Q2 2014 Earnings Call

Company Participants

- Constantine P. Iordanou
- Mark Donald Lyons

Other Participants

- Amit Kumar
- Ian J. Gutterman
- Jay H. Gelb
- Josh D. Shanker
- Kai Pan
- Meyer Shields
- Ryan Byrnes
- Vinay Misquith

MANAGEMENT DISCUSSION SECTION

Operator

Good day, ladies and gentlemen, and welcome to the Second Quarter 2014 Arch Capital Group Earnings Conference Call. My name is Towanda and I will be your coordinator for today. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. As a reminder, this conference is being recorded for replay purposes.

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 assessments 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 historical 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 turn the conference over to your host for today, Mr. Dinos Iordanou and Mr. Mark Lyons. Please proceed.

Constantine P. Iordanou {BIO 2397727 <GO>}

Thank you, Towanda, and good morning, everybody, and thank you for joining us today. We had an excellent second quarter and first half of 2014 from both an underwriting and investment perspective.

We believe that our diversified approach and the construction of our book of business over the past 12 years has functioned well in many various market environments. This balanced approach has been a hallmark of Arch from inception and is designed to allow us to achieve appropriate returns in many market environments.

Earnings were solid and were driven by excellent reported underwriting results. And our premium revenue grew by approximately 13.5% on a net basis, driven by our insurance and mortgage segments.

On an operating basis, we earned $1.17 per share for the quarter, which produced an annualized return on equity of 11% for the 2014 second quarter, which was slightly higher than the ROE reported in the same quarter last year. On a net income basis, Arch earned $1.48 per share this quarter, which corresponds to an annualized 14% return on equity.

Our reported underwriting results in the second quarter were excellent as reflected by a combined ratio of 86% and were aided by a low level of catastrophe losses and favorable loss reserve development. We also benefited from an improved accident year performance in our U.S. insurance group, which was offset by an increase in the accident year combined ratio of the reinsurance group.

As we discussed last quarter, we expect that the reinsurance combined ratio to rise on a year-over-year basis as a result of changing its mix of business. The rise in the combined ratio reflects the fact that the reinsurance group is writing less property and property cat business, which has a lower expected loss ratio than liability business and, secondly, as we have found additional pockets of casualty and professional liability business that meet our return requirements. Because of the long duration of this business, we believe it will produce good economic returns over time, even in today's low interest rate environment.

Net investment income per share on a sequential basis increased 10% in the quarter to $0.53 per share, primarily as a result of a fund distribution, which Mark Lyons will get into in more depth in a minute. Our operating cash flow for the quarter was $254 million compared to $183 million in the same period last year. The total return of the investment portfolio was 180 basis points for the quarter, inclusive of fluctuations in foreign exchange rates.

Our book value per common share at June 30, 2014, rose to $43.73 per share, increasing by 5.3% sequentially and 18.8% relative to the second quarter of 2013. The insurance segment's net written premium grew by approximately 15% on a net basis with alternative markets, E&S casualty and travel accident lines generating most of the increase.

The alternative markets growth came predominately from a renewal rights transaction. Most of our organic growth is coming from small accounts with low limits which should have lower volatility, as well as from our loss sensitive business.

On the other hand, competitive conditions in the property reinsurance sector have negatively affected primary property rates and property growth has been flat. In the primary markets in which our insurance group participates, we continue to obtain rate increases above loss trend, however, slightly below the levels that we observed last quarter. We continue to see our best opportunities in some sectors of the E&S market and in our binding authority and program business. In these areas, we have seen improved pricing and a gain in exposure units.

On the reinsurance side of the business, we have seen a continuation of softening in terms and conditions that we noted in prior quarters. As you may have heard on other calls, the property cat area remains under pressure, primarily due to the alternative capacity that has entered that market.

From a production point of view, net written premium was essentially flat in the quarter for the reinsurance group over the same period of 2013. Although on a gross basis the reinsurance segment grew by nearly 10%, almost all of the growth in the segment was from business produced for Watford Re.

Our mortgage segment includes primary mortgage insurance written through Arch MI in the U.S. and other MI internationally, the reinsurance treaties covering mortgage risk, which is return globally, as well as other risk sharing and structural mortgage businesses. As you may know our mortgage insurance business in the U.S. serves two major markets: one, the credit union market; and two, banks and other mortgage lenders.

Net written premium in the second quarter of 2014 was approximately $50 million, of which $25 million was written by Arch MI U.S. As we discussed on prior calls, Arch MI has a dominant position in the credit union sector and is in the process of building out its client base with the bank channel lenders.

As of June 30, 2014, we have approved 222 master policy applications from banks. Of these approvals, 20 represent national accounts and the balance are regional accounts. This represents an increase of 14 in national accounts and 175 in regional accounts as compared to Q1 2014.

Of the top 25 originators, we have 11 approvals so far. Of course, approvals are the first step in the process. It takes time to integrate systems and then get into the banks rotations in order to receive new mortgage insurance policies.

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% as on a present value basis improvement in the insurance group and the addition of the mortgage segment offsets lower expected returns in the reinsurance segment.

Before I turn it over to Mark, I would like to discuss our PMLs. As usual, I would like to point out that our cat PML aggregates reflect business bound through July 1, while the premium numbers included in our financial statements are through June 30. And that the PMLs are reflected net of reinsurance and all retrocessions.

