Q2 2016 Earnings Call

Company Participants

- Constantine P. Iordanou
- Marc Grandisson
- Mark Donald Lyons

Other Participants

- Amit Kumar
- Brian Robert Meredith
- Ian J. Gutterman
- Jay Arman Cohen
- Jay Gelb
- Josh D. Shanker
- Kai Pan
- Michael Nannizzi
- Quentin McMillan

MANAGEMENT DISCUSSION SECTION

Operator

Good day, ladies and gentlemen, and welcome to the Arch Capital Group Second Quarter 2016 Earnings Conference Call. At t his time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will follow at that time. As a reminder, this conference call is being recorded.

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 the 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 introduce your host for today's conference, Mr. Dinos Iordanou. Sir, you may begin.

Constantine P. Iordanou {BIO 2397727 <GO>}

Thanks, Abigail. Good morning, everyone, and thank you for joining us today for our second quarter earnings call.

We had a good quarter on a relative basis, and I might say it was a very acceptable quarter also on an absolute basis. In today's market, we are emphasizing to our troops underwriting discipline, execution and risk management in order to preserve capital and maintain balance sheet integrity. We continue to believe that our strategies of diversifying revenue streams and actively managing the allocation of capital will allow us to better navigate in this environment, which is challenging for all of us.

As reinsurance returns have narrowed and as you can see in our second quarter financial statements, we're fortunate to have our other business segments, the primary property casualty segment and the mortgage segment, contribute more meaningfully to our operating results. Our reported combined ratio moved to a bit under 90% for the second quarter, as catastrophe losses added 4.1 points to our combined ratio. Loss reserve development remains favorable in each of our segment which in the aggregated reduced our combined ratio by nearly 9 points.

There were no noticeable changes in the property casualty operating environment from last quarter. There are some signs that reinsurance terms, especially ceding commissions, may have bottomed out. In our insurance segment, we saw a slight deterioration in rates across some sectors, particularly in the excess capacity layers and short tail areas. But rates were generally stable as most other lines, while the mortgage insurance environment remains very, very healthy. Marc Grandisson will give you more details on the segments in a few minutes.

On an operating basis, we produce an annualized return on equity of 9%, while on a net income basis, we earn an annualized return on equity of 13.2% for the quarter and a 7.9% on a trailing 12-month basis, which is a better measure to see a long-term profitability.

Remember that net income movements can be more volatile on a quarterly basis, as these earnings are influenced by changes in foreign exchange rates and realized gains and losses in our investment portfolio.

Net investment income per share for the quarter was $0.57 per share, flat sequentially from the first quarter of 2016. Despite volatility in the investment and foreign exchange markets in the second quarter of 2016, on a local currency basis, total return on our investment portfolio was a positive 163 basis points. Once we include the effects of foreign exchange, total return was 127 basis points in the quarter in dollar terms.

Our operating cash flow was $153 million in the second quarter as compared to $232 million in the second quarter over a year ago. Mark Lyons will discuss the cash flow and other financial details in a few minutes.

Our book value per common share as of June 30, 2016 was $52.04 per share, a 4.4% increase from the first quarter of 2016. While some segments of our business have become more competitive, we believe that group-wide and on an expected basis, the present value ROE on the business written in the 2016 underwriting year should continue to produce ROEs in the range of 10% to 12% on allocated capital.

Before I turn the call over to Marc Grandisson, I would like to discuss our PML, which is essentially unchanged from April 1. As usual, I would like to point out to you that our cat PML aggregates reflect business balance through July 1, while the premium numbers included in our financial statements are through June 30, and that the PMLs are reflected net of all reinsurance and retrocessions.

As of July 1, 2016, our largest 250-year PML for a single event remains in the Northeast at $495 million or about 8% of common shareholders equity. Our Gulf of Mexico PML at $434 million and our Florida Tri-County PML increased very slightly to $392 million.

I kept my promise to be brief, and I will now turn it over to Marc Grandisson to comment on market conditions before Mark Lyons discusses our financial results. Marc?

Marc Grandisson {BIO 4369887 <GO>}

Thank you, Dinos. Good morning to all.

The insurance industry returned to an average level of cat losses in the second quarter, with insured claims estimated in the $13 billion to $15 billion range worldwide. As you know, Arch underwrites globally, and we will pay a portion of these losses. However, previous underwriting actions taken in both our reinsurance and insurance segments helped minimize Arch's exposure to these events.

You may have heard us discuss cycle managements in previous calls, but I feel it's worth repeating today that our appetite for assuming risk is directly related to our ability to earn an appropriate margin in our view. It's not prudent to grow lines of business where the expected margins are not adequate relative to the risk assumed. The insurance industry continues to face dual headwinds from low investment returns available in the market and underwriting margin compression as we raised sales (08:18) to keep up with loss trends in many lines of business.

Our focus remains on deploying capital judiciously and carefully in the P&C space. But we are continuing to redeploy it aggressively in our mortgage or MI segment, where returns are very attractive and above our long-term goals. We remain bullish on the sector and believe that returns will remain above our hurdle rates for the next several years.

Within the U.S. mortgage MI sector, we estimate that our market share of the primary new insurance written or NIW in the U.S. was in the 9% to 10% range in the second quarter, up from 6.4% in Q1, as Arch MI continues to gain traction in the bank channel. The acceptance of RateStar, our risk-based pricing module, is a primary driver of this growth, and we believe that it will allow us to earn better risk-adjusted return.

In addition, we continued our market leadership in underwriting new U.S. GSE risk-sharing transactions and continued to see good volume from our Australian primary insurance relationship. Our U.S. MI operation increased its NIW to $6.4 billion during the second quarter of 2016, of which approximately 76% came through the bank channel. Over 80% of our bank channel borrowed or paid MI commitments by the end of the second quarter were obtained through RateStar. Our current return expectation across our MI segment is in excess of our long-term ROE target of 15%.

Let me turn now to our primary P&C insurance operations in the United States. Overall, we saw rate changes of negative 180 basis points this quarter versus a positive 20 basis points last quarter. We believe that we have mitigated some of that rate erosion after consideration of our ceded reinsurance coverage. Most of our controls or low-volatility segments had rates changed in a zero to positive territory, while our cycle managed segments experienced single to double-digit rate decreases. As we noted, frequently, our cycle managed segments are more heavily reinsured.

Our UK operation is still pressured from a rate level perspective, with an overall rate decrease across all our product lines of 4.6% this quarter. Our cycle management culture is a key factor in our strategy, and we are reacting accordingly to market conditions. Our net written premium was essentially flat, but we continued to realign the portfolio towards the more effective opportunities in the UK.

Globally, our insurance group continues to adjust its mix of business on a gross basis and also in a net basis, as we are able to buy reinsurance on favorable terms. Ceded premiums increased 5% in our insurance group this quarter over the same period last year.

Areas of opportunity for growth in the insurance sector in the second quarter were in our construction, national accounts, travel and alternative market lines. The vast majority of our growth came as a result of our ability to take advantage of the current dislocation in areas where major players are challenged. In contrast, our executive assurance, excess property and program businesses are areas where rate levels lead us to a more defensive strategy.

