Q4 2013 Earnings Call

Company Participants

- Dinos Iordanou, Chairman, President & CEO
- Mark Lyons, EVP, CFO & Treasurer

Other Participants

- Amit Kumar, Analyst
- Crystal Lu, Analyst
- Jay Gelb, Analyst
- John Hall, Analyst
- Josh Shanker, Analyst
- Mark Dwelle, Analyst
- Meyer Shields, Analyst
- Michael Nannizzi, Analyst
- Ron Bobman, Analyst
- Ryan Byrnes, Analyst
- Vinay Misquith, Analyst

Presentation

Operator

Good day, ladies and gentlemen. Welcome to the Fourth Quarter 2013 Arch Capital Group earnings conference call. My name is Dominique I will be your operator for today.

At this time all participants are in a listen-only mode. Later we will conduct a question-and-answer session. (Operator Instructions)

Before the Company gets started with its update management wants to first remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the federal securities laws. These statements are based upon management's current assumptions and assumptions and are subject to a number of risks and uncertainties.

Consequently actual results may differ materially from those expressed or implied. For more information on the risks and other factors that may affect future performance investors should review periodic reports that are filed by the Company with the SEC from time to time. Additionally, certain statements contained in the call that are not based on historic facts are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

The Company intends the forward-looking statements in the call to be subject to the Safe Harbor created thereby. Management also will make reference to some non-GAAP measures of financial performance. The reconciliation to GAAP and definition of operating income can be found in the Company's current report on Form 8-K furnished to the SEC yesterday which contains the Company's earnings press release and is available on the Company's website.

I would now like to hand the call over to Mr. Dinos Iordanou and Mr. Mark Lyons. Please proceed.

Dinos Iordanou {BIO 2397727 <GO>}

Thinks, Dominique. Good morning, everyone and thank you for joining us today.

We had excellent Fourth Quarter which capped off a very good year. And also we were very pleased that two weeks ago we finally closed on the CMG and PMI transactions. I will comment further on these acquisitions shortly but first let me share a few observations on our Fourth Quarter.

Earnings were solid and were driven by excellent reported underwriting results. On a consolidated basis our premium revenue grew by approximately 17% on a gross written basis and 22% on a net written basis although there were a few noteworthy items that I will get to in a few minutes.

On an operating basis we earned $1.12 per share for the quarter, which produced an annualized return of equity of 11.7% for the Fourth Quarter. For the entire year operating income was $4.39 per share which also represented an 11.7% return on equity. On a net income basis Arch earned $5.07 per share which corresponds to a 13.5% return on equity which is excellent in a year where investment returns on our fixed-income assets were challenged.

A reported underwriting results in the Fourth Quarter were excellent as reflected by a combined ratio of 85.3% and were aided by better-than-expected performance on catastrophe business, favorable loss reserve development and improved accident year performance in our insurance group operations primarily due to rate increases that we have seen over the last eight quarters and we are earning now. The underwriter returns for the entire year were also excellent at 85.9% combined ratio.

Net investment income per share on a sequential basis was flat for the quarter at $0.49 per share. Our operating cash flow for this quarter was $224 million, a $34 million increase from the same period a year ago.

The total return of the investment portfolio was 97 basis points for the quarter and 128 basis points for the full-year 2013 inclusive of fluctuations in foreign exchange rates. Our book value per common share at December 31, 2013, rose to 39.82% increasing by 3.9%sequentially and 10% relative to December 31, 2013.

In the primary markets which our insurance operations participate we continue to obtain rate increases above loss trend although I have to say in the Fourth Quarter they moderated somewhat relative to the Third Quarter. In our US insurance operations we achieved rate increases in the quarter that provides 80 basis points of expected margin improvement which was approximately half of what we experienced in 2013 Third Quarter.

Our US insurance operations represent approximately 80% of our premium volume in that sector. We continue to see our best opportunities in some sectors of the E&S market in our binding authority and program business which are predominantly small accounts. In these areas we have seen steady improvement in pricing and a steady gain in exposure units which contributed to our solid growth in the Fourth Quarter in the insurance group.

On the reinsurance side of the business we have seen a continuation of softening in terms and conditions that we noted in prior quarters. First, the property cat area is under pressure primarily due to the alternative capacity that has entered the market. For January 1 business we experienced approximately a 15% reduction in rates on a gross basis.

Also as we reported on last quarter's call cedents are aggressively requesting additional ceding commissions on quota share contracts and reinsurance buyers continue to shift business to excess of loss treaties in combination with requests for further rate reductions. These conditions create an environment of increased risk to reinsurance for potential negative arbitrage.

Cedents were both on insurance and reinsurance enterprise. Should we experience some pain in our reinsurance segment we stand to benefit from the improvement in terms offered on our insurance operations there were significant buyer of reinsurance.

From a production point of view net written premiums in the reinsurance segment grew by 36%. The increase in the reinsurance segment stems primarily from two significant treaties including a large unearned premium transfer along with premium growth in the mortgage space which in this quarter is included in the reinsurance segment results.

The insurance segment grew premium by 11.5% on a gross written basis and 14% on a net written basis. Growth in the US operations offset a strategic reduction in professional and indemnity contracts in our international operations.

Most of the business we write in national accounts and the construction segment are on a large deductible loss sensitive basis. They guaranty cost large account capacity market continues to be unattractive to us.

Group wide on an expected basis we continue to believe the ROE on the business we underwrote this year will produce an underwriting year ROE in the range of 11% to 13% with a slight improvement in the insurance group results offset by a slight deterioration in the reinsurance group due to lower cat rates. As I indicated in my opening remarks we are very pleased that we have entered the US mortgage insurance market through the purchase of CMG and PMI. As you may know, CMG has been in the business of providing mortgage insurance on a continuous basis since 1994 with approximately $100 million of annual premium volume catering exclusively to the credit union marketplace.