As of July 1, 2014, our largest 250-year PMLs for a single event decreased to $674 million in the Northeast or 11% of common shareholders' equity, where Gulf PMLs also decreased to $623 million. Our Florida Tri County PML now stands at $426 million, the lowest level in memory.

I will now turn it over to Mark to comment further on our financial results. Mark?

Mark Donald Lyons {BIO 6494178 <GO>}

Great. Thank you, Dinos, and good morning. Firstly, I'd like to reemphasize that last quarter we made some changes to our reporting format, primarily by adding two new segments in addition to our two prior segments which were insurance and reinsurance.

The new segments are mortgage business and the other segment. The mortgage business, as Dinos has commented on, encompasses both insurance and reinsurance across U.S. and international operations, includes any risk-sharing transactions with the GSEs or banks – would also be reflected here.

Previous to last quarter, mortgage insurance, reinsurance and risk sharing transactions were reported within the reinsurance segment. But that is no longer the case. And we have provided apples-to-apples comparatives, so you can properly reference prior periods.

The second new segment called other continues to solely reflect Watford Re results at this time. Unlike our other segments, Watford Re operates through a management team that is independent from Arch. It also has a distinct and separate investment portfolio and investment strategy. Therefore, the other segment presents Watford Re's results inclusive of its investment performance.

Also, as a reminder, although Arch only holds an approximately 11% minority interest in the common shares of Watford Re, we have consolidated 100% of their results on a line by line basis in Arch's consolidated financial statements with a requisite offset reported as noncontrolling interests. We have consolidated Watford, not due to our percentage ownership, but due to the GAAP accounting rules for variable interest annuities or VIEs.

The financial supplement shows consolidated financial statements that include the other segment which, as I said, is Watford Re as well as providing other financial information that excludes the other segment. And those are footnoted as such on each page of the supplement to help your ease in analysis.

Furthermore, within the segment information of the supplement, we have provided a sub total of Arch's core segments without Watford Re and have also additionally provided Watford Re's results posted alongside to arrive at Arch's consolidated segment view. These permit views with and without the influence of Watford Re. The investment information of the supplement, however, is completely shown excluding the other segment. So, my comments that follow today are on a pure Arch basis, which excludes the other segment, unless otherwise noted.

So, beginning in that vein, the consolidated combined ratio for the quarter was 86.2% with 1.8 points of current accident year cat related events, net of reinsurance and reinstatement premiums compared to the 2013 second quarter combined ratio of 87.4%, which reflected 4.8 points of cat related events. Losses from 2014 second quarter cat events, net of those above items, totaled $16.5 million, primarily emanating from Midwest tornadoes, the April Chilean earthquake and other small miscellaneous catastrophes.

The 2014 second quarter consolidated combined ratio also reflected 9.4 points of prior year net favorable development, net of reinsurance and related acquisition expenses, compared to 9.1 points of prior period favorable development on the same basis in the 2013 second quarter. This results in a 93.8% current accident quarter combined ratio, excluding cats, for this quarter compared to 91.7% of an accident year combined ratio for the second quarter of 2013.

The 2014 accident year combined ratio, excluding cats, for the reinsurance segment was 92.1% compared to 82.1% in the corresponding quarter last year. In the insurance segment, the 2014 accident year combined ratio, excluding cats, was 95.8% compared to an accident quarter combined ratio of 98.6% a year ago.

Approximately, 78% of the net favorable development in the quarter, excluding the associated impact on acquisition expenses, which from the reinsurance segment was approximately 54% of that due to net favorable development on short-tailed lines concentrated in the more recent underwriting years.

Furthermore, roughly 60% of the reinsurance segment's – that favorable development was attributable to medium-tailed lines spaced throughout many underwriting years and about 40% due to net favorable development on longer-tailed lines, primarily from the 2002 through 2007 underwriting years, the youngest of which is 90 months in age.

The remaining 22% of the net favorable development on a consolidated basis was attributable to the insurance segment and was primarily driven by short-tailed lines from the 2008 through 2013 accident years. Similarly to prior periods, approximately 69% of our consolidated $7.3 billion of total net reserves for loss and loss adjustment expenses are IBNR or additional case reserves, which continues to be a fairly consistent ratio across both the insurance and reinsurance segments.

On a consolidated basis, the expense ratio for the second quarter of 2014 was 32.8% versus the prior year's comparative quarter 32.2% expense ratio. The marginal increase in the operating expense ratio component reflects the addition of our U.S. mortgage insurance operations and incremental expenses due to certain platform expansions at both our reinsurance and insurance businesses, partially offset by a higher level of net premiums earned.

Our U.S. insurance operations achieved a 2.5% effective net rate increase this quarter, which was slightly above our view of weighted loss cost trends. This average effective rate change reflects rate reductions in some units, such as nearly an 8% reduction in property businesses and a 3% reduction in D&O financial institutions businesses, and healthy increases of nearly 10% in our private not-for-profit D&O line, 7.5% in E&S casualty, and approximately 5% in both construction and excess workers' comp.

As always, we make capital allocation decisions based upon our view of the absolute returns and not relative improvements alone. For example, although our insurance property businesses did not experienced margin expansion this quarter, our view is that this line is still producing acceptable net returns for our shareholders.

The ratio of net premium to gross premium in the quarter on a consolidated basis was 73.2% versus 77.9% a year ago. In the reinsurance segment, the net-to-gross was 83.1% this quarter compared to 91% a year ago, primarily reflecting sessions to Watford Re and more retro purchases protecting their property book.

