):
    a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely

affect the registrant's ability to record, process, summarize and report financial information; and

b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date:	May 10, 2021
By:	/s/ Jonathan D. Levy
Name:	Jonathan D. Levy
Title:	Chief Executive Officer

Certification
of Chief Financial Officer
Pursuant to Section 302 of the
Sarbanes-Oxley Act of 2002

I, Robert L. Hawley, certify that:

1. I have reviewed this Quarterly report on Form 10-Q of Watford Holdings Ltd.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in the report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
    a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
    b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
    c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
    d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrants most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and to the audit committee of registrant's board of directors (or persons performing the equivalent functions):
    a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely

affect the registrant's ability to record, process, summarize and report financial information; and

b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date:	May 10, 2021
By:	/s/ Robert L. Hawley
Name:	Robert L. Hawley
Title:	Chief Financial Officer

Exhibit 32.1

Certification Pursuant to Chapter 63, Title 18 United States Code §1350

As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the Quarterly Report of Watford Holdings Ltd. (the "Company") on Form 10-Q for the period ending March 31, 2021 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Jonathan D. Levy, as Chief Executive Officer of the Company, certifies pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. the Report fully complies with the requirements of section 13(a) of the Securities Exchange Act of 1934; and
2. the information contained in such report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date:	May 10, 2021
By:	/s/ Jonathan D. Levy
Name:	Jonathan D. Levy
Title:	Chief Executive Officer

A signed original of this written statement required by Section 906 or other document authenticating, acknowledging or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to Watford Holdings Ltd. and will be retained by Watford Holdings Ltd. and furnished to the Securities and Exchange Commission or its staff upon request.

Certification Pursuant to Chapter 63, Title 18 United States Code §1350

As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the Quarterly Report of Watford Holdings Ltd. (the “Company”) on Form 10-Q for the period ending March 31, 2021 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), Robert L. Hawley, as Chief Financial Officer of the Company, certifies pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. the Report fully complies with the requirements of section 13(a) of the Securities Exchange Act of 1934; and
2. the information contained in such report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date:	May 10, 2021
By:	/s/ Robert L. Hawley
Name:	Robert L. Hawley
Title:	Chief Financial Officer

A signed original of this written statement required by Section 906 or other document authenticating, acknowledging or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to Watford Holdings Ltd. and will be retained by Watford Holdings Ltd. and furnished to the Securities and Exchange Commission or its staff upon request.