The access to this marketplace is done through CUNA Mutual employees who under a seven-year service agreement with us will continue to distribute mortgage insurance products to these clients on our behalf. Our objective is to expand our penetration in this sector and we believe that this operation will benefit from the financial strength of Arch which should further enhance our ability to better serve these clients.

As to the lenders channels previously serviced by the PMI operations we have nearly concluded the buildout of our national sales management infrastructure with 75% of our national sales managers already on staff and working hard. This team will focus their sales activity on the top 40 mortgage originators and will complement our regional EAR and ERISA sales management teams that will cater to regional and smaller banks.

This hiring activity took place over the past couple of quarters and was an advanced investment by us in important personnel. These proactive steps should enable us to accelerate our sales activity by at least one quarter.

Of course, some of the costs related to these actions were already reflected in our 2013 operating results. Beginning with the 2014 First Quarter we will be reporting the mortgage segment as a third business segment and for prior-year comparisons we will also give you the quarterly performance of our mortgage activities going back to 2013.

Before I turn it over to Mark, I would like to also discuss our PMLs. As usual I would like to point out that our cat PML aggregates reflect business bound through January 1 while the premium numbers included in our financial statements are through December 31 and that the PMLs are reflected net of all reinsurance in retro sessions.

As of January 1, 2014, our largest 250 year PML for a single event decreased slightly to $801 million in the Northeast representing approximately 15% of common equity shareholders while the Gulf PMLs also decreased to $670 million and our Florida Tri-County PML now stands at $566 million. With that I will turn it over to Mark to comment further on our financial results and then after Mark we will entertain your questions. Mark?

Mark Lyons {BIO 6494178 <GO>}

Great. Thank you, Dinos. Good morning everyone. I have a bit of a cold so hopefully you guys will bear with me.

The consolidated combined ratio for this quarter was 85.3% with 2 points of current accident year cat related events net of reinsurance to reinstatement premiums compared to the 2012 Fourth Quarter combined ratio of 112.4%, which reflected 25.8 points of cat related events. Cat losses occurring in the 2013 Fourth Quarter represented $16.8 million net of reinsurance recoverables or reinstatement premiums mostly due to the Illinois tornado and other smaller events.

The 2013 Fourth Quarter consolidated combined ratio also reflected 7.9 points of prior-year net favorable development compared to 7 points of prior-period favorable development in the 2012 Fourth Quarter. Over 90% of this net favorable development in the quarter was from the reinsurance segment with approximately 60% of that due to net favorable development, longer tail lines spread relatively evenly over many underwriting years but particularly in the 2003 to 2007 underwriting years.

The remaining 40% of the reinsurance segments net favorable development was attributable to shorter tail lines associated with the more recent underwriting years. The remaining aggregate 10% of favorable development in the quarter was emanated from the insurance segment and was mainly driven by shorter tail lines predominantly from the more recent accident years.

Similar to prior periods, approximately 69% of our total net reserves or losses and loss adjustment expense was $7.1 billion our IBNR or additional case reserves, which is a fairly consistent ratio across both the reinsurance and the insurance segments over time. The insurance segment accounts for 63% of the total loss and LAE reserves as of yearend 2013.

Therefore reflecting those the current accident year, accident quarter consolidated combined ratio excluding cats for the Fourth Quarter was 91.2% compared to 93.6% in the Fourth Quarter of 2012. On a year-to-date consolidated basis the 2013 calendar year produced an 85.9% combined ratio on a reported basis compared to 95.4% for 2012 resulting in a $309 million improvement in underwriting income and primarily reflecting the lower level of catastrophic activity compared to 2012.

The 2013 full year expense ratio increased by 50 basis points which was driven by a 60 bps increase in the acquisition expense ratio offset by a 10 point improvement in the operating expense ratio relative to full calendar year 2012. The 2012 year, as you may recall, already had its operating expense ratio improved by 50 basis points over the prior year 2011.

The full accident year 2013 combined ratio excluding cats was 91.3% compared to the accident year's 2012's full year combined ratio excluding cats at 94% which represented 270 basis point improvement. Overall, on a consolidated basis the full 2013 year saw $327 million of gross written premium growth, or 8.5% and roughly $300 million, or almost 10% on a net basis.

The insurance segment grew net written premiums by nearly 7% and the reinsurance segment by 14% for the full year of 2013. Also on a consolidated basis the ratio of net premium to gross premium in the 2013 Fourth Quarter was 78.4% compared to 75.3% a year ago. In the reinsurance segment the net-to-gross ratio was 96.2% in the quarter compared to 92.3% a year ago primarily due to changing mix of business on a written basis.

The insurance segment had a 69.2% net-to-gross ratio compared to 67.7% a year ago predominantly as a result of that ongoing strategy to grow the lesser volatile, smaller account businesses and reduce our exposure in the higher severity businesses. In the reinsurance segment the 2013 accident quarter combined ratio excluding cats was 84.0% compared to 83.9% in the corresponding quarter a year ago. The reinsurance segment results this quarter reflect changes in the mix of business on a net written business with a higher contribution from casualty and other specialty and a lower relative contribution from property, cat, marine and aviation in the Fourth Quarter of 2012.

The casualty growth primarily reflects one large professional alliance treaty, which Dinos had mentioned, which included an unearned premium transfer that is reflected as a one-time written premium increase in addition to ongoing subject new and rental business. The full 12-month accident year combined ratio excluding cats for the reinsurance segment was 82.2% compared to 83.3% for the full 2012 accident year, which represents a 110 basis point improvement.

In the insurance segment the 2013 accident quarter combined ratio excluding cats was 96.4% compared to 100.4% a year ago. The Fourth Quarter of 2013 showed a 60 bps reduction in the expense ratio with the acquisition expense ratio increasing by 50 bps which was more than offset by a 110 basis point reduction in the operating expense ratio.

