Q4 2014 Earnings Call

Company Participants

- Constantine P. Iordanou
- Mark Donald Lyons

Other Participants

- Brian R. Meredith
- Charles J. Sebaski
- Ian J. Gutterman
- Josh D. Shanker
- Kai Pan
- Meyer Shields
- Michael Nannizzi
- Sarah E. DeWitt
- Vinay Misquith

MANAGEMENT DISCUSSION SECTION

Operator

Good day, ladies and gentlemen, and welcome to the Quarter Four 2014 Arch Capital Group Earnings Conference Call.

My name is Laura, and I will be your operator for today. At this time, all participants are in listen-only mode. We will conduct the question-and-answer session towards the end of this conference. As a reminder, this call 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. A 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 call over to Dinos Iordanou and Mark Lyons. Please proceed.

Constantine P. Iordanou {BIO 2397727 <GO>}

Thank you, Laura. Good morning, everyone, and thank you for joining us today. We had an excellent fourth quarter in closing a very, very good year. In our history over the last 12 years, we had three years that we are in over $800 million of net income, and this is one of them.

Earnings were driven by excellent reported underwriting results and solid investment results. Net premium revenue grew by 7.5%, as growth in our insurance and mortgage businesses more than offset a decline in reinsurance net writings. As a reminder, our U.S. direct mortgage business was acquired in the first quarter of 2014, and therefore, the year-over-year comparison should be viewed in that light.

On an operating basis, we earned $1.15 per share for the quarter, which produced an annualized return on equity of 10.4% for the 2014 fourth quarter versus 11.7% return in the fourth quarter of 2013. On a net income basis, Arch earned a $1.60 per share this quarter, which corresponds to an annualized 14.5% return on equity. As we discussed in prior calls, starting shortly after the financial crisis, we have allocated a greater portion of investable assets in alternative categories, which includes all of our equity investments.

Looking back over the past five years, from 2010 to 2014, operating return on average equity has averaged 10% annually, where our net income ROE has averaged 14%. This is a significant delta of 400 basis points, over each year, and roughly translates into an additional $190 million of annual income, for each of the last five years.

As I indicated earlier, reported underwriting results, in the fourth quarter were excellent, as reflected by a combined ratio of 85.5% and were aided by low level of catastrophe losses and continued favorable loss reserve development.

Net investment income per share, on a sequential basis, increased for the quarter to $0.56 per share, up from $0.53 per share in the third quarter of 2014. Our operating cash flow for the quarter was essentially flat at $227 million compared to $224 million in the same period last year.

Despite headwinds from foreign exchange, the total return of the investment portfolio was 85 basis points for the quarter and 134 basis points, if expressed in local currency. As you know, we maintain a natural hedge, with our investments as we match our outstanding liabilities, in the currency that they exist with investments in the same currency.

Our book value per common share, at December 31, 2014 was $45.58 per share, an increase of 3.5% sequentially and 14% annualized and 14.5% as it compares to the fourth quarter of 2013.

With respect to capital management, we continue to have capital in excess of our targeted levels. And in the fourth quarter 2014, we repurchased 3.6 million shares at an average price of $56.28 for a total cost of $202 million and have purchased an additional $70 million of our shares so far in the first quarter of 2015.

We've increased M&A activity in the sector. We continue to evaluate opportunities, such as acquisitions of other business units, people and renewal rights transactions. As you know, we prefer to deploy our excess capital back into our business. But today, these opportunities have not met our criteria.

The insurance segment's gross written grew by 9.8% and net written premium by a similar 9.6%. The growth emanated from our professional lines, excess in surplus casualty business including our contract binding unit and alternative markets. And it was partially offset by decrease in construction and national accounts businesses. Mark will have more details on this later in the call.

Most of our organic growth is coming from small accounts with low limits, which should have lower volatility. On the other hand, competitive conditions in the property sector had negatively affected primary property rates, and accordingly our U.S. premium volume in those lines.

In the primary markets, in which our Insurance Group participates, despite an increased competitive marketplace, we continue to obtain rate increases in most lines of business at approximately the same level as we have observed last quarter.

On the reinsurance side of the business, as you might have heard on other calls from our competitors, we have seen a continuation of softening in pricing and broadening pressures on terms and conditions.

From a premium production point of view, net written premium was down 6.5% in the quarter for the Reinsurance Group, where gross premiums rose by nearly 5% with the growth in the segment primarily coming from businesses we produce on behalf of Watford Re.

Our mortgage segment includes primary mortgage insurance written through Arch MI in the U.S. and reinsurance treaties covering mortgage risk, which is written globally, as well as other risks sharing transactions. Net written premium in this segment declined sequentially in the fourth quarter of 2014 to $53 million from $58 million in the prior quarter.