The insurance segment added 67.9% net-to-gross ratio compared to 71.3% a year earlier. This decreased net retention predominantly reflects the impact of new alternative market accounts added during the quarter following a renewal rights agreement entered into with SPARTA Insurance.

This agreement added nearly $93 million of gross written premium, but only $25 million on a net written basis due to inherent captive sessions. The Worldwide Insurance Group net-to-gross ratio would have been 72.9% without the SPARTA impact, which is in line with last year's comparative quarter.

The mortgage business posted an 85% even combined ratio for the quarter. The expense ratio, as expected, continues to be high as front-ended operating expenses acquired through the CMG, PMI acquisition outpaced premium production until proper scale was achieved. The net written premium increase of approximately $32 million in the quarter is driven by our new U.S. primary operation, mostly via the credit union channel, and from the 100% quota share of PMI's 2009 to 2011 underwriting years as part of the acquisition of CMG and PMI's platform.

At June 30, 2014, we were on risk for $10 billion of risk-in-force split $5.3 billion from our U.S. mortgage insurance operation, $4.6 billion through worldwide reinsurance operations and $139 million for risk sharing transactions. It's important to note that U.S. operations utilize policy-specific coverage ratios to determine risk-in-force from insurance-in-force figures. As you may recall, insurance-in-force represents the aggregate amount of the individual loans insured.

Outside the U.S., we followed market practice to estimate risk-in-force on a similar basis, while for risk sharing transaction, risk-in-force reflects our percentage participations within bound (20:22) layers as well as the impact of contract limits. That is risk-in-force on risk sharing transactions does not exceed the contractual limits of liability involved.

The other segment, being Watford Re, reported 108% even combined ratio for the quarter on $51.8 million of net written premiums and $13 million of net earned premiums. As stated earlier, these premiums reflect 100% of the business assumed rather than simply Arch's approximate 11% common share interest.

The total return on our investment portfolio was a reported 180 basis points in the 2014 second quarter, driven primarily by strong equity and alternative investment performance, along with improved returns on both investment and non-investment grade fixed income sectors. Excluding foreign exchange, total return was 163 bps during the quarter.

Is worth noting that equities and alternative investments account for roughly 15% of invested assets as of June 30, 2014, which is virtually identical to its proportion one year ago and amounts to $2.2 billion. This allocation on a portfolio basis we believe have the potential to ameliorate future impacts on fixed income securities from rising interest rates and widening credit spreads.

Our embedded pre-tax book yield before expenses were 2.17% as of June 30 compared to 2.27% at March 31, 2014, while the duration of the portfolio shortened slightly at 3.14 years from last quarter's 3.24 years and 3.04 year durations from June 30 a year ago. The current duration continues to reflect our conservative position on interest rates in this current yield environment.

Reported net investment income in the 2014 second quarter was $72.5 million or $0.53 per share versus $67 million in the 2014 first quarter or $0.49 per share and versus $68.4 million or $0.50 per share in the 2013 second quarter. The increase this quarter is primarily due to a $4.1 million interest distribution from one alternative investment fund. Such distributions are extremely lumpy and should not be viewed as a run rate change.

Our effective tax rate on pre-tax operating income for the second quarter of 2014 was an expense of 3.6% compared to an expense of 3.3% in the second quarter of 2013. Approximately $1.4 million or 80 basis points of the company's second quarter tax expense is associated with catch up of the first quarter to this higher effective rate.

Additionally, we have 30 basis points of discrete tax items within the annualized 3.6% rate mentioned earlier. Fluctuations in the effective tax rate can result from variability in the relative mix of income or loss reported by jurisdiction, along with forecast variances for the last six months of the 2014 year.

Our total capital was $7.13 billion at the end of this quarter, up 5% relative to March 31, 2014, and up 8.9% relative to year-end 2013. During this quarter, we did not repurchase any shares under our buyback authorization.

Our debt to capital ratio remains low at 12.6% and debt plus hybrids represents only 17.2% of our total capital, which continues to give us significant financial flexibility. We also continue to estimate having capital in excess of our targeted capital position.

Book value per share was $43.73 at June 30, 2014, up 5.3% versus March 31, up 9.8% relative to year-end 2013 and up nearly 19% relative to one year ago at June 30, 2013. This change in book value per share this quarter primarily reflects the company's continued strong underwriting performance as evidenced by the 30% increase in underwriting income relative to the second quarter of 2013.

So, with these introductory comments, we are now pleased to take your questions.

Q&A

Operator

Thank you. Your first question comes from the line of Jay Gelb with Barclays. Please proceed.

Q - Jay H. Gelb {BIO 21247396 <GO>}

Thanks and good morning. Mark, I want to touch base first on the normalized growth rate in the insurance segment. If my math is right, if I take into account the one-time nature of the SPARTA transaction, it looks like normalized top line growth was around 8% on a gross basis and 10% on a net basis.

A - Mark Donald Lyons {BIO 6494178 <GO>}

That sounds right.

Q - Jay H. Gelb {BIO 21247396 <GO>}

Is that a pretty reasonable run rate going forward or could that have been elevated by some other factors?

A - Mark Donald Lyons {BIO 6494178 <GO>}

Well, when you look at the sources coming from contract binding businesses, coming from program businesses, it's a payoff of investments that were done recently in contract binding operation. Some E&S casualty business has been strengthened through cumulative rate changes. So I would say, yes, you could view that as an ongoing item.