The full 12-month 2013 accident year combined ratio excluding cats for the insurance segment was 97.4% compared to or 100.7% combined ratio for the full 2012 accident year, a 330 basis point improvement. As respects pricing levels, the US insurance operation achieved a 3.8% weighted average effective rate increase on a gross written basis for the Fourth Quarter, which produced an additional margin expansion of 80 basis points over the Fourth Quarter of 2012. These figures represent the excess of written effective rate increases over estimated loss trends and provide continuing evidence of additional margin expansion although the degree of expansion is shrinking.

Margin expansion continued in our program, casualty, excess Worker's Compensation and A&H businesses while contracting marginally in healthcare, surety and some executive assurance units. It is important to note that these are gross effective rate changes and with the recent softening in the reinsurance marketplace the net economics have improved more so than the gross economics in various areas.

As one example, the US Insurance Group's E&S property division, which was able to secure significant improvements in their cat treaty, had a minus 0.5% effective rate decrease for the Fourth Quarter on a gross basis. But after reflecting the impacts of the improved cat treaty, the net estimated rate change was plus 6%, or a 650 basis point swing to the good.

This one division's net impact was enough to increase the US total aggregate effective rate change by 30 basis points from 3.8% to 4.1% and provides a better measure of true underlying margin expansion of roughly 110 basis points. Specialty casualty, Workers Comp and national account businesses have now experienced 11 consecutive quarters of rate increases whereas our executive assurance middle-market and alternative asset protection books along with our retail construction division have each experienced 10 consecutive quarters of increases. Furthermore, the excess work comp unit has now enjoyed 9 consecutive quarters of rate increases.

Reported net investment income in the 2013 Fourth Quarter was $0.49 per share substantially unchanged from the 2013 Third Quarter but less than the $0.53 per share in the corresponding quarter of 2012. The difference from the Fourth Quarter of 2012 is attributable to a reduction of investment income from fixed-income securities and increase in investment expenses on a year-over-year basis.

However, this quarter's investment expenses are consistent with the first nine months of 2013. Our embedded pretax book yield before expenses was 2.38% as of December 31, 2013, compared to 2.41% at September 30. The duration of the portfolio shortened slightly this quarter to 2.62 years from 2.83 years as of September 30.

As Dinos mentioned, the total return on the portfolio was 97 bps in the 2013 Fourth Quarter. We had equities and the high-yield corporate bond augmenting the returns on our core investment grade fixed-income portfolio.

Excluding foreign-exchange total return was 85 basis points in the quarter. The full-year 2013 total return on the portfolio was 1.28% including the effects of foreign exchange compared to 5.88% for the full 2012 year. Excluding foreign-exchange the full 2012 year total return was 1.13% compared to 5.59% for the full 2012 year.

Our effective tax rate on pretax operating income for the Fourth Quarter of 2013 was an expense of 8.3% and the full year 2013 was an expense of 4.8% versus a benefit of 3.8% for the full year 2012. As always fluctuation in the effective tax rate can result from variability in the relative mix of income or loss reported by jurisdiction.

The increase in the Fourth Quarter's tax rate on a pretax operating income was predominantly driven by a valuation allowance that was established against our Canadian operations deferred tax asset. This valuation allowance stems from operating losses coincident with structural change effective 1/1/2013 that altered our Canadian operations from being a branch of a US entity to a full Canadian domestic company.

Our total capital was $6.55 billion at the end of the 2013 Fourth Quarter compared to $5.84 billion at the end of the 2013 Third Quarter and $5.57 billion at yearend 2012. This represents a $704 million increase in capital from the Third Quarter end and a $979 million increase in capital relative to yearend 2012.

This full-year 2013 increase in capital is primarily driven by $688 million of net income available to common shareholders partially offset by approximately $209 million of unrealized losses, share repurchases and foreign translation adjustments along with the $500 million of senior notes we issued this quarter. This new debt has a 30 year tenor with a fixed rate 5.144% coupon and was issued at par. This coupon represents 130 basis point spread over the referenced 30 year treasury and effect on the date of execution which was December 13, 2013.

These notes were issued by Arch Capital Group US Inc. and are unconditionally guaranteed by the Company. The proceeds were used to fund the acquisition of the CMG and PMI mortgage insurance operations discussed already by Dinos and are also available for other general corporate purposes.

As a result our capital structure at yearend 2013 is comprised of 13.7% debt, 5% preferreds and 81.3% common equity. At the end of 2013 we continue to estimate having capital in excess of our targeted capital position. As Dinos has also mentioned book value per share increased nearly 4% in the Fourth Quarter to $39.82 and up 10% from yearend 2012's book value of $36.19.

Again driven by the Company's continued strong underwriting results. So with these introductory comments we're now pleased to take your questions.

Questions And Answers

Operator

(Operator Instructions) Amit Kumar, Macquarie Capital.

Q - Amit Kumar {BIO 15025799 <GO>}

Congrats on another strong quarter. Just if you follow up on the MIPS because I guess that's the most exciting piece right now. First of all, would you help us in terms of framing out what you believe the market opportunity is in terms of how you are thinking about the total mortgage originations and what share, what private MIs have of that?

A - Dinos Iordanou {BIO 2397727 <GO>}

Well you have a multiple part question but I will try to frame it in broad terms and then maybe Mark can get more specific to it, but first and foremost the CMG is no change in the marketplace. CMG has been operating since 1994 so in essence us acquiring that entity will transfer that $100 million or so volume over to us while PMI's still underwriting as of 2011, and therefore all of that production will be new to us. Now to size the market, there is only 7, 8 competitors in the market and the FHA. The FHA roughly has about half the market today, is continuing to depopulate that as more and more private capital is assuming the risks.

So we believe there is quite a bit of room in us expanding in that area. And the third point I will make, also both Fannie and Freddie through their stacker and Connecticut Avenue Security transactions, they are putting more of the credit risk to the private markets especially for mortgages that fall below the -- have a higher than 20% down payment that they are not required by law to purchase direct mortgage insurance.