Turning to our reinsurance group, which continues its strong performance. Our teams are increasingly more selective given the conditions in their markets. Underwriting year returns in many of the traditional reinsurance lines are in the low-single digit and some are even negative on an expected basis.

Adjusting for one large loss portfolio transfer and the impact of the Gulf Re acquisition last year, our reinsurance net premium written declined by 2% for the second quarter of 2016 versus 2015.

And with that, I'll hand it over to Mark to cover the detailed financial result.

Mark Donald Lyons {BIO 6494178 <GO>}

Thank you, Marc, and good morning, all. As getting into the financial information, I guess, I'll be the most verbose (12:42) side of the - out of the three of us. So, as was true in my previous calls, the comments that follow are on a pure Arch basis, which excludes the other segment, that being Watford Re, unless otherwise noted. I will continue to use the term core to denote the results without Watford Re and the term consolidated when discussing results including Watford Re.

However, due to an all industries clarification issued recently by the SEC regarding non-GAAP measures, our earnings release now emphasizes GAAP measures as some previous tables and commentary that used to be in the earnings release have been shifted into the financial supplement. So please read them together.

Various examples are on page 7 of the earnings release, we now show the reconciliations from net income to after-tax operating income, where previously, it was the reverse. The point being is that you start with the GAAP measure, not the non-GAAP measure. We also, on page 1 of the earnings release, now present consolidated underwriting result that includes Watford Re rather than the core underwriting result that previously had excluded it.

Lastly, the schedule showing prior period development and cat losses by segment, along with the schedule displaying the components of net investment income and investment total return, are now on pages 21 and 23 of the financial supplement, respectively. So, hopefully, that provides a little bit of a roadmap.

Okay, with that said, the core combined ratio for this quarter was 89.9%, with 4.1 points of current year cat-related events, which are net of reinsurance or reinstatement premiums, compared to the 2015 second quarter combined ratio of 87.9%, which reflected only 1.9 points of cat-related events.

Losses recorded in the second quarter from 2016 catastrophic events, net of reinsurance recoverables and reinstatement premiums, totaled $36.3 million versus $15.9 million in the corresponding quarter last year, primarily emanating from U.S. Texas hailstorms and floods, Fort McMurray, Canada wildfires, and earthquake events in Japan and Ecuador.

This was a quarter that experienced the high throughput via cat events, yet the largest of these have less than an $8 million net impact to Arch. This result evidences our continued emphasis on property lines setting and the overall focus towards reducing our cat PML exposure given that in our view, current pricing does not adequately compensate for the exposure assumed in many cases.

The 2016 second quarter core combined ratio reflected 8.9 points of prior year net favorable development, net of reinsurance-related acquisition expenses, compared to the nearly identical 9.2 points of prior-period development on the same basis in the second quarter of last year. This resulted in core accident quarter combined ratio, excluding cat for the second quarter of 94.7%, compared to 95.2% in the corresponding quarter last year. This quarter, the reinsurance segment had two unique transactions that impacted the financial segment in different ways, both related to loss portfolio transfers.

The first reflects the commutation of a pre-existing contract that resulted in recognizing $19.1 million of other underwriting income. However, this contract had been accreting approximately $1.5 million of gain a quarter. So, the incremental impact is approximately $17.5 million for the quarter. This contract had been receiving the positive accounting treatment since inception, since it did not pass risk transfer under GAAP. Since this gain shows up in other underwriting income, it is outside of the combined ratio.

The second transaction involves a newly bound loss portfolio transfer with a long-term client, where we have familiarity with the underlying exposures. This contract has sufficient risk transfer under GAAP and, therefore, receives insurance accounting treatment.

As a result, we booked this contract at approximately 100% combined ratio and its impact is solved (16:44) directly in the combined ratio. Furthermore, it covers the cedents net after all annoying (16:49) reinsurances, thereby making this a frequency contract. That said, the reported calendar quarter of reinsurance segment combined ratio of 82.1% would actually be 79.4% without the impact of this new loss portfolio transfer. In addition, it results in a 7.7-point increase in the calendar quarter loss ratio with a five-point benefit to the expense ratio, therefore, totaling a 2.7-point worsening of the calendar quarter combined ratio over what it would have otherwise been.

Now, getting back to our results for the quarter, the reinsurance segment 2016 active quarter combined ratio excluding cat was 98.4%, compared to 94% even in the 2015 second quarter. This quarter's combined ratio reflects the impact of the loss portfolio transfer we just discussed, that contributed approximately $40 million of net written and net earned premiums, as well as the impact of a large marine attritional loss that had no equivalent in the second quarter of last year. Without the impact of these items, the accident quarter loss ratio was nearly flat over last year's quarter.

In the insurance segment, the 2016 accident quarter combined ratio excluding cat was 96.3%, compared to an accident quarter combined ratio of 97.6% a year ago. This 130-basis-point decrease was driven by 100 bps in the loss ratio and 30 bps in the expense ratio, with the loss ratio decrease reflecting a lack of the large attritional losses that we experienced during the second quarter of 2015. When one adjusts for this, the non-cat non-large attritional loss ratio was essentially flat quarter-over-quarter.

The mortgage segment 2016 accident quarter combined ratio was 66.1%, compared to 77.4% in the second quarter of last year. This decrease is predominantly driven by the continued expense ratio improvement in our U.S. primary MI book due mostly to growth, along with beneficial mix changes towards GSE transactions receiving insurance accounting treatment in lieu of derivative accounting treatment.

Regarding prior periods' reserve development, the insurance segment accounted for roughly 6% of the total net favorable development in the quarter and this was primarily driven by shorter-tailed lines from the 2012 through 2014 accident years, with some contributions from longer-tailed lines spread primarily across accident years 2003 through 2012, and partially offset by a large energy casualty claim from the 2015 accident year (19:25) Bermuda insurance operations.

The reinsurance segment accounted for approximately 81% of the total net favorable development in the quarter with approximately 70% of that's due to net favorable development on short-tailed lines concentrated in the more recent underwriting years, and the balance due to net favorable development on longer-tailed lines, primarily from the 2002 through 2013 underwriting years.

The mortgage segment contributed to the balance or 13% of the total net favorable development in the quarter, which translated to a near 17-point beneficial impact to the mortgage segment loss ratio, primarily resulting from continued lower-than-expected claim rates from our U.S. primary mortgage insurance operation and from the quota share treaty covering the 2009 to 2011 book years as part of the original PMI and CMG purchase transaction.

As discussed in previous quarters, almost all of the favorable development benefit is offset by the contingent consideration earn-out mechanism negotiated within the purchase agreement. This contingent consideration impact, however, is reflected in realized gains and losses and not within underwriting income.

This quarter, the nominal payout cap within the contingent consideration mechanism was reached, which is 150% of the transaction closing book value. Effects will still be felt in future quarters, though, as we continue to accrete to the contractual payment date and the discount rate employed to account for increased certainty decreases over time.