However, if rates start to fall off on E&S causality, for example, of course, we're going to make other decisions.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Yeah. It's always – Jay, it's always subject to what the market will give us. We're very, very diligent in monitoring pricing as we do. And at the end of the day, if conditions remain as such and they don't deteriorate, yes, that would be appropriate. But surprises happen either way. Sometimes – it's not always predictable where the market is going to go.

Q - Jay H. Gelb {BIO 21247396 <GO>}

All right. Thank you for that. And then on the mortgage insurance operation, could you discuss what you feel the impact or perhaps even the benefit of the new proposed capital rules for mortgage insurers will be for Arch given that your business is essentially fresh capital as opposed to your competitors which are largely dealing with legacy issues?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, clearly, the higher capital requirements – for us, there is two issues. One is we will require to overcapitalize the unit to begin with in essence to gain the approvals. And we are waiting for us to generate the revenue to fit into that capital requirement. So, in essence, maybe we've got a size 10 shoe and a size 3 foot right now. And we've got a long way to go to fill it. So, for the short-term, I think is a great advantage for us.

Over time, I think the higher capital requirements will require some adjustment in pricing because everybody is going to be looking for appropriate returns and – but I don't know how the market is going to react to that. And also, it might affect the fees that the GSCs – they're charging. So it's not the final rule. It's a proposed rule. They are hearing comment. But, from our perspective, I think it's positive. It puts the MI business in more solid financial footing with more capital requirements. And, in essence, it might create more demand for new capital like ours in the marketplace. So we view it as a positive event for us.

Q - Jay H. Gelb {BIO 21247396 <GO>}

And then my follow-up to that is what do you feel is a normalized return on equity in the MI business once it gets to steady state for Arch taking – if the new rules are in fact adopted?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, it's still, I believe, in the 15% plus range based on the macroeconomic conditions that we are experiencing. Delinquencies are going down or they – and the average loss per delinquent loan has improved from a year ago. But you can't expect that to continue forever. So the environment is good. But, in some sectors, when you really get into the details, especially on the high LTV and low FICO score area, the new capital requirements – it will require price increases in order for returns to be achieved. So, we'll see how the market reacts to that, but that's the way we see it.

A - Mark Donald Lyons {BIO 6494178 <GO>}

Yeah. Jay, I would also add to Dinos' comments that we are not wholly a U.S. primary mortgage operation.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Right.

A - Mark Donald Lyons {BIO 6494178 <GO>}

The reinsurance group is in the U.S. and beyond as the primary side having an Irish operation, plus with these risk sharing transactions. What's reported in the segment is the amalgamation of all those things. So I think, as Dinos pointed out in his opening comments, the way we diversify, we continue to do that in thinking even though it's a new line of business for us.

Q - Jay H. Gelb {BIO 21247396 <GO>}

That's helpful. Thank you.

Operator

Your next question comes from the line of Vinay Misquith with Evercore. Please proceed.

Q - Vinay Misquith {BIO 6989856 <GO>}

Hi. Good morning. The first question is on the mortgage insurance business, just trying to model the numbers out near-term. We've seen the combined ratios the past couple of quarters in the low 80%s. Is that what you expect going forward next year or do you expect that to come down a little bit?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

It will come down, not a little bit, more than a little bit. Don't forget we have a start-up cost issue with a significant sales force that we have created and no revenue to go against that sales force. Even though – and I shared the numbers in my opening remarks as to how many contracts we have or how many banks, et cetera. That activity is not going to stop producing premium revenue until the fourth quarter, first, second quarter of next year.

It's a tedious laborious effort. You have to integrate systems. You've got to get on their rotation. And then once you get on their rotation, you start receiving accounts and premium. So, in the meantime, we probably have – we have finished the build out of our sales force. And our sales force is some 50 plus people for the bank channel. Of course, the credit union channel, our sales force is rented through a contractual agreement for CUNA Mutual. So, all that expense, it's in these numbers. And we expect those numbers to improve significantly next year when there is premium attached to it. Mark, do you want to add more detail on that?

A - Mark Donald Lyons {BIO 6494178 <GO>}

I have nothing to add.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Okay.

Q - Vinay Misquith {BIO 6989856 <GO>}

So just looking at the loss ratio, it was 30% this quarter, about 21%, 22% last quarter. I mean was there a one-time spike this quarter for any reason?

A - Mark Donald Lyons {BIO 6494178 <GO>}

I believe it's just more a function of mix of business between all the sources we talked about before, outside of risk sharing, because risk sharing isn't accounted for in insurance principles, way it's derivative accounting. But it's just simple as that, Vinay.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. But the bottom line is there to expect maybe slightly lower than say the high 70%s sort of combined next year on this business?

A - Mark Donald Lyons {BIO 6494178 <GO>}

Not unreasonable.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Not unreasonable, even better than that. Yeah.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. Okay. Right. From your words to God's ears. Okay. Great.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, I mean, that's what we get paid to work towards, right. So, we do go to church, but also we work hard too.

Q - Vinay Misquith {BIO 6989856 <GO>}

The second question is on the cat business. I mean, Dinos, I think your company is the only – like sort of one of the few companies that have actually cut back significantly on cat reinsurance. Now the level of cut back is significant, 46% this quarter, I think year-to-date about down 40%. How do you view some people's arguments that you can buy a retro and therefore you can arbitrage and that you should write the business on your own balance sheet?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, that approach is not totally foreign to us. As I share those numbers with you, we did try to do quite a bit of that – of maintaining our relationship with our reinsurance customers and then retrocede some through the purchase of retrocessional covers for us. And that's an approach that even some of our competitors – they're following. So, when you look at our numbers, it's not always obvious to you that we cut a lot of our market relationships. We try to maintain as much of that depending as to how advantageous it was for us to maintain that relationship and buy retrocession. So, in essence, on an expected basis, we still had the same return characteristics.