But they are in protecting their books Fannie and Freddie purchased that on a bulk basis. So I don't know how best to describe the market to you but we believe it's a good opportunity and a strongly capitalized company like Arch Mortgage will be a welcome addition to the marketplace with enough room for us to grow.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. I don't know if Mark has anything to add to that?

A - Mark Lyons {BIO 6494178 <GO>}

Not too much. As you know, if you split this thing by channel is how we look at it, the credit union space we would have now that the acquisition is closed, 45% market share perhaps that could go a little north. We'd like to protect that, perhaps marginally increase it over the short term and over the longer term on the lender or bank channel we certainly hope to get to a double-digit market share three years down the line or so.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. And the lender channel is through PMI, right?

A - Mark Lyons {BIO 6494178 <GO>}

That's correct.

A - Dinos Iordanou {BIO 2397727 <GO>}

Well the old PMI. There is no PMI. It will be --

A - Mark Lyons {BIO 6494178 <GO>}

Mostly on paper.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. Because I am looking at some statistics and it shows CMG at least having currently a 3% market share but that's in the traditional private MI business.

A - Mark Lyons {BIO 6494178 <GO>}

Right, that's 3% of the total. I was quoting of the channel itself. 45% of the credit union channel.

Q - Amit Kumar {BIO 15025799 <GO>}

How much would that equate to in terms of the overall market? Like what would the 3% look like?

A - Mark Lyons {BIO 6494178 <GO>}

The inverse of what you just said.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. Sorry, go ahead.

A - Mark Lyons {BIO 6494178 <GO>}

The 45% of the credit union channel is 3%, 3.5% of the aggregate channel.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. I guess the only other question I have, and I will stop, is I know in the past you talked about sort of a mid-teen return on this. Has that thought process changed and what would be -- I don't know if a capital charge is the right word, how should we think about capital versus MI versus capital deployment in other avenues? Thanks.

A - Dinos Iordanou {BIO 2397727 <GO>}

No, our prospect of ROE has not changed. We still believe that these high mid-teen ROE-type of business on -- while you are at risk to capital is about 18 to 1.

Probably over time that will get further down depending what the regulators will do to probably 15 to 1. But for the time being it is 18 to 1 and we do like that business. Of course it will take some time for us to get to a steady state, probably three years as Mark said, and then the real accretion to our ROE will start happening at that point in time.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. In three years accounting, so 2016 is the first year, right?

A - Dinos Iordanou {BIO 2397727 <GO>}

No, mid-2014 is kind of the first year because the sales forces just about now. We won't be writing a lot on the old PMI platform until probably Third Quarter of this year.

It takes time to get the book policies in place and then you start receiving the flow from the originators. In the small banks and regional business a little faster, on the national mortgage originators a little longer because they have to go through the vendor management routines and it takes a bit of time.

We try to accelerate that in anticipation of the close and we had people working on it in the Fourth Quarter and of course in this First Quarter. But our success is mostly now with the smaller and regional banks because the process is a little easier and we are gravitating to the large originators.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. I'll stop here. Thanks for all the questions and good luck for the future.

Operator

Jay Gelb, Barclays.

Q - Jay Gelb {BIO 21247396 <GO>}

Just wanted to touch base on the 11% to 13% accident year return on equity target. With primary commercial rates peaking and reinsurance rates softening what do you feel will be able to continue to drive that over time?

A - Dinos Iordanou {BIO 2397727 <GO>}

Jay, depends on what happens going forward. Don't forget if everything remained steady, let's say we just, we barely -- if we say the rate increases we achieve in the future are only good enough to cover loss cost trend then your ROE will unless you allow your capital to build up excessively, it will remain constant in that range, right?

So we haven't seen that change. As a matter fact even though rates -- rate increases have moderated a bit, it is still above loss cost trend not by as much as 150 or 170 basis points we saw maybe two quarters ago, but 80 basis points as we saw in the Fourth Quarter, so it will depend on that. But right now we are very confident about the business we write it will generate that kind of return on equity.

Q - Jay Gelb {BIO 21247396 <GO>}

If market conditions were to deteriorate worse than expected next year can you talk about Arch's ability to pull back on volume?

A - Mark Lyons {BIO 6494178 <GO>}

Before you go there, this is your question along with some of Dino's answer. Remember, we're quoting you these margin expansion numbers on a written basis. So a lot of it is baked into 2014 already because of what was done in the four quarters of 2013.

So even if you had the assumption of 2014 being a 0 margin expansion you can pretty much figure out, barring unusual capital of cats and things of that nature, you could arithmetically pretty much get to a strong insurance result.

A - Dinos Iordanou {BIO 2397727 <GO>}

Yes, the earned premium comes later on than the written premium. So the 2014 is baked, if you have a change it will affect 2015 and beyond.

But I can't predict the future if we are going to have a change. The math is pretty easy. Depends how many -- if you're gaining margin expansion or if you're losing it.

Our ability, which is your second question, to navigate through these markets all you got to do is look at our history. Even in today's market that predominantly we like on the insurance group we have in our European operations, we have reduced significant volumes in the professional indemnity space because we just don't like the what's happening in that particular -- too much competition, too many players and we're not getting rate increases above trend so in essence that will deteriorate and we don't like to be playing in spaces that the economics get worse.

Q - Jay Gelb {BIO 21247396 <GO>}

Right, okay. Then can you just update us on your thoughts around share buyback given the growth opportunities in areas like mortgage insurance? You said in the past that we shouldn't look for much in the way of share buybacks but just wanted to confirm that that was still your current thinking.

A - Dinos Iordanou {BIO 2397727 <GO>}

Yes, our current thinking hasn't changed. We will maintain a bit of access capital as cushion. That's always been our philosophy.

And we continue to look for opportunities to deploy capital in our business. But absent of good opportunities we'd probably revert back to share buybacks if we are accumulating excess capital at a faster pace than we need to have.

Q - Jay Gelb {BIO 21247396 <GO>}

Okay. Thanks very much.