The overall core expense ratio improved by 180 basis points, but this was affected by the loss portfolio transfer referenced earlier. Controlling for this transaction, the core expense ratio improved by 20 basis points driven by the continued improvement in the mortgage segment expense ratio and continued marginal improvement in the insurance segment expense ratio.

On a written basis, ceding commissions achieved within the insurance segment quota share sessions improved 210 basis points over the second quarter of 2015. As stated last quarter, the growth at alternative markets business reduces this benefit somewhat due to the associated capital cessions (21:36).

Core cash flow from operations was $153 million as Dinos mentioned in the quarter versus $231 million in the second quarter of 2015. This reduction was caused primarily by higher loss to be paid net of recoveries and the timing of outflows associated with ceding more premiums this quarter versus a year ago.

Core interest expense for the quarter was $12.4 million, compared to $12.6 million in the first quarter, and $4 million in the prior year's quarter. The prior year quarter amount included a favorable adjustment for a deposit accounting transaction, which resulted in an $8.4 million reduction in the interest expense in that quarter. As mentioned earlier, this deposit contract was commuted during the quarter.

Our effective tax rate on pre-tax operating income available to Arch shareholders for the second quarter of 2016 was an expense of 5.9% compared to an expense of 3.9% in the second quarter of last year. This quarter's 5.9% effective tax rate includes approximately 20 basis points or $250,000 related to a true-up of the prior year's tax provision to the estimated annual effective rate as of June 30.

As always, fluctuations in the effective tax rate can result from variability in the relative mix of income or loss reported by jurisdiction. Our total capital was $7.6 billion at the end of this quarter, up 4% relative to March 31. Our debt-to-capital ratio this quarter remains low at 11.7% and debt plus hybrids represent only 16% of our total capital, which continues to give us ongoing financial flexibility. We continue to estimate having capital in excess of our targeted position. We did not purchase any shares this quarter under our authorized share buyback program and the remaining authorization is approximately $446 million as of June 30.

With these introductory comments, we're now pleased to take your questions.

Constantine P. Iordanou {BIO 2397727 <GO>}

Abigail, we're ready for questions.

Q&A

Operator

Thank you. Our first question comes from Kai Pan with Morgan Stanley. Your line is open.

Q - Kai Pan {BIO 18669701 <GO>}

Good morning and thank you.

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

Hi, Kai.

Q - Kai Pan {BIO 18669701 <GO>}

First question – hi. These two large portfolio transfer transaction, can you give me more details about it? For the one you commute, what's the reason for that and for the one you just booked? And so, how do you - what attractive to you, what (24:16) to you and do you see other opportunity - similar opportunities?

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

Well, the first one we commuted, we always try to keep very good relationships with our clients. It was a client request, they want it, and we felt the terms of commutation, they were attractive to us, so we accepted it. The second is in the normal course of business, we always look with transactions and this was a transaction presented for us. We like the economic, so we did it. Marc, you want to add with?

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah, the only thing I would add on the second one, it was really as a result of being intimately very familiar with the book of business. It's a kind that we have known for many years and the years under which that LPT is - the year just covering (25:00), we actually had underwriting risk alongside with that party as well, and that came as a result of a - again, a request by the client to seek and improve their capital ratios, and that's really a - this is why it's driven, that's what it's driven by.

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

Yes, it's a capital relief situation here.

Q - Kai Pan {BIO 18669701 <GO>}

Do you see more similar opportunities?

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

Yeah, we see activity in that sector as a matter of fact. But we don't make predictions as to - are we going to do any of that, because I have the faintest idea if that's going to happen. The instruction to our guys is, you look at them, you like the economics, we do them, we got the capital. If you don't like the economic, we pass.

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

Yeah. And Kai, so it's always tough with the long runway on those. Hit ratio is below, but we continue to see them and entertain them.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. That's good. On the MI side, the Australian reinsurance transaction, is that considered like a one-off or is it a continuing relationship if that could recur?

A - Marc Grandisson {BIO 4369887 <GO>}

This is an actual ongoing relationship. It's a quota share of a primary insurance book of business.

Q - Kai Pan {BIO 18669701 <GO>}

Okay, so...

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

And we will continue until we can.

A - Marc Grandisson {BIO 4369887 <GO>}

Until we both can and the good parties agreed to.

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

Right.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. Are there additional sort of like gross opportunity with that client?

A - Marc Grandisson {BIO 4369887 <GO>}

At this point, we don't perceive that we had a very significant portion of their portfolio and we're sort of happy, very comfortable with that position.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. And lastly, it's on your rate commentary in the insurance industry. It seems like it's down like decelerated in term of pricing decline. Could you give a little bit more color on the pricing dynamics there? And in this environment, how do you sort of imagine your portfolio? It looks like your, like, core combined ratio actually improved in the insurance segment, you said mostly due to mix change. Will that be enough to keep the margin?

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

Well, it's a complicated question. Let me give you the strata data. We don't give you the granular performance or in each one of the sectors for obvious reasons. You listen but so our (27:28) competitors et cetera, so we're not going to tell them everything that we do. But it's true in our comments that the aggregate rate reduction across the entire renewal (27:41) group was about 1.8%, that's 180 bps.

And then, you're factoring some loss claims trend. That means that's not a good market to operate. Now, having said that, we have sectors that we're very defensive because that's where we're seeing the significant rate reductions. I mentioned in my remarks, property lines and access both in D&O, professional and liability line with the capacity players. And at the end, there is no – it's pure supply and demand. There is no differentiation in the product, et cetera. And it's under pricing pressure.

We try to manage those down and we try to put more emphases on a small to medium-size business that we have more control on the rating and also the quality of the risk, et cetera. Now, I'm going to turn it over to Marc Grandisson, because he runs the insurance group now. He runs all of our operations. And he's more granularly involved with this decision as he does the review to the profit sense, et cetera, to give you a little more flavor.

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah, the flavor was actually given in the remarks. I did mention specifically the controlled and low-volatility business, which is a small to medium size where we have more intimate and more influence over what's happening in the form and pricing. We are getting flat to single-digit rate increases in many instances.

The ones that are more cycle-managed, more open market, a lot more competitive, a lot more commoditized, this one had the single-digit 5% to 7% rate decrease. So, and as I mentioned also in my comments, the cycle-managed one is the one where we are a little bit more willing and then, working harder to buy reinsurance to actually mitigate those rate decreases.

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

And I would just add on top, because Marc nailed it, is the additional layer that we talked about, the ceding commissions. So, on the commoditized product line, you manage your mix to increase reinsurance, and this is the environment you're getting – continuing those big overrides that drop the bottom line and really help the net income.

Q - Kai Pan {BIO 18669701 <GO>}

This is great. Thank you so much, guys.

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

Thank you.

A - Marc Grandisson {BIO 4369887 <GO>}

Thank you.

Operator

Thank you. Our next question comes from Jay Gelb with Barclays. Your line is open.

Q - Jay Gelb {BIO 21247396 <GO>}

We've heard some other reinsurers and perhaps even some of the brokers say that they view the reinsurance market is bottoming. Would you agree with that?