Believe me, if I can write as much cat business as I wrote a year ago and not affect returns, I would have done it. But our reinsurance team and our cat teams in Bermuda, I think they're one of the best group in the business. And I spend a lot of time with them. But we have utilized the same approach as some others. We maintain bigger gross lines and then we retrocede it out because we believe the price on the retrocessions – it was advantageous to us.

A - Mark Donald Lyons {BIO 6494178 <GO>}

And, Vinay, I would also add, because our diversified platform on the insurance group side because of that softening, instead of being a provider, they're a purchaser. They're taking maximum advantage of this helping their net economics much more dramatically than their gross economic.

Q - Vinay Misquith {BIO 6989856 <GO>}

That's helpful. And just to clarify, so, on the property cat, you're saying that despite the purchase of retrocessional, the profitability is still lower this year than it would be last year. Correct?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, you can't take 15% or so rate off the table and expect the same profitability. Now the profitability is not the same across every part of the curve. And when we buy retrocessional cover, it sometimes is laser (36:44) to be in where we believe is the least appropriately priced segment on the curve, probability distribution. So – and like I said, half the guys we've got working on our cat team, they're smarter than me. So – and I have a lot of confidence in them and they have a track record of 12 years of doing extremely well. So even though I spend a lot of time with them, most of the time they're educating me and I like the education I get.

Q - Vinay Misquith {BIO 6989856 <GO>}

All right. Thank you.

Operator

Your next question comes from the line of Josh Shanker with Deutsche Bank. Please proceed.

Q - Josh D. Shanker {BIO 5292022 <GO>}

Yeah. Good morning, everyone. You had mentioned a little bit in the prepared remarks, but I'm just looking at the accident year loss ratio deterioration in the reinsurance business. And there's all sorts of things we're talking about. It just seems - it's sizable. Can you break down the components business mix, higher or lower price on reinsurance? That can give us more color into understanding it?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, I'll give you the high level and Mark - maybe on a follow-up with him. I give you more detail. But the basis is you take the cat business and the combined ratio in that business is south of 80%. And you're replacing some of that volume with liability business that we - at least will reserve early on in the 100% to 105%. That's 20 points, 25 points difference in comparing combined ratio.

So, you're taking big chunks - and you saw our property cat premium went down by some 40% and you're replacing that with - on an economic basis, still very acceptable business because with the duration of liabilities you're still going to earn double-digit returns. But on a combined ratio, that business would book in at 100%, thereabouts. That mix change is what's causing for us the current accident year to be booking at the levels that we have. Mark, do you want to -

A - Mark Donald Lyons {BIO 6494178 <GO>}

Yeah. It is mix. Dinos is right. He's right on point. But I wouldn't want to reemphasize and not get lost in the sauce what Dinos just differentiated between combined ratio and return. 1.5 duration year business versus a 4.5 year duration business even allows the interest rates - has a different economic - return characteristics than that, clearly.

The other thing I would just mention is you guys are placing bets on - between companies about what their reserving policy is and how conservative they are. I think our track record speaks for itself. We've mentioned that our 2013 reserve position from the views of outside actuarial firms was stronger towards the end of 2013 than it was at the end of 2012.

So you draw your own conclusions. But we're happy with where we're booking it. And it's mix and it's also we believe our level of conservatism. The longer-tailed line it is, the more you get different kind of risks associated with it. You get legal theory risk. You get all kinds of different risks that manifest itself. So we've got to reflect those in our initial loss specs.

Q - Josh D. Shanker {BIO 5292022 <GO>}

And thinking forward into the coming quarters or years, is the 2Q 2014 results a reasonable way to think about where loss ratio is, given the new mix of business or is the evolution going to continue?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, if the mix doesn't change, it's a reasonable place to be. But what a lot of people haven't really caught up with us and hopefully - I hope the competition never does - is that we navigate and we try to go where we believe we can find business with proper returns. And sometimes, our shifts - the zigging and zagging is severe. I remember when we started Arch, Paul Ingrey once told me is that I don't care how big you get as a company as we were growing, but I hope we're not going to lose the agility of navigating like a BT board instead of an aircraft carrier. And that's been our strategy. It's not just getting in and out of certain things, but going from large accounts to small accounts and all that. And we try to react very, very quickly.

And we don't worry too much about these optics that, oh, my reinsurance combined ratio on a current accident year is going to go up by 10%. That doesn't tell you absolutely nothing is that business that you write acceptable on a total return over time or not. That's the key issue and that's where all of our guys are focusing on. And then, we let the accounting take - and then we explain the accounting later on. But believe me. Our guys are not going to write business that are not in the double-digit expected return, including the investment income component.

Q - Josh D. Shanker {BIO 5292022 <GO>}

Makes sense. And I think I mis-asked my question. I guess what I was interested in is the relationship between premium earned and premium written. Given what's been earned through in 2Q 2014, does that represent the book of written business that you guys think you're going to earn through over the next nine months?