Operator

Michael Zaremski, Credit Suisse.

Q - Crystal Lu {BIO 21493547 <GO>}

Hi. Good morning. This is Crystal in for Mike today.

My first question is can you elaborate on the Watford Re fund? If you can't comment on the potential size of the fund and the impact to the financials perhaps you can discuss its strategy which appears to be casualty lines focused where it's most third-party funds in the marketplace are property focused.

A - Dinos Iordanou {BIO 2397727 <GO>}

What we have announced in January is we have agreed in principle to act as a reinsurance manager, reinsurance underwriter for Watford Re. We are just going to be a new multiline Bermuda reinsurer fully rated and Highbridge Principal Strategies will act as the investment manager of the Watford Re.

The venture is not yet finalized so we're limited as to what we can say about it. But they are in the middle of capital raising so we can't comment on that.

On the conceptual thing, think of this as a kind of a semi-virtual company. It will have its own management, a CEO, a CFO, a Chief Risk officer, underwriters to do underwriting reviews per se on our activities. Then the bulk of the underwriting activity will be done by the Arch employees and the Arch underwriting system and the investment operations will be done by Highbridge Principal Strategy.

Both of us are, Highbridge and Arch, is bound contractually for a long time to provide those kind of services. So that's the principle concept of the facility.

Q - Crystal Lu {BIO 21493547 <GO>}

Okay. Thank you. That's very helpful.

Operator

Michael Nannizzi, Goldman Sachs.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Maybe, Dinos, have you talked about how much capital right now is at the -- is in the MI?

A - Dinos Iordanou {BIO 2397727 <GO>}

In the MI space?

Q - Michael Nannizzi {BIO 15198493 <GO>}

No, that you have pushed down into CMG in order to write business.

A - Dinos Iordanou {BIO 2397727 <GO>}

CMG is capitalized, we just bought the entity. Our financial strength will, as a matter fact they are under review by the rating agencies to, they're a triple minus with a positive outlook, triple-B-minus with a positive outlook based on waiting for the closing of the transaction.

So we expect a significant balance on the credit rating of that facility. But we are going to be adding capital to it to maintain adequate capital ratios and depending on their production we will continue maintaining adequate capital. Mark, do you want to -- ?

A - Mark Lyons {BIO 6494178 <GO>}

To the extent, if you're real question, Michael, is emanated from consideration at closing, which is a little different than ongoing capital base --

Q - Michael Nannizzi {BIO 15198493 <GO>}

No, my question is as we're thinking about the earnings power here, how should we think about insurance in force? How should we think about whether or not you feel like you need to contribute capital related to potential changes to the GFC standards or anything of the like?

I'm just trying to figure how much is in there? How much business do you think you're going to write so we can start to think about what sort of ROEs this business is going to be able to generate and when.

A - Mark Lyons {BIO 6494178 <GO>}

I understand the underlying premise in your question but we don't know to what extent we're going to be penetrating that lender market. As Dino says that is not going to get any traction until midyear and then get the monthly streams behind it.

But it is clear that we are going to be whatever the capital standards are that come out, as Dino said, it is approximately 18 to 1 now and get stiffened over time, that's what we are going to need to do. But that will be a function of the actual rate on which we put on these exposures.

A - Dinos Iordanou {BIO 2397727 <GO>}

And you've got to understand, Michael, that based on our agreements with Fannie and Freddie at the beginning we will probably be a bit over capitalized because we have contributed in our MI operations approximately $350 million, $400 million. That doesn't limit what we do in the US.

Also this is part of the things that we do overseas. You're going to get a lot more clarity on this on the First Quarter when we are going to start reporting the segments individually and then you can build your models after that.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. Okay, would it be possible to get insurance in force just as a kind of ballpark at this point, or do you want to wait until --?

A - Dinos Iordanou {BIO 2397727 <GO>}

Right now I think the risk to capital ratio is closer to 10 to 1.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay.

A - Dinos Iordanou {BIO 2397727 <GO>}

So it's not going to -- this is what it looks like now to us. And that will start going up as we produce more business but it will take probably a couple of years, maybe three years before we get to the point that we have enough production and then we need to add additional capital in order to support the proper capital ratio.

A - Mark Lyons {BIO 6494178 <GO>}

And one way to think about that in rough terms, in round numbers, because it's closed, CMG has roughly $5 billion at risk in force. So if you use the 18 to 1 that Dinos just talked about, that translates to about $280 million, $275 million of implied capital needs, that's arithmetically as opposed to GFC requirements. That assumes 100% of it is kept on shore as well, which is likely not the case, but anyway I'm just giving you --

Q - Michael Nannizzi {BIO 15198493 <GO>}

That's great. That's what I was looking for. Thank you.

Then just last one. The marginal tax rate on the MI business, will that be different from your consolidated tax rate or do you expect it to be similar?

A - Mark Lyons {BIO 6494178 <GO>}

It should be marginally higher because there may be a difference in the quarter share percentage.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. Great.

Then last question if I could offer this topic, I guess one question I have is obviously you are seeing a lot of flux on the reinsurance side and it seems like you are prepared to move capacity into the insurance market and particularly probably there are some opportunities on the E&S side and as a buyer reinsurance challenging, or competitive reinsurance conditions are helpful. But at what point do you see or could we see others employ that same strategy of just kind of lifting the capital out of the reinsurance market and moving it into the insurance market and kind of bringing that situation with them? Is that something you think about?

A - Dinos Iordanou {BIO 2397727 <GO>}

I can't talk about others because I don't know what they're going to do. First of all, if you have a structure like Arch, which you have businesses in both segments you have the opportunity to do it.

If you are a pure reinsurer you don't have the opportunity to do that because if you are lacking insurance operations you've got to stick with what you have. Having said that it is the willingness of managements to decide as to where they're going to allocate capital and in which segments.