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

In general, I do. Marc, (30:39)?

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah, my comment on this is – I will be careful because we don't know again the future. There are certainly signs that reinsurance markets are pushing back on markets like property cat for instance. There is some layers that have to be re-priced in the second quarter, because there was too much aggressiveness in trying to get the price down. So there's some pushback. It's still going down, but not to the same level.

In addition, we also have pushback from the market on getting increased ceding commission. We are successful in getting a couple of points, which Mark and Dinos mentioned before. But this is landing around 1% to 2% increase, but there's a lot of push to get more than that. So, there's still a lot of pushback from the market at this point in time.

What I tell our troops is, again, we're going to react to whatever we see in the marketplace. It could be a bottom, it could be a plateau before more damage being done. It's really too early to tell.

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

But you see shortfalls. That's an indication that there is a pushback if you can fill the placement and you got to go back with filling a shortfall.

So, there are signs that we're hitting the bottom. Listen, where interest rates are, where investment income is, you better make it on the underwriting. And if you're not making it on the underwriting, you better pack it in and go and open a Greek diner. You make more money doing that.

Q - Jay Gelb {BIO 21247396 <GO>}

Okay. The next topic I wanted to touch on is the mortgage insurance business. And based on our model, it looks like the underwriting profits from that could double this year compared to 2015, driven by the strong top-line growth and improving margins. How big of a business can you envision this being over time?

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

Well, first, you got two questions there. One is you're projecting earnings – I don't think your comment is actually solely correct. You got to understand that in our MI book, we have U.S. MI, we have the Australian MI which is more steady. We got GSEs which is more steady. And then, we have some early transactions. We had a couple of reinsurance transactions that did declining because they're maturing. They were a vintage 2012 and the duration is six, seven years. So, we're towards the end of those. So, I would say yes, the contribution of earnings is going to grow, but it's not going to be exponential the way you put it.

Having said that, the second part of your question is do we like the sector and, yes, we do and we're willing to contribute more of our capital. But we don't want it to be totally the dominant exposure that we have. And the way we think about it, we want to have a balance over time between reinsurance, insurance and mortgage.

Having said that, in different parts of cycles, depending which segment is the most attractive, the earnings might be coming heavier in one area and lighter in another area. But that's the beauty of allowing us to navigate and allocate capital into our three businesses.

At the end of the day, we'll not be 100% mortgage company, we won't be 100% reinsurance company, and we won't be 100% P&C company. But the market will determine which sector is a little bigger or a little smaller. But for us - because at the end, we're only chasing margins. And if you're chasing earnings, you got to go where the earnings are.

Q - Jay Gelb {BIO 21247396 <GO>}

Of course. On the mortgage insurance front, do you envision it being organic growth, the charges going forward, or is Arch interested in acquisitions in that space?

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

We're interested in everything. I mean, we like the sector but our history has been let's make sure that we have the right strategies that we can always grow organically and depend on that, because acquisitions, sometimes they happen, sometimes they don't. And at the end of the day, you don't have.

We don't have a strategy that is focusing on acquisitions for growth. Our strategy is focusing on let's see if we can build it organically. But we're not excluding anything that you might be thrown that way and is attracted to us. Marc you do you agree.

A - Marc Grandisson {BIO 4369887 <GO>}

I agree with you, yes.

Q - Jay Gelb {BIO 21247396 <GO>}

Thank you.

A - Marc Grandisson {BIO 4369887 <GO>}

Welcome.

Operator

Thank you. Our next question comes from Michael Nannizzi with Goldman Sachs. Your line is open.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Thank you so much. One question, Mark, just on the reinsurance business or the LPT specifically. It seems like all of that was earned in the second quarter. Should we assume that there really isn't a durable impact for the remainder of the year either in terms of top line or losses, firstly? And then, secondly, should we assume that it renews again in the second quarter next year and we should see that lift in premiums again when that happens? Thanks.

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

Okay. Good question. So, both of those, you should view that as a unique special event, not recurrent and really not earnings that was virtually fully earned right away. So, consider it a quarterly outlier.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay, so not expected to...

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

There is no underwriting gain or loss. We booked it at $100 million (36:43) combined. And at the end of the - yeah, that's small increment on the flows that is going to run (36:53), it's going to be there. But there is - for all intents and purpose and for your model, ignore both of them. Yes.

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

I mean, Michael, is it possible a year from today, we reevaluate the ultimate as favorable or what have you?

Q - Michael Nannizzi {BIO 15198493 <GO>}

Sure.

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

But don't think of it as a quarter-by-quarter impact.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. Okay, great. Thanks. And then, looks like Watford premiums were down year-over-year. So, I was just curious, because it look like sessions and the segments were up. So, does that just mean that you're ceding business to more non-Watford entities, or how should we think about that?

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

Well, I think you've got - Marc already talked about it. If you're looking at overall session, you have the insurance group continuing to cede a little bit more.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Yes.

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

I think in totality, it was roughly the same net of growth at an ACGL level. But the mixture between, you still got the reinsurance guys doing some retrocession there, because mostly leveraging reinsurance from the insurance sector side.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Yes.

A - Marc Grandisson {BIO 4369887 <GO>}

There's not much change in the buying as well on the reinsurance side as well. It's very consistent.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it, okay. But just the net, like the dollar amount of sessions and the businesses was higher whereas the net premiums in your other segment, which I assume is all Watford, were down. So, I was just curious if your strategy in terms of how much business you're placing with Watford was changing or if that's – there's some other distortion in there.

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

No. Let me take you back and then, I'll turn it over to Marc. At the end of the day, dependent if we're shipping premium out to third-party reinsurance or to Watford, it's got to make economic sense. So, we're not going to – if I can get it cheaper in the open market, I'm not going to give it to Watford just to maintain volume.

I'm going to go and buy from where is the most attractive place for me. Having said that, I don't think we have changed anything strategically as to what we'll do with Watford. Our responsibility with Watford is to be the underwriting managers and underwrite business that at the end of the day, it's going to give them flow as close to zero, of course, that's possible. And when we find those opportunities, we do it and we give it to them.

And if the business produces returns that are acceptable to Arch, we won't cede it out. We'd keep it at Arch. So, our philosophy and our strategy have not changed.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay. Got it. Thank you. And then, just lastly, just back to mortgage for just a second, written premiums both gross and net have increased nicely. I'm guessing a lot of that is the GSE business – I mean, all the business but GSE seems to be growing more. Earned premium has lagged that growth. So, I guess I'm just trying to figure out how – yeah?

A - Marc Grandisson {BIO 4369887 <GO>}

I can answer some of that.

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

Go ahead, Marc.

A - Marc Grandisson {BIO 4369887 <GO>}

The premium written, a lot of it – half of the growth actually comes from Australia as a result of being the product with a single premium upfront. So you get all the premium upfront and the earnings pattern is extremely (40:12) drives along.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay.