A - Mark Donald Lyons {BIO 6494178 <GO>}

Well, it has to shift somewhat. I mean the extent - we're still getting earned premium from property cat business that has now been 40% reduced from the prior comparative quarter. So I don't think you're going to hit a steady state till closer to 4Q.

Q - Josh D. Shanker {BIO 5292022 <GO>}

That's perfect. Thank you very much, Mark.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Yeah.

Operator

Your next question comes from the line of Kai Pan with Morgan Stanley. Please proceed.

Q - Kai Pan {BIO 18669701 <GO>}

Good morning. Thank you for taking my call. Just a quick question on the capital management side. It looks like you took a pause in buybacks in recent quarters and to focus on the MI acquisition as well as some other initiatives. Now with that behind you largely and you still have excess capital and your price book probably coming down from the level we've seen earlier, are you sort of like - how do you think about your priorities in term of your capital management?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, nothing has changed in our philosophy. Excess capital belongs to shareholders. Eventually, we'll find a way to get it back to them. Where our share price is today probably share buybacks make a lot of sense. The only thing that is in our minds we're still in the hurricane season. Usually, we like to be a bit conservative around that part of the season. But because you can't predict if you're going to have a storm or not and you might need to write some big checks.

Absent of that, I think, is an appropriate time for us based on what you described for us to buy back shares. But we'll make that decision in due time and do consideration based on those parameters. We still have a big authorization. We do have excess capital. But we've got the rest of the year to worry about. Right now, when I go to church and I light a candle, it's not to have a cat, so.

A - Mark Donald Lyons {BIO 6494178 <GO>}

Just don't go into confessional.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Yeah.

Q - Kai Pan {BIO 18669701 <GO>}

All right. Since – then – if there is no big cats, what's your view on a genuine like property cat pricing? I just wonder are we closer to the floor. How much more you can take that your return on the business were below your targeted returns?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, I think that business, especially on some part of the curve, they have been pushed below double-digit. I think some of that business has been priced at a high single-digit returns. And at least from our perspective, as gray hair old underwriters being in the cat business and pricing it with an expected return of 8%, 9% or 10% is insanity. And that's what we are. But I don't know where it's going to go. I mean if I was that smart, I'll be a lot wealthier. It's – I don't know what the competition is going to do. There is new capital that is coming in that 8%, 9%, 10% returns are very acceptable to them on an expected basis.

So, if you ask me to guess, I'll probably say we're getting very close to some people that are going to say hey, this team has gone far enough. But I've been surprised in my career as to how cheap reinsurance can get sometimes. I've seen reinsurance get priced at negative ROEs many times. We just – I just hope we're smart enough that we're never going to do it. And I have confidence in our guys that they are smart enough as far as I'm concerned that they're not going to get there ever, but.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you so much.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

You're welcome.

Operator

Your next question comes from the line of Ryan Byrnes with Janney Capital. Please proceed.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Yeah. Great. Thanks for taking my question. Just also wanted to – also in the reinsurance and also I guess the insurance as well, but where the impact that rates are having on the underlying loss ratio? I know there is some business mix shift, especially in the reinsurance segment, but are rates having any impact on the underlying loss ratio right now as well?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Go ahead.

A - Mark Donald Lyons {BIO 6494178 <GO>}

I think on – it has to and it has to do it on both sides, but we think – meaning insurance and reinsurance. But we think that weighting factor that we talked about is a weighting of loss ratios that reflect the marketplace realities of – some with rate increases, some with rate decreases. So we don't do this in bulk. We do this line by line with a view where we think it's going. So, on the insurance side and the reinsurance side, we think those reflect exactly the market environments we're living in.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Okay. Yeah. Thanks for that. And then just one other quick numbers one. The impact of SPARTA in the quarter on the insurance side. Is that – should that be a one-time or should that elevated premiums flow through in the third and fourth quarter and I guess first quarter next year as well?

A - Mark Donald Lyons {BIO 6494178 <GO>}

Well, it's a good question. It's roughly – it's going to be north of $100 million annualized. It's not even – it doesn't – I think second quarter is the thickest quarter.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

$100 million gross.

A - Mark Donald Lyons {BIO 6494178 <GO>}

$100 million gross. Sorry, yeah.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

It's probably north of $100 million gross, about $33 million, $35 million net. So assuming that we take everything over the clients because we have to make some adjustments to the pricing and there is a client on the other side that might say yes or no to our adjustments, right. But don't forget a lot of these clients – they're paying predominantly through these rented captives most of their own losses. That's why you're funding and the excess is only a component, about 25% of the premium gross to net, thereabouts.

So if you're going to do comparisons, I think because we're an A plus carrier and SPARTA was going into runoff, I think a lot of the accounts canceled and rewrote just to get on our books. So I would think that's more of a one-time adjustment. Of course, all this premium is renewable next year and it's going to get again on our books a year from today. But there are not going to be a lot of renewals in the third and fourth quarter, because accounts that they had renewals in the third, fourth quarter, even in the first quarter, they truncated their placements by cutting off the prior and then renewing fresh with us in a much better and stronger paper, so.

A - Mark Donald Lyons {BIO 6494178 <GO>}

But on an annualized basis, right, because, I think, there's going to be quarterly fluctuations.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Right.

A - Mark Donald Lyons {BIO 6494178 <GO>}

It's reasonable to assume that we'd be maybe $120ish million gross and $30 million net, something like that, $30 million, $35 million net. So the quarterly breakdown isn't smooth, but if you think of it annualized, then I think that's proper.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Great. No, thanks for the call there, guys.