Even in the insurance segment we don't have a lot of liking on the large accounts business where rates are today especially if they are written on a guaranteed cost basis. If you eliminate loss sensitive type of transactions that it is less underwriting risk and more service oriented type of business.

Predominantly we're focusing on very tiny binding authority business and small accounts across the board not only in our program business or our binding authority business but also in what we do throughout the world. And that is also a focus of our reinsurance operations as reinsurers of underlying businesses. They still look for the small, medium-size type of accounts to reinsure.

A - Mark Lyons {BIO 6494178 <GO>}

And let me just add, Michael, don't view this as a panacea of moving capital from reinsurance to insurance. We just got done quoting that the full accident year was about 83 combined for the reinsurance group.

They've worked hard to be well diversified. So although there's focus on cat, cat is clearly not the only game in town.

That's a 17% return on revenue right there. So it's not -- the sky isn't falling.

A - Dinos Iordanou {BIO 2397727 <GO>}

It's definitely clear that when things are getting more challenging especially in the reinsurance business, talent will make a difference and discipline will make a difference and I think our track record speaks for itself. We have terrific underwriting teams in our reinsurance group, and I think they're as disciplined as they come.

I do have a management tool that I got from my father, it's a Louisville Slugger, but I only keep it in the corner of my office because I never have to use it. These guys are more disciplined than I am.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Thank you very much for the answers.

Operator

Josh Shanker, Deutsche Bank.

Q - Josh Shanker {BIO 5292022 <GO>}

Dinos, what happens if there's an Andrew or a Katrina and with all this collateralized paper are there no second event covers out there? Does the industry suddenly scramble for protection on day two?

A - Dinos Iordanou {BIO 2397727 <GO>}

It depends what these facilities that have the collateralized paper will do. Are they going to ante up additional capital so they can participate? Or I don't know the answer to it.

You can have different scenarios as to what's going to happen. For example if I'm a buyer on a retro plan of collateralized capital and I have a major event, I am not releasing that collateral until I know exactly who -- that I get paid for my losses. So in essence if they want to reload and participate it is up to them but I don't know what that reaction is going to be at that point in time.

Q - Josh Shanker {BIO 5292022 <GO>}

In terms of your buying are you buying protection at this point with collateralized paper more so than rated paper or how do you view the trade-off there?

A - Dinos Iordanou {BIO 2397727 <GO>}

We buy both. We buy both and we model things out and we believe if we can have a good purchase we don't really care if it's traditional or fully collateralized.

Q - Josh Shanker {BIO 5292022 <GO>}

And is there reversal expected for this Canadian tax charge in 2014? Is this one time or does it get earned back through the other direction in the future?

A - Mark Lyons {BIO 6494178 <GO>}

That's a good question and you kind of answered it yourself. This is not a write-off.

This is a valuation allowance against the deferred tax asset. So depending upon revaluations periodically and if performance is good in 2014 you start to see the unwinding of that.

A - Dinos Iordanou {BIO 2397727 <GO>}

Not in 2014, you see unwinding of that in 2015 and beyond.

A - Mark Lyons {BIO 6494178 <GO>}

We'll call it a reevaluation allowance.

Q - Josh Shanker {BIO 5292022 <GO>}

Okay, perfect. Thank you very much.

Operator

Vinay Misquith, Evercore.

Q - Vinay Misquith {BIO 6989856 <GO>}

So the first question is on the debt. A little surprised that you took on debt because I thought that you guys were sitting on a lot of excess capital. Could you help us understand that decision please.

A - Dinos Iordanou {BIO 2397727 <GO>}

Well we do. But don't forget it was attractive terms especially on a net basis.

So we said all along that we kept a very conservative balance sheet to give us those kind of opportunities. We felt we can raise at attractive churns and in the right jurisdiction.

So we chose a path and maybe we have a bit of excess capital beyond what we had before. But we also have the opportunity to deploy it in other business and there is a few things that we are working on. And if that doesn't materialize we can always return it to shareholders.

A - Mark Lyons {BIO 6494178 <GO>}

Just to amplify that, Vinay, saying it's attractively priced, it's tax-deductible, we tended to want to raise it in the jurisdiction where it is going to be deployed. And as a general statement we don't really like to trap capital if we can get away with it.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. The second question is on the opportunity in the mortgage insurance space. I believe you said that you don't want to get more than about 20% of your capital. In the next three years where do you think, how much of capital do you think you will be able to deploy right now?

A - Dinos Iordanou {BIO 2397727 <GO>}

Not enough to even get as close to 20%. We just said we have put in about $400 million, we are about 10 to 1 right now. It has a lot of room to get to 18 to 1.

If we are very successful probably you are looking out three years out before we need -- and don't forget I can't even predict what my balance sheet is going to look three years out but I can tell you we will have a lot more than $560 billion of common equity. So the 20% it will take quite a bit of time.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay.

A - Dinos Iordanou {BIO 2397727 <GO>}

We didn't say we want to be 20% tomorrow we said we will work on the opportunities the market gives us and we are going to try to build it but from a risk management point of view we didn't want to deploy more than 20%. And of course there is other ways to deploy capital as you have seen with our activity at Watford.

Q - Vinay Misquith {BIO 6989856 <GO>}

But just looking in terms of the capital that you are looking at deploying (multiple speakers).

A - Dinos Iordanou {BIO 2397727 <GO>}

Within the Arch balance sheet, yes.

Q - Vinay Misquith {BIO 6989856 <GO>}

Right. So do you think that the mortgage insurance operation you could maybe do about $1 billion in terms of capital deployed in the next two to five years?

A - Dinos Iordanou {BIO 2397727 <GO>}

Maybe five years out, but not in the two to three years.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. All right. The last question is on the ROE.

Looking at the 11% to 13% underwriting your ROE, trying to translate that into GAAP ROE and other deviates in the balance because you got excess capital. Could you help us understand this difference?