A - Marc Grandisson {BIO 4369887 <GO>}

And also, on the written premium for that, but the rest of the unit, there will be a lag in earnings, because we have to write the business and it takes a long time to write and we have some singles as well on the Arch U.S. MI, so we did write some singles there, not as much as the other guys in the world, but we did some. So, there is definitely going to be a lag between the written by virtue of being single upfront mostly from the Australian business.

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

In the way you got to think about this is that, first, the mortgage business has a six to seven years earning pattern, right? The Australian market, a lot of it is single upfront, but it was still earned over six, seven years. So, you have lack in the earnings and lack on the income that is going to come over time.

In the U.S., you see our numbers. We do about 20% singles, 80% is the monthlies. The monthlies, they book and earn on a month by month. The singles, they're written upon, but they earn over six, seven years.

So, as long as you monitor those two, it would give you a good ability to put both the earnings stream as it's going to come in and also the net income stream that is delayed. That's why some people like to talk about embedded value in the mortgage sector, which some of you might have models predicting what's going to happen in the future.

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

And Michael, just – I think you're probably going to go back and you're thinking about how you're going to project this stuff on a go-forward basis. I just want to clarify, both Marc and Dinos talked about Australia being a singles market. I just want to make sure you realize that the contract itself is not a big bullet single. It's a contract over a whole set of singles that they accept one month and one day after the other after the other, I think. So, it's a book of business that has singles incepting (42:15) throughout the term. It's not a big bullet single...

Q - Michael Nannizzi {BIO 15198493 <GO>}

Right. But it's not a bulk transaction.

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

We're getting it every month, but we're not getting a little component month by month over seven years. We get it all upfront.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Right, I got it. So it's not bulk, it's...

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

So, all the mortgage is going to be one in one year (42:32). The premium is going to be booked in that particular year. But it's going to be book month by month.

Q - Michael Nannizzi {BIO 15198493 <GO>}

I understand. So, it's flow business, not bulk business. It just happened to be single.

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

Yes.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay. Got it. Great. Thanks so much.

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

You're Welcome.

Operator

Thank you. Our next question comes from Quentin McMillan with KBW. Your line is open.

Q - Quentin McMillan {BIO 19411547 <GO>}

Hi. Good morning, guys. Thanks very much. Mark, you had a lot of information in there and thanks for walking us through everything with a little bit of a more complicated quarter, a couple of those one-off things.

But one thing that I wanted to understand just a little better is you mentioned the reserve development in the mortgage that had an offset in the contingent consideration reaching the nominal payout cap.

Can you explain that a little bit better for us, sort of how the reserving works there and why you had this big - relatively bigger $11 million reserve development and it sounds like it's an offset somewhere else in the balance sheet, so it's not really a gain? Is that the right way to think about it?

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

Well, think of it more as an (43:37). You've got prior period development. Rough number (43:42) for $10 million or $11 million, I think, in totality. So, it was $10 million or $11 million on a realized loss is how it goes through. And then, you've got the standard part of your development. So, it has to be coming from the same source, kind of like a profit commission, some client does (44:02), with a loss ratio increase and might decrease the profit commission.

Similarly here, you've got the subject years of what we've purchased. So, it was – it's continually lower delinquency rate and claim rates associated with those that dictates and indicates the reduction, because on the CMG transaction, we bought – it was a provision that was a stock purchased. So, we initially paid 80% of book with an earn-out mechanism. And depending upon the...

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

Actual performance.

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

...the actual performance, which is exactly what this is indicative of. We could pay out more up to 150% of the closing book value. We hit that nominally – not present value, but nominally this quarter, but it's directly related. So, I think it continues to have good performance as mostly shown through improved loss reserve development, you get an increase in the contingent consideration.

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

Then, from now on, anything that is positive we will continue. It sticks to our ribs. They have ate all of them here. It's (45:12) done.

Q - Quentin McMillan {BIO 19411547 <GO>}

Okay. That's great and very clear and really helpful. Thanks very much. And secondly, on the MI side as well, you mentioned 80% of the 75% of the bank channel – I'm sorry, 76% of the bank channel came through RateStar.

Obviously, that's having great success for you guys. Can you just talk to us about what you're seeing the competitors now do in response to RateStar or maybe sort of what you expect the competitive environment to look like because of that?

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

Well, I don't know what they're going to do and as far as we're concerned, at the end of the day, RateStar is the proper way in our view to price mortgage. This is no different than in the auto sector, when you introduce many different variables to price risk appropriately and that's what we've been doing. We're pretty happy with not only the performance from a production point of view, but also when we go and back that, what RateStar gives us versus rate card. But we still have the rate card. Our clients – some 20% of our business and 50% of our business in the credit union channel is coming through the rate card. But we test both and what we like a lot about the RateStar is that, first and foremost, the

(46:38) variability around the mean is very narrow. And we like that, it gives us stability and more predictable earnings, while the rate card has much bigger variability.

And now, how competitors, they're going to – their response? I don't know. I think the best way for them to respond is just – and I don't want to give my competitors advice, is go to a risk-based pricing tool and make sure that they're pricing risk appropriate. I mean, that's the proper response. If they try to just cut rates on the rate cut and all that, it's like somebody in a quicksand and they keep moving their feet.

A - Marc Grandisson {BIO 4369887 <GO>}

So, one thing I would add to this is the only – the other one that's a big competitor of ours is the FHA as you guys know. So that one is a government agency, that's also even harder for us to even figure what they want to do with the prices. So, I just want to make sure I put it out there, yeah.

Q - Quentin McMillan {BIO 19411547 <GO>}

So, the government's tricky to figure out. That's unusual.

A - Marc Grandisson {BIO 4369887 <GO>}

Exactly.

Q - Quentin McMillan {BIO 19411547 <GO>}

If I can sneak just one more in. I'm sorry. On – the valuation of the stock, obviously, is a very high quality problem to have. It's been up there and above what your three-year return threshold would be for buybacks and I'm kind of assuming that's why buybacks were limited in the quarter.

Just assuming that we stay in the sort of heightened valuation for the stock in the near term over the long-term, how do you guys sort of expect to deploy capital or what might you do?

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

Well, I think you're reaching a conclusion that, in my view, right; it might not be. It wasn't as much the valuation of our stock, but it was more where we see opportunities in the marketplace. And let's face it, we've seen most of the opportunities on the MI space.

So, basically we kept that powder dry for the reason that we can deploy more capital in the MI space and that was the main reason behind it.

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

And as Dinos alluded to, though, it's a combination of things. We never have a price line, as you know, on that. It's more of a guidance. And for most of the quarter, we rated I'd say a little south of 14 (49:00) to book value. So, it's got to be a little clearer than that given the combination of things.

A - Marc Grandisson {BIO 4369887 <GO>}

Right.

Q - Quentin McMillan {BIO 19411547 <GO>}

Okay. Perfect. Thanks very much guys.

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

Thank you.

Operator

Thank you. Our next question comes Josh Shanker with Deutsche Bank. Your line is open.

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

Yeah. Thanks very much, everyone. I want to look at the favorable development of the mortgage reinsurance segment and understand – I mean, I realize that this is very low loss content business, but you're only weighing a short period of time and almost took all losses out for the quarter. I mean, what's going on? Is that onetime in nature? Is the business so good that it's not showing any losses, sort of?