Operator

Your next question comes from the line of Amit Kumar with Macquarie. Please proceed.

Q - Amit Kumar {BIO 19777341 <GO>}

Thanks and good morning. Just one quick follow-up on the other segment. Once Watford ramps up, how should we think about, I guess, the longer term combined ratio ranges?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Combined ratio for whom, for us or Watford?

Q - Amit Kumar {BIO 19777341 <GO>}

For Watford and you. I mean, you get the fees, but for them? I guess the question I'm trying to ask is – is the business being ceded to them similar to what you would have put on your balance sheet otherwise?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Yeah. The business that we price on their behalf and we put on their books goes through the same underwriting scrutiny that if we were doing it. The only difference between what we do versus what we would do for Watford, Watford has a higher return on the float. So investment income attributed to a particular deal will be higher. And so some deals, even though from an underwriting perspective, quality of risk, selection of risk, et cetera, it will be still acceptable, it might not make the cut with Arch because we're applying risk-free rate of returns. It will be acceptable for Watford, because the investment income component is more advantageous. That's the only difference between the two. We still have an expectation over time when we get into a steady state environment that Watford Re business – it would be sub-100% combined ratio, probably in the mid 90%s. That's our target. We're trying to get it in the mid 90%s.

A - Mark Donald Lyons {BIO 6494178 <GO>}

And let me just add because Dinos' comments were driven mostly towards the loss ratio as opposed to the expense ratio. And the componentry there between ACQ and – acquisition and OpEx is a little different. They're going to be thinner on OpEx and thicker on ACQ. But, again, mix is a big deal here. So line of business is a difference. Quota share versus XOL is a difference, on any given quarter, how those things mix in. You'd say, as they grow, you'll get some benefit on OpEx for scale benefits, but it won't be enormous. So quarter-by-quarter, it's really a function of what's written and what the acquisition is associated with that.

Q - Amit Kumar {BIO 19777341 <GO>}

Got it. That's all I had. Thanks for the clarification and good luck for the future.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Thank you.

Operator

Your next question comes from the line of Ian Gutterman with Balyasny. Please proceed.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Good morning, Dinos. I think it's still morning. Am I keeping you from souvlaki or are you okay?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

No, no.

A - Mark Donald Lyons {BIO 6494178 <GO>}

We've got five minutes.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

I've got five minutes and then I'll go and get my souvlaki sandwich.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Okay. Okay. Good. I guess my first question is on the accident (54:14) ROE, the 11% to 13% you mentioned. I think in the past, when you've given that number, usually the reinsurance has been above whatever the overall number was and the insurance has been below. Is that still the case? Or given the changes in the relative marketplaces, are they now even? Is insurance above reinsurance? I'm just curious how that's going.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

On an underwriting year basis -

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Right

A - Constantine P. Iordanou {BIO 2397727 <GO>}

They're getting closer. I think, they're about equal.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

About equal.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Don't forget, my reinsurance guys don't like to write unprofitable business but they are accepting. In the past, they wouldn't accept anything that it was south of 15%. Now they are accepting business at 10%, 11%, 12% ROE. Of course, this is unallocated capital. We allocate capital on every deal and that's the way they see it.

The insurance group never had the volatility, but also the opportunity to price business at 20% ROE. You get that on reinsurance. You don't get it on insurance. So, the insurance group fluctuates from 10% to 15% and thereabout. I think inception to-date, our insurance group has produced like 14% ROE, inception to-date, meaning 12 years, if I – and so, directly to your question. I haven't done the calculation. Now, it'd be bothering me, so I'm going do it next week. But I would think they're about the same. And the mortgage business, once it get to a steady state, it will be better than that.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Of course, of course. You could probably guess part of the reason I was asking is a couple of competitors talked about ROEs in reinsurance being single-digit now. So being willing to accept single-digit business, I was just curious how far you have felt it have fallen.

A - Mark Donald Lyons {BIO 6494178 <GO>}

Yeah. We -

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Even, if want it, my guys won't do it.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Exactly. Exactly.

A - Mark Donald Lyons {BIO 6494178 <GO>}

One other clarification. We just saw in the quarter that net written, which will be future net earned, was a 15% growth in the insurance group and flat in the reinsurance group. So as the core margins continue to expand on an earned basis from the insurance group and they make up a higher percentage of the total net earned premium, the arithmetic is going to work.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Exactly. Okay.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Ian, you've got to understand. Our reinsurance team is the same. These are all pulling great guys. And believe me. Whatever he has done, it was like – they are all brainwashed. They believe in the philosophy. They practice it. And it has been a great thing for the group over the last 12 years. They had one or maybe the top teacher in the business, if not the top, one of the top teachers. And we get the benefit. And I'm not going to do anything to change that. They look at accounts. They see where they're going. They cut back lines. They switch to different lines. They have a methodology and their numbers speak for themselves.