A - Dinos Iordanou {BIO 2397727 <GO>}

I don't understand the difference. All you've got to look, Vinay, is our performance. This year we did 11.7% on an operating basis for the year and we have done 13.5% on a net basis and it was not a stellar year from an investment point of view because of what happened to the fixed-income securities.

So 2011 to 2013 without significant -- don't forget there is no significant deterioration in the underwriting conditions globally. Insurance group is improving, reinsurance group is slightly losing some ground.

On balance when I look at it I think nothing has changed for us. I view 2014 to be as good as 2013 and maybe slightly better, so at the end of the day we do an in-depth, and I will turn it over to Mark, calculations on these things but they are projections and we feel comfortable with it, that's what we put it in our commentary. Mark, anything more you want to say?

A - Mark Lyons {BIO 6494178 <GO>}

No. I think you nailed it. Nothing to add.

Q - Vinay Misquith {BIO 6989856 <GO>}

So wasn't 2013 a very low year for cats and 2014 should be a more normal year for cats?

A - Dinos Iordanou {BIO 2397727 <GO>}

The cat business for us is I would say on an expected basis the low cat might give you another $100 million, $150 million of excess profit and on a bad cat year you take that off, right? Because you can't assume 0 cats and then are cat loaded like $250 million a year.

So basically, yes, that will have a fluctuation. If you do the math, so it's a few points of ROE that it can swing, 2 to 3 up, or 2 to 3 down depending on heavy or no cat activity, and that's what you saw.

The other event that happened this year is that the fixed-income market didn't really help very much with the ROE on a net income basis and or the growth in book value. So you can do your own math but when we look at the business we underwrite we allocate it two notches above our rating, cap it out through the SMP model. And we run everything through to see -- I'm not saying everything we underwrite today produces that kind of ROE.

We've got business that are in the mid-single digit, but we still in it because we like the future of that business and we have business that they are 15% ROE. In the aggregate when you put that all in the hopper, we come with that range. That's why I give you a range. I don't give you a bullet point because I'm not that smart to know exactly which segments we're going to be successful to grow versus other, and mix will make a difference. But 11% to 13% we are very comfortable with.

Q - Vinay Misquith {BIO 6989856 <GO>}

Thank you.

Operator

Ryan Byrnes, Janney Capital.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Just wanted to get your thoughts on why you are making a bet on your professional lines in D&O on the reinsurance side rather than the insurance side.

A - Dinos Iordanou {BIO 2397727 <GO>}

Don't forget, we are doing it on both, on insurance side and on the reinsurance side, but you got to go by geography. We're not making a big bet in Europe and other parts of the world because we don't see the uplift on the rate. The bet we are making in the US is we view that as a unique situation, a good underwriting team with a very good track record and having a significant amount of business in the primary D&O space, which has experienced more stickiness. And also the better rate improvement than anything we've seen in the D&O world in the last 3 to four years.

So we're backing I think a good team. We like the management from the top down all the way through and at the end of the day we were willing to do that.

Having said that doesn't meet our insurance operations in the D&O space in the US they are not trying actively. We have easy opportunities to grow.

Where we don't see opportunities also we don't have any misguided misconceptions. We will cut that back.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Okay. Great. Then just quickly, last question is can you refresh us maybe on the, on your M&A pipeline or for one-off type deals, I guess another use of capital going forward?

A - Dinos Iordanou {BIO 2397727 <GO>}

We don't comment on future activity but in general terms we have seen as we reported on the CMG transaction opportunities sometimes do special deals in reinsurance because people they're looking for capital relief and sometimes you've got to have the excess capital available and ready to deploy it immediately. If we see those type of opportunities drying up then we've got to rethink about what do you do with excess capital? But right now I'm still in a wait-and-see pattern looking at all these opportunities that we are discussing.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Great. Thanks for the answers.

Operator

John Hall, Wells Fargo.

Q - John Hall {BIO 1497612 <GO>}

I was wondering on the mortgage insurance side, you sort of moved into that segment first in reinsurance and now with the closing of CMG do you think being a primary player is going to reduce your opportunities to continue to write reinsurance there?

A - Dinos Iordanou {BIO 2397727 <GO>}

Well I don't believe so. The opportunities might have went away anyway. A lot of the reinsurance transactions they were out of necessity because some of the direct mortgage insurance they were in need of capital and we recognize that from the first day.

We did the first transaction and that was the reason that we were always had an interest. Our interest to enter the primary mortgage insurance business didn't happen yesterday.

We had that interest going back four years ago. We just had to find is the right opportunity with the right facility, etc.

As you know, technology plays a big role in that, you've got to have robust systems to be in that space, you've got to have good relationships with organizations like yours which we expect to do a lot of business with, you are the largest originator. And you got to have the interfaces and all of that.

So when we found that opportunity we entered the market. Having said that we always knew that our reinsurance opportunities especially from the primary mortgage, it will purely depend on their capital needs.

And now the capital markets have opened to some of the potential clients, some existing clients and potential clients. So I don't know what their needs are going to be in the future but our intent is to be both as a reinsurer and also primary in the US and also overseas.

A - Mark Lyons {BIO 6494178 <GO>}

Just to augment that a bit, your question necessitates a scenario or two and how will the capital markets continue to view our mortgage insurance spaces? As the GFC capital requirement let's hypothesize.

They go from 18 to 1 and they go 16 and they go to 15. This could be increasingly difficult for some of the legacy players to come to the compliance.

The extent that the Capital Markets get a little more cold shoulder towards it, reinsurance as a capital source becomes a very attractive.

Q - John Hall {BIO 1497612 <GO>}

Great. Thanks very much.

Operator

Meyer Shields, KBW.

Q - Meyer Shields {BIO 4281064 <GO>}

Two quick questions if I can. First in that 40% of the reinsurance segment reserve releases that came from shorter tail lines is there any way of breaking that down between normal run rate losses and the major cats that have been incurred since 2011?