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

Josh, it's been a continual march downward on the delinquency rates and the associated claim rates as they come out of that. So remember, this is really 2011 and prior, so there's vintage seasoning associated with this.

So, it's not like the PC and it's really – you got to think of it as more of a report year (50:09) view of the triangle. So...

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

Yeah, this is CMG mostly, which is the credit union of business and we bought that company and we bought the reserves and we bought all the assets and the liabilities that come along with it and we had that pricing mechanism, the adjustment we talked about.

But at the end of the day, you got to report that performance and the performance was better than we even expected ourselves. Otherwise, I am the dumbest on two legs, because what I negotiated didn't work for me, work for them, because I'm paying a lot more for that company than if I would have taken 100% book value at that time. In retrospect, if I know what I know today, I would've negotiated better.

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

You can't see us nodding here, Josh.

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

So, if I look at the mortgage loss reserve, what percentage of it in broad terms is legacy business versus Arch MI business?

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

I don't have that at my finger tips. But I would say substantially.

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

The vast majority – all the stuff.

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

Okay. So, the fact, that you're not favorable developments (51:32) to negate your current accident year losses. So if you – comparing apples and oranges, you have a huge back reserve and a small sort of new co-reserve.

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

That's correct.

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

That's right. And remember, Josh, we kind of alluded to it, I think, in the prepared remarks that sort of part of their original transaction was a quota share on 2009 to 2011, I call it back book. And so that is also experiencing some of the same aspects. So that wasn't the CMC, that was CMI.

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

And do you have any reason to believe that business that you can protect RateStar underwritten business has a better loss ratio than rate card business?

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

We priced RateStar and rate card to give us the same ROE, so we have the same target. Now, as we back testing both, because every month, I ask the guys and we back test based on the volume that comes in and we underwrite. The only difference between the two, it's not on expected return on equity. I think both of them, on an expected basis, they're about the same. And we did price both at about 15% ROE.

The difference is that, RateStar is – the RateStar produce business is very narrow – narrower around – it's 3 to 4 ROE points up and down SME. Rate card (53:16) is much wider. Give you an example, if you had just (53:24) credit score has one variable that you're going to test for, if you're testing the 750 (53:29) in the rate card that says RateStar, the rate card, even though the mean might be 15%, it might be as some business all the way up to 20%, 22% and some all the way to 7% or 8%, where with RateStar it's more like 12% to 13% all the way up to 17%, 18%.

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

Okay, that makes sense. Well, I appreciate the answers if I'm right. Maybe I'll be ceding the microphone to Ian right now, so we'll see what happens.

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

Well, you were right on your write-up, but just you couldn't predict our one-off transactions. And when you're ready to predict our one-off transactions, I want you to call me because you and I will go to Vegas together.

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

I'll make sure I do that. Take care.

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

Thanks. Take care.

Operator

Thank you. Our next question comes from Amit Kumar with Macquarie. Your line is open.

Q - Amit Kumar {BIO 19777341 <GO>}

Oh, man, this sucks. No, Ian – I'll try to ask some intelligent questions now. This is a big thing for me. So very quickly, these are more – most of my questions have been answered. But sort of big picture question. One is sort of tying in the comments in response to other questions. If returns were stable in reinsurance and insurance and if your MI business is growing rapidly, should we expect a slow trend up in the AY ROE? And if that is the case, does your book value grow at a faster clip than the industry, all those being kept equal?

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

No, because your assumptions, I don't think you were totally listening to us correctly. We said that reinsurance is deteriorating. I mean, still very good results, don't get me wrong, but is under pressure, so we're losing ground there. And we're losing lesser ground on the insurance side, but both those sectors were losing ground.

So in essence, from a profitability point of view, they're not going to have the same ROEs as before. And that's – the reason I didn't change the 10% to 12% on an underwriting basis because I'm offsetting what I'm losing on those two sectors by what I'm gaining through mix change on the MI sector, and that's the way you got to think about it.

Q - Amit Kumar {BIO 19777341 <GO>}

Got it. Yes, that's a fair comment. And I'm sure Ian has already disappointed and me. The next question I have is, again, on MI, with the Baron story coming out on Sunday, there has been a lot of focus, a lot of sort of new investor feedback, as well as from traditional investors. The one question which I was getting, and this is sort of interesting, is that the traditional P&C investors were asking, if things go south, wouldn't Arch be locked in unlike traditional P&C, where you can cut back on your writings, pull back on the capital and then wait for the cycle to turn? It seems that there was some fear on that thought process, whereas Arch becomes bigger and bigger in MI, maybe a different class of investors cycle in a traditional investor cycle out. What would you say to that in terms of if the cycle does turn, how easily can you sort of pull back or pull out or change your strategy?

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

Well, let me see – it's a very complicated question but it's a very, very good question, because it talks about what you need to do from a risk management point of view on capital allocation and also what the history has taught us in this particular sector.

Let me start by pointing out to you that the performance on the bank channel versus the credit union channel was even – the worst year for the credit union channel through the financial crisis was a 152 (58:08) loss ratio. Nothing to write home about but not catastrophic, right? And what I'm sharing with you is information we have through the PMI transaction, right?

On the bank channel, you've got in excess of 300, (58:29) 2x. When we examine that, and we've done a lot of analysis on it, most of it, it wasn't just economic conditions. Yes, economic conditions will have an influence. And that's the cat event that you have to plan for and make sure that from an aggregation point of view, you're comfortable with how much risk you're taking.

(58:54) will tell you that if you don't violate your underwriting guidelines, your performance even in down economic conditions and employment going to 15% and prices coming down by 25%, you can withstand all that as long as you discipline on your underwriting side. Because most of the delinquencies, they came from fraudulent loans, loans that there was very little verification, the underwriting information, it was very suspect, and on top of it, very, very loose underwriting, people writing risk that they shouldn't be taking that risk.

Having said that, it's no different when you write long-tail liability lines on the P&C world. If you're pricing your workers comp at 20% or 30% below, independent, if you stop writing tomorrow, you're going to have that tail that is going to continue hitting you with adverse loss development year after year after year. For the duration of those liabilities, it's probably even longer than the duration that you have on the MI space. They kill this business in my view and in all of our underwriters is to maintain discipline in accepting risk.

The beauty of it is that even when you stop underwriting, let's say, your pricing is at – and where risk-based pricing maybe the market will reject your pricing and they're going to find it cheaper from a set of competitors. You continue to have means of revenue coming from what you underwrote properly in the prior year. And then the only thing you need to worry about is the broad economic downturn, increase in unemployment and price reduction in the housing market, et cetera.

And we test for that and we have cash flows and also that determine as to what size we want MI to be as part of the overall Arch family, so that that's what we are. Marc?