A - Mark Donald Lyons {BIO 6494178 <GO>}

And, again, remember, we're on both sides of the mirror with a diversified platform. The insurance group has a lot of treaties now with ceding commissions that begin with a three and that's going to find its way through as net premiums are earned.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Absolutely, absolutely. The other part – obviously you said the MI will be above once it ramps up. I guess the only concern I had on the MI with the new proposed rules is it seems the business will be more pro-cyclical, right. If we start having delinquencies, the capital charges start spiking up. I'm not necessarily saying if we have an 2008 again. Hopefully, we never see that again. But if we had any kind of downturn, it becomes a lower ROE business than we would have thought. Does that change your sort of long-term outlook? I'm not saying that's not still attractive, but is it a little bit less attractive than when you got into it when you have rules that make it pro-cyclical into a downturn?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

No. I think it's as attractive as we make. We thought about these issues even when we're making the decision. The big lesson in MI is no different than any lesson in accepting risk. When you throw out underwriting standards as the MI fraternity and throughout in 2005, 2006, 2007, you're looking for trouble. And I can do the same with D&O. I can do the same with a private passenger auto. And I can do the same with any line of business. Once you throw out your underwriting guidelines, now your volume and your production, it will be significantly affected if you maintain discipline. What we've been telling both the regulators and our investors is we got into this with the idea that we will be disciplined. No different approach to underwriting MI that we underwrite any other line of business.

Now, yes, you're absolutely correct. Sometimes even though you're very disciplined in the quality of the loans you're going to underwrite, the FICO scores, et cetera, macroeconomic conditions will change some of the other drivers like delinquencies and all that. But then it doesn't mean that you make a decision to get into a particular line of business for just one year or two years or five years. You look at it over the prospect of it at least 10-year period of time and does it make sense or not. Still makes a lot of sense for us and we believe we have the right management to manage it in a prudent way over the future. That's our opinion and we still believe it is an attractive place for us to be.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Okay. Good point. And then just the last one before lunch. I want it for real quick. Mark, tell me if I'm doing this math right. It looks like out of the $55 million of gross about $15 million was sort of new business – third-party new business, if you will, and about $40 million was ceded from Arch's books. Is that about right?

A - Mark Donald Lyons {BIO 6494178 <GO>}

Yeah. You're kind of in the ballpark, maybe a little more external.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Okay. Just -

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, no, no. There is more external, but sometimes we are in the front of it.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Well, that's what I was kind of getting at. So your front – yeah, that's what I was trying to figure. How much is sort of -

A - Constantine P. Iordanou {BIO 2397727 <GO>}

For some deals we get a fee and we get – and also we get 150% collateral behind it. So we do have some agreements that we view when we put our paper out that they're beneficial to both of us, them and us. And for certain clients, we do that. But, of course, it increases the cost and sometimes it doesn't make the deal go through. But, in some cases, it does. But they're starting to sell just purely their own paper because if you're going to get the best economics for a client, you get the best economics when you buy Watford Re paper.

A - Mark Donald Lyons {BIO 6494178 <GO>}

And, Ian, I think the big takeaway is that I know there is increased market acceptance. The flow of business is strong and getting stronger. And it's across more varied lines of business. And that's exactly what you hope for.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Right.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Okay. That's what I was wondering. Was the third-party flow in line with what you thought or were you finding you were having to write more business on the Arch paper and cede it out the back door to get acceptance?

A - Mark Donald Lyons {BIO 6494178 <GO>}

No. We're happy where it is.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Got it. Perfect. All right. Thank you, guys.

Operator

Your next question comes from the line of Meyer Shields with Keefe, Bruyette & Woods. Please proceed.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Thank you very much for fitting me in. One quick question, Mark. Did the SPARTA business or the alternative market business overall have a material impact on the acquisition expense ratio in insurance?

A - Mark Donald Lyons {BIO 6494178 <GO>}

Let me think about that. It's only $24 million, $25 million of net written. But the ceded is – by definition was another $70 million of ceded. So I can give you a better answer off to the side and comment on it, but I would think it'd be a marginal impact on the net acquisition ratio, in the 10%s.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Perfect. I'll follow-up on that. And then, Dinos, big picture. When you talk about the 11% to 13% underwriting year returns, are those at the level that you're booking the reserves initially or how you actually expect them to play out over time?

A - Constantine P. Iordanou {BIO 2397727 <GO>}

No. We book the reserves a little more conservative than - our philosophy on reserves is that you price something, let's say, has three-year to four-year duration. The original setting up of IBNR is at the pricing level, where we priced it. Any bad results that emerge in the first three years or four years, we let go through. We don't adjust the IBNR. So any unusual large loss that might come through, we just book it immediately. We don't adjust IBNR. And then, we relook at everything, usually depending on the duration of the business three years or four years out and then we make judgments at that point in time. So that's been our reserving philosophy.

So when you get in the 11% to 13% - and the reason we have 11% to 13% is you can be precise on an underwriting year as to how well it's going to behave. If too many moving parts, trend might change on you, et cetera. But that's the philosophy that we have. And the allocation of the capital to that calculation is we do it as we allocate capital to the operating unit and we use the S&P model at two notches above our A+ rating. And that's the way we allocate capital to the operating unit.

So - and because we're a total return shop - and I don't want to - maybe I should be putting an exhibit in our releases. Even though operating ROE is smoother and ROE - total ROE is - it can be volatile depending on realized capital gains, et cetera, you will find out that for the last probably three years or so that our returns - they've been better than our operating returns from an ROE point of view. And Don can give you those statistics because we keep them and we have them.

Q - Meyer Shields {BIO 4281064 <GO>}

That's helpful. Thank you very much.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

You're quite welcome.

Operator

I would now like to turn the conference over to Mr. Dinos Iordanou for closing remarks.

A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, thank you. And I thank everybody for bearing with us. And we're looking forward to seeing you next quarter. Have a wonderful afternoon.

Operator

Thank you for joining today's conference. That concludes the presentation. You may now disconnect and have a great day.