A - Mark Lyons {BIO 6494178 <GO>}

Most of it is non-cat. So I am estimating, but I believe it was closer, it was north of 50% on the non-cat.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Great. And second, if you were to tease out the mortgage insurance results in 2013 from reinsurance would the underwriting margin have gone up or down?

A - Dinos Iordanou {BIO 2397727 <GO>}

The margin will go down slightly though -- it will be negligible.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Perfect. Think you very much.

A - Dinos Iordanou {BIO 2397727 <GO>}

It's taking out the MI out of --

A - Mark Lyons {BIO 6494178 <GO>}

It's funny because we looked at that ourselves. And if I do it in combined ratio perspectives probably the best way to do it, the calendar quarter for the reinsurance division would have been about 90 bps higher, which is marginal, and 40 bps higher the full calendar year with the mortgage insurance removed.

Q - Meyer Shields {BIO 4281064 <GO>}

Good. That's very helpful. Thanks so much.

Operator

Ron Bobman, Capital Returns.

Q - Ron Bobman

I had a question about Watford. Generally, is the Third Quarter of this year sort of a reasonable timeline for when Watford will begin binding business?

I was wondering if you could describe it a little bit about some of the types of lines of business that you envision for Watford. And will it only write business that Arch Re is not writing, or might there be deals where you both participate?

Then finally -- just to add one more related question, sorry Dinos, and then the professional liability reinsurance deal that you did with the large unearned premium reserve pickup in the Fourth Quarter, is there any tie between that and Watford? Is the prospect of Watford starting soon in any way linked and will it participate at all on that treaty? And that's it for me, thanks.

A - Dinos Iordanou {BIO 2397727 <GO>}

Let me start with the fresher one, the last question. No, it had nothing to do with Watford because Watford even though the probability is very high at the time we made that transaction we were making it for us.

We want to maintain that. Now in the future if we choose to put some in Watford or not it will be up to us.

Having said that in your question about what business Watford will take, yes, they will take sometimes business that we ship out today, other participants and they will participate with that. Sometimes we're going to be side-by-side and sometimes there might be deals that they will do on their own.

At the end of the day the underwriting standards of Watford Re will be the same underwriting standards as we have at Arch. I am not reprogramming the brains of our underwriters.

What might be slightly different that it might cause some business to go to Watford it will depend on duration of liabilities and what kind of expected return we expect from the Highbridge Principal Strategy, it's a hedge fund who is going to be managing the asset. So there might be situations that some accounts might not make the cut for Arch but it will make the cut and produce north of 15% ROE for Watford.

Then for we will do those two. But I want to emphasize our underwriting teams when they are working on Arch accounts or Watford accounts they're going to use the same basic tools and the same principles that we have established over the last 12 years.

Q - Ron Bobman

Thank you very much.

Operator

Mark Dwelle, RBC Capital Markets.

Q - Mark Dwelle {BIO 4211726 <GO>}

One real quick question. On the CMG premiums you gave us, $100 million, is that a written or an earned -- ?

A - Dinos Iordanou {BIO 2397727 <GO>}

It's an annual written premium and seeing it has been steady-state is annual year end too.

Q - Mark Dwelle {BIO 4211726 <GO>}

Okay. That was my second question.

Okay, that's all he needed. Thank you.

Operator

Michael Nannizzi, Goldman Sachs.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Just quick follow-up. I had a question on, I remember a while back, maybe Dinos it was you or Mark, you had mentioned that the MI would not meaningfully impact earnings until 2016. Did that contemplate the interest cost related to this debt raise or was that just on the underwriting side?

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A - Dinos Iordanou {BIO 2397727 <GO>}

It contemplate everything.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay. It did contemplate this period's debt risk.

Also just wanted to square the 11% to 13% comment. I guess does that ROE comment on business written today?

I'm guessing that contemplates the accident year loss ratio you initially book is above your estimate of ultimate losses? Because otherwise it doesn't look like on an accident year basis you would be there for 13%.

A - Dinos Iordanou {BIO 2397727 <GO>}

I don't totally understand the question. Did you understand the question?

Q - Michael Nannizzi {BIO 15198493 <GO>}

In other words you had, booked a 13.5% this year, 11.7% operating --

A - Dinos Iordanou {BIO 2397727 <GO>}

13.5% on a net basis --

Q - Michael Nannizzi {BIO 15198493 <GO>}

Yes, 11.7% operating, but you had some obviously some favorable development in there. So taking that into consideration you're probably -- that would be somewhere in the $250 million to development, maybe you are in the 7% to 8% range.

So if you are booking business on a 11% to 13% ROE basis I am guessing that assumes that the accident year result is not going to close that gap for 2014 or 2015 that there is some assumption that preserves and continue their trend that we have seen in the last several years?

A - Mark Lyons {BIO 6494178 <GO>}

Well some of it is, remember, these comments Dinos is making on the range are underwriting years not accident years. In an improving market accident year 2013 will be worse than underwriting year 2013, and underwriting year 2014 will improve even more. So accident year is the starting point but you have to translate probably a pretty material movement to convert that to an underwriting year in improvement.

A - Dinos Iordanou {BIO 2397727 <GO>}

On your reserve question, we've been reserving conservatively all of our lives. We are not planning to change that.

Usually performance comes -- as I say, the current accident year, it's a self grading exam. Maybe four or five years out it becomes an exam but the professor will grade.

And that philosophy hasn't changed with us. So I don't believe that our reserve philosophy will change. So in essence based on historical averages I would think the same kind of performance is going to emerge.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. Great. Thank you very much.

Operator

With no further questions in the queue I would like to hand the call back to Mr. Iordanou for closing remarks.

A - Dinos Iordanou {BIO 2397727 <GO>}

Well thank you all and we are looking forward to talking to you in the next quarter, which is going to be probably a little more exciting first time we are going to report the MI as a separate section of our three businesses and I am sure you're going to have a ton of questions. With that have a wonderful day. Thank you.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect and have a wonderful day.