As we discussed last quarter, some of our growth in the third quarter came from participation on single paid premium policies. These are loans where the mortgage insurance premium is paid up front. In the fourth quarter, we have seen increased competition in the single paid premium policies, and as a result we reduced our writings significantly.

As in all of our units, underwriting discipline is the foundation that Arch was built on and we will continue to exercise that discipline in all of our segments. What is important to note is that our sales force is now fully staffed. And as a result of their efforts, we continue to gain traction in the back channel. As of December 31, we have approved more than 481 master policy applications from banks and more than 150 of these banks have already submitted loans for us for our approval.

Of these master policies, 34 represent national accounts and the balance are regional banks. Of the top 25 mortgage originators for conforming mortgage sold to the GSEs with of course attached mortgage insurance, we now have approval on master policies with 19 lenders of those 25 lenders.

We continue to see GSE risk-sharing transactions increasing in 2015, with the GSE established goals for credit risk-sharing rising from $90 billion; this is notional value of mortgage loans for each Fannie and Freddie in 2014, to $150 billion and $120 billion for Fannie and Freddie, respectively in 2015. That's a significant increase. Today on average approximately 70% of the risk-sharing has been provided by the capital markets, although an increasing percentage of the risk pool has been allocated to the insurance and reinsurance markets in 2015.

While current accounting treatment requires us to use derivative accounting for the GSE risk-sharing transactions, we expect these contracts to receive insurance accounting treatment on a perspective basis for all the enforce any new transactions in the near future.

Group-wide, on an expected basis, we believe the ROE on the business we underwrote this past year will produce an underwriting year ROE in the range of 10% to 12%. As on a percentage value basis, improvement in the Insurance Group and the addition of the mortgage segment approximately offset lower expected returns in the reinsurance segment.

Before I turn it over to Mark, I would like also to give you our PMLs. As usual, I would like to point out that our cap PML aggregates reflect business bound through January 1, while the premium numbers indicated in our financial statements are through December 31, and that the PMLs are reflected net of all reinsurance and retrocessions we purchased.

As of January 1, 2015, our largest 250-year PML for a single event decreased significantly in the Northeast to $544 million, or 9% of common shareholders' equity, while Gulf PMLs also decreased to $527 million, and our Florida Tri-County PML now stands at $419 million.

Last quarter, I said, that was the lowest number as of that time. This quarter now brought us to even lower PML accumulation for the group.

I will now turn it over to Mark to comment further on our financials and then we'll come back and take your questions.

Mark Donald Lyons {BIO 6494178 <GO>}

Great.

Constantine P. Iordanou {BIO 2397727 <GO>}

Mark?

Mark Donald Lyons {BIO 6494178 <GO>}

Thank you, Dinos, and good morning, everyone. As was true our last quarter's call, my comments to follow today are on a pure Arch basis, which excludes the other segment, that being Watford Re, unless otherwise noted. Furthermore, since the accounting definition of the word consolidated includes the results of Watford, I will not be using that term, but instead we will be using the word core to refer to our combined segments of insurance, reinsurance and mortgage. This permits an apples-to-apples comparison of Arch's current results with prior periods.

So, moving on now with that being defined, the combined ratio this quarter for our core businesses was 87.5% with 2.3 points of current accident year cat-related events, net of reinsurance and reinstatement premiums compared to the 2013 fourth quarter combined ratio of 85.4%, which reflected 2 points of cat-related events.

Losses recorded in the fourth quarter from 2014 catastrophic events, net of reinsurance recoverables and reinstatement premiums totaled $19.9 million, primarily emanating from our reinsurance operations, representing smaller events around the globe.

The 2014 fourth quarter core combined ratio reflected 8.3 points of prior year net favorable development, net of reinsurance and related acquisition expenses, compared to 7.9 points of prior period favorable development on the same basis in the 2013 fourth quarter. This results in a 93.5% current core accident quarter combined ratio, excluding cats for the fourth quarter of 2014, compared to the 91.3% accident quarter combined ratio in the fourth quarter of 2013.

In the insurance segment, the 2014 accident quarter combined ratio excluding cats was 96.4% compared to an accident quarter combined ratio of 96.5% a year ago, and also represents a sequential improvement from the 98.0% accident quarter combined ratio last quarter. The reinsurance segment 2014 accident quarter combined ratio without caps was 87.3% compared to 84.9% in the 2013 fourth quarter, but this also represents a sequential improvement from the 90.6% combined ratio last quarter.

As noted in prior quarters, the reinsurance segment's results reflect changes in the mix of premiums earned including a lower contribution from property catastrophe business. The mortgage segment 2014 accident quarter combined ratio was 98.9%, compared to 62.1% for the fourth quarter of 2013. This increase is predominantly driven by the substantial change in mix resulting from the January 2014 acquisition of our U.S. primary mortgage operations.