A - Marc Grandisson {BIO 4369887 <GO>}

One difference I would say with casualty and I totally agree with the analogy is that we have a lot of tools that are – that we can use to really assess and evaluate the origination at any given time. So you know exactly what's been originated at any one point in time. We can assess what the risk is in our portfolio. And I would argue that in MI book of business, there's a lot more when we continue than a casualty book of business, all lines of business, more and more genius, much more stable, a lot more predictive in terms of what you bring to the table by virtue of the variable use of price. So it's always a factor. Things could change after you've underwritten it, but certainly when you underwrite it, you have a very good sense for the quality of what you have underwritten.

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

Yeah. And then I'll just add one more thing. Your premise is that all PC business can be decisions on an annual basis. As the market softens, you get an increased proportion of multiyear contracts, and this is as an industry statement. And this is a differentiator between carriers. And it's a difference between having multiyears, but legitimate re-underwriting abilities versus one where you're locked in. And that's becoming increasingly common. And as that grows in proportion, it's not quite of a stark difference as you think.

Q - Amit Kumar {BIO 19777341 <GO>}

Got it. That is actually very, very helpful. Thanks for the answers and good luck for the future.

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

Thank you.

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

Thanks, Amit.

Operator

Thank you. Our next question comes from Jay Cohen with Bank of America Merrill Lynch. Your line is open.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

Great. Thanks for that last answer. That was actually helpful. A question on mortgage insurance, shocking. When I look at the results for the quarter and I take out the favorable development and I come to this kind of accident year of loss ratio, first of all, is that a reasonable concept in mortgage insurances?

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

No. Sorry, to interrupt you halfway through, Jay, but...

Q - Jay Arman Cohen {BIO 1498813 <GO>}

No, that's helpful.

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

Yeah, you've got to think of it as a – it's report year. You're closer to a claims made in view of business and in current view. So accident year and claims made business really is report year, and this is really the same thing.

You can't reserve unless you have a delinquency and that's – we don't like the accounting model. We talked about it in other calls, but at the end of the day, I'm not setting up the rules. I just play by them.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

The trend I've seen in this ratio, which has kind of steadily calm down, that not necessarily is kind of the thing to look at going forward?

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

You mean the delinquency rate or...

Q - Jay Arman Cohen {BIO 1498813 <GO>}

The loss ratio excluding whatever you want to call it, the loss ratio you're reporting excluding the prior-year development which has gone from 30 down to 17 makes it hard for us to forecast that number. Is the more recent year – recent quarter, is that a reasonable number to use?

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

It's really – there's more mixture going on here than you think. Marc and Dinos talked before about the glide path difference on some of the old reinsurance contracts that are now running out. The insurance accounting treatment on a lot of the GSEs have a different loss expectation than does some of the primary U.S. So I hate to say it, but it does come down to a lot of mixture.

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

If we were a pure primary MI, it would be easier for you because – then you will see what the average claim cost is, which doesn't move very much in the mid-40,000 range. And you will look at the delinquency and that is improving bit by bit. But because we have – we got the Australian business, we have the GSE business and those that depends what blocks will you add gets a little more complicated.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

Got it. It's a bit of a modeling challenge certainly.

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

I mean, listen, you've got to have some challenges.

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

Jay, a high level to help you, I think the way we think about it in the run rate basis, the expenses is about 25 to 30 and the run rate, I mean, I think about it globally in the industry mature book of business. And currently, the loss ratios anywhere to see them reported 20 to 30. It sort of use give a range and kind of had to be if nothings happens, we think that significantly below this, but trying to get you a long-term average.

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

That's the way we think at ultimate...

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

Look at a long-term average.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

Got it, that's helpful. The second question was on the – this contingent consideration. Mark, what was the cap that they – what was up to a $550 you said?

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

I don't know.

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

At 50% of the stated value at closing.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

Okay, got it.

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

But it was unknown provision, basically we will continue to the recalculating the book value based on the actual performance of the loan portfolio from the date of closing in prior.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

So it's on that that basically has kind of helps your operating earnings and it was offset in the kind of the net income some extent?

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

Yes, we have net income or just realized.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

Right.

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

So it's operating versus net income.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

Yes, but going forward, it sounds like that offset on the unrealized loss or realized loss won't be there to the same degree anyway, in FY starts to focus through more right to net income.

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

You will as I commented because the financial statements reflect more of the present value of it. So it would increase over time like any interest unwinding.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

Right.

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

Well, especially if we capped out an anomaly will accrete towards the payment date plus will required through GAAP accounting to – as it becomes more certain, we have to drop the discount rate used in that present value cap. You get both forces causing additional affect in future calendar quarter.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

Yes.

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

Yes, but they're going to be smooth. So don't get too over excited.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

But that make sense, and then lastly just on the political environment, your – fairly global company and since those parties have miss used with free trade. Are you – can one concerned about this? Two, are you doing anything to prepare for maybe a challenge in the trade environment?

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

Not specifically because at the end of the day, listen free – will affect that global GDP and global GDP will affect the revenue for the insurance sector. But having said that, because we're highly regulated business, a lot of work we do is global, it's local from the regulation point of view.

You operate and local licenses and you participating with the local market et cetera. I don't see significant change in the way that insurance business is done, if there are barriers that they put on. At the end of day though, if GDP growth is very low, it will affect our ability to get revenue, and it's been always like that. You can track the growth on the PNC world of insurance as - with GDP and there is very, very good power licensing.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

Great. As usual, helpful comments, thank you.

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

Thank you.

Operator

Thank you. Our next question comes from Brian Meredith with UBS. Your line is open.

Q - Brian Robert Meredith {BIO 3108204 <GO>}

Thanks. I'll be quick here. So just back on the MI business, I'm just curious that the Australian reinsurance business have better economics than the U.S. IM business, as that going to come, then is that contributing to maybe the improved loss ratios and stuff we're seeing? And then as - is that any other opportunities that you are seeing in the Australian market?

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

So, on the Australian market, right now the Australian transaction that we have is really like an insurance of flow business that we've done with that partner of ours down under. That has not gotten a lot of earned premiums. I wouldn't expect a lot of pickup from that really.

We have done in the past some reinsurance transactions that we - to go back to your point about - second question about opportunities, there were opportunities in the past. That's also what got us to really focus more intently on Australia, we had quota share reinsurance transactions with a couple of players down there. But since we have started significant relationship with that bank, we don't feel that we have the need to do anything more in this segment.

Q - Brian Robert Meredith {BIO 3108204 <GO>}

Got you. So you have capped out in Australia, you wouldn't do anything else?

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

For now, the answer is we're comfortable where we are right now.

Q - Brian Robert Meredith {BIO 3108204 <GO>}

Great. That's helpful. And then I'm just curious on the LPG transaction, just trying to understand that, what kind of interest rate or return assumptions are you using when you're doing a transactions like that ticket returns that you did?

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

Right now, our units are doing pricing – transactions or portfolios using a treasury fee rate by and large. That's what we're using that how they compensate on when they calculate the ROEs.

Q - Brian Robert Meredith {BIO 3108204 <GO>}

So if you do under combined ratio, that means that there's like virtually zero capital sign, but – okay.