The full accident year 2014 core combined ratio without cats was 94% even versus 91.3% for the full 2013 accident year. By segment, the Insurance Group's full 2014 accident year was 96.3% versus 97.5% for the 2013 accident year and the Reinsurance Group combined ratio for the full 2014 year was 90.7% versus 82.9% for the 2013 accident year.

The insurance segment accounts for roughly 16% of the total net favorable development in the 2014 fourth quarter, excluding the associated impact of acquisition expenses and this was primarily driven by shorter-tailed lines from the 2007 through 2013 accident years. The reinsurance segment accounts for approximately 84% of the total of net favorable development this quarter with approximately half of that due to net favorable development on short-tailed lines concentrated in the more recent underwriting years and about half due to net favorable development on longer-tailed lines, primarily from the 2002 through 2006 and 2009 through 2011 underwriting years.

Our core operations across the full 2014 calendar year experienced $307 million of net favorable development, net of reinsurance, reinstatement premiums and related acquisition expenses, which represents 8.8% combined ratio points versus $254 million of net favorable development last year for the 2013 calendar year, which represent 8.1% combined ratio points.

This full 2014 calendar year net favorable development was approximately split 15% in the Insurance Group and 85% in the reinsurance segment. Approximately 68% of our core $7.3 billion of total net reserves for loss and loss adjustment expenses, our IBNR and additional case reserves, which remains fairly consistent across both the reinsurance and insurance segments.

The core expense ratio for the fourth quarter of 2014 was 34.7% versus the prior year's comparative quarter expense ratio of 33.7%, driven by an increase in the operating expense ratio, partially offset by a decrease in the acquisition expense ratio. The increase in the operating expense ratio component continues to reflect the addition of our U.S. mortgage insurance operations, which is operating at a higher expense ratio until business hits a steady state, as well as the effect of incremental expenses due to certain platform expansions in both our reinsurance and insurance businesses.

The insurance segment improved to a 32.4% expense ratio for the quarter, compared to 33.9% a year ago, primarily reflecting a lower net acquisition ratio, driven mostly by a change in the accounting treatment of New York Workers' Compensation surcharges and securing improved treaty ceding commissions on quota share contracts ceded.

The reinsurance segment expense ratio increased from 31.7% in the fourth quarter of 2013 to 32.5% this quarter, primarily due to a higher level of operating expenses supporting selected platform expansions.

The ratio of net premium to gross premium of our core operations in the quarter was 75.2% versus 78.4% a year ago. The insurance segment had a virtually constant ratio of 69.1%. The reinsurance segment net to gross ratio was 85.5% this quarter, compared to 96% a year ago, primarily reflecting cessions to Watford Re as a reinsurer.

Our U.S. insurance operations achieved a plus 3.3% effective renewal rate increase this quarter net of reinsurance. As commented on last quarter, the pricing environment is quite different for short-tailed lines versus long-tailed lines. Short-tailed lines of business had an effective 2% renewal rate decrease for the quarter compared to a 4% effective renewal rate increase for the longer-tailed lines both on a net of reinsurance basis.

Rate increases on longer-tailed lines continue to be above our view of weighted loss cost trends. Looking more deeply, some lines incurred rate reductions, such as nearly 6% reduction in property and 3.5% reduction in our high capacity D&O lines, while others enjoyed healthy increases such as a 9% effective rate increase in our lower capacity D&O lines, 10% increase in national account businesses, 6.5% rate increases in our contract binding book, 6% increases in our A&H share, Accident & Health businesses, and 4.5% rate increases in programs.

Also certain lines continued their achievement of strong cumulative rate increases. So, for example, our lower capacity D&O lines have now achieved 14 consecutive quarters of rate increases, and have in fact secured double digit rate increases in 10 of those 14 consecutive quarters.

The mortgage segment posted a 100.6% combined ratio for the calendar quarter. The expense ratio, as expected and as mentioned earlier continues to be high as the operating ratio related to our U.S. primary operation will remain elevated until proper scale is achieved. The net written premium of $52.7 million in the quarter is driven by the $25.3 million from our U.S. primary operation and $27.4 million of net written premium from our reinsurance mortgage operations, including the 100% quota share of PMI's 2009 to 2011 underwriting years as part of the acquisition of the CMG companies in the PMI platform.

This reflects a lower sequential level of written premium on competitively bid single premium U.S. mortgage insurance as Dinos has already noted versus the 2014 serial quarter for the third quarter. At December 31, 2014, our risk-in-force for mortgage business equaled $10.1 billion, which includes $5.6 billion from our U.S. mortgage insurance operations, $4.4 billion through our worldwide reinsurance operations and $135 million through the risk-sharing transactions.

Our primary U.S. mortgage operation down $1.4 billion of new insurance written during the quarter, which represents the aggregate of original principal balances of all loans receiving new coverage during the quarter. The weighted average FICO's for the U.S. primary portfolio remained strong at 733 and weighted average loan-to-value ratio held steady