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

No, capital, no, there's no return. No return. The capital is allocated based – no underwriting return. But the duration of liabilities there, I would say, five years there will be take that five years and that's 5% pickup on the float. Now, when you look at the contract, we assign capital to it and you got to see what's the upside, downside and how much capital it goes and you make those calculations.

So, again, some of these transactions, they have a limited risk transfer. Some of them, they have mores transfer, and that's when we got to go through a test, if this is going to be the positive accounting or reinsurance accounting. This one has enough risk transfer. But we're happy with it, because the familiarity of the book of business and our participation on that book of business has that quota share participant in prior years.

Having said that, don't misconstrue on the combined that might be the expected value of the contract over time. At the end of the day, you're reserve conservative. Then if you're wrong, nobody is taking the money out of your pocket. You – the sale that we get it eventually.

Q - Brian Robert Meredith {BIO 3108204 <GO>}

Gotcha. And then last question, is there any update on your ability to kind of take advantage of opportunities from AIG and some of the other companies that have been doing re-underwriting, we've talked about that in the past...

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

We don't target specifically any company. I mean, there is re-underwriting be done by many companies, including AIG and others. All I have to say is that, we've seen some increased opportunities in sectors that we believe we have good underwriting expertise. And we're getting into the batter's box so to speak. We haven't been hitting a lot of doubles, triples or home runs, maybe a single here and there, which tells you that the market hasn't come up to our liking yet. But we have increased – the opportunities that we see have increased noticeable.

Q - Brian Robert Meredith {BIO 3108204 <GO>}

Great. Thank you.

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

Welcome.

Operator

Thank you. Our next question comes from Ian Gutterman with Balyasny. Your line is open.

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

It's not kept that as he's like you know, on the lunch menu today.

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

My first question is going to be about big diners, but given the call is getting long, I just thought, I hold off.

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

Are you ready to invest with me – where the two of us. As I'm getting closer to retirement, I got to think of things to do, so think.

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

Exactly, I'll be opened to kind an offer. So I won't ask about anything. I want to stick to the other two legs of the stool. And probably a lot of these are number say questions this late. In insurance, you talked about in the release some of the adverse development from an energy casualty claim, any color on that?

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

Yes, it's a – as I name it, Sempra Energy, it's out of our Bermuda operation, where you have a plane down there given the towers need attachments and where we play, there are Wall Street Journal front page events. This was a gas leak explosion. The estimate is $660 industry loss. Also where we are on two layers, the look lowest of which is excess of $265 million, nowhere on the key self and another layer above it. So we fully reserved it on a net basis, so can't move any more than where it is.

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

Yes, got it.

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

But it was a big loss for us. It's a manmade disaster cat, call it that exactly.

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

Exactly.

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

That's why, I think you saw our cat losses in the insurance pool.

A - Marc Grandisson {BIO 4369887 <GO>}

That was the Bermuda insurance market.

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

Right. That made the kind of complex risk so to try.

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

Another one I ask you is, so did you – I thought this is an adverse development with the cat as well?

A - Marc Grandisson {BIO 4369887 <GO>}

No, it's on a cat.

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

In the accumulation of the natural catastrophe was – but it was in the adverse development.

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

Okay. That's helpful. Okay.

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

15-year, and it just takes a while for the things and especially there has been things like that.

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

Sure. And so my question on the cats and the insurance segment, I guess, that was higher than I thought, and I just look back, I think the first time and long time that cats and insurance have been greater than reinsurance. I guess I just was curious there was anything unusual that cause that?

A - Marc Grandisson {BIO 4369887 <GO>}

Nothing unusual. But listen on the insurance side, you get on two buildings and got 5 million or 10 million a day, and then all of a sudden you kind of, you can have 15 million. And we got an operation in Canada. So I don't know exactly the specific account. But it wasn't a significant number of claims, it was a few claims that – and don't forget, we don't like personal line.

So for us to get hit, we've got to hit on apartment buildings, or school or something of that store, and it's been very easy to get quote with 5 million on a couple of them. And all of a sudden. We're not reporting tens of millions of dollars. I mean, at the end of the day, yes, it was slightly higher than the insurance. But it was nothing unusual for us. Those losses we had in the second quarter were mostly insurance, no losses. So it was heavily some of the reinsurance in Canada, but a lot of that outside was insurance – more in reinsurance. And I will echo with Dino said, I think a small loss of cat loss of about 10 million in our insurance group. It's not having variability of about 10 million is not a big deal for us.

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

Understood. I was curious to know.

A - Marc Grandisson {BIO 4369887 <GO>}

Within the variability. Yes, it can happen – it was reviewing the whole hospital or in the whole apartment building in the wrong- and you put 10 million up, you're going to get hit, you get hit.

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

And sort of relate to that just overall for the combined insurance – the reinsurance business just looking at the cash for the quarter was at basically in line with the catalog you've talked, I think on the envelope. A lot of the call people are talking about this being an active pack quarter making it seem like this is much above average. Is that your view, or this is an above the average quarter and you came in average or just as an average quarter and people are kind of talking about making it seem like a bigger...

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

When you have 13 billion or 15 billion worldwide, I would say, it's slightly above average, I don't. If you're a pan, and you say 40 billion annual cat mode worldwide is maybe that's the expected number. But I haven't spent a lot of time maybe, Mark, you have – I know there's a lot of statistics and we look at that. But I would characterize this, it's slightly above average.

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

Okay.

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

But not, this is not something that is not going to happen, I guess.

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

It definitely is slightly in the above average in the U.S., if you're going to see those numbers, they're not totally outside. So one thing I'll tell you that, Canada is really, really outside of north, that's really what takes a lot of time. Most of our guys and it's not really reflected in the cat load of anything that people like in general around the world.

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

I would offer that perspective varies depending upon whether your results are two or three times your cat load versus inside your cat load.

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

That's kind of what I was getting out a little bit, okay. So my last one is just, Mark, if you can help me on the LPT math, I just want to make sure I'm doing this right. So the 2.7% you talk about was on the overall combined. So on the accident year - the accident year is higher than the calendar year. The accident year is getting maybe 30 bps or so, so it was that much of an impact, is that right?

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

I'll say, we did it on a calendar year basis.

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

But your accident year was 98 something. So 100 versus 98 doesn't change it too much.

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

Yes, that's correct.

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

Yes. So the question is, so when I get into the accident year, when it pull it out was still pretty close to a 98, maybe high 97s, that was up about 3, 4 points and even running. I'm curious what happened there. I know you mentioned some large losses, but was it just that or...?

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

No, I mean, when you think there was a - we had a marine loss with the vessels that - it does - we believe loss. So when you take that large threshold, that was pushing 300 bps, I believe. So and there's a couple of the noise, but that really account for it.

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

Make sense, perfect. All right enjoy the cat events, talk to you next quarter.

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

Thank you.

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

Thank you.

Operator

I'm showing no further questions. I would like to turn the conference back over to Mr. Dinos Iordanou for closing remarks.

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

Thank you all. Enjoy your lunch and we'll talk to you next quarter.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program. You may all disconnect. Everyone have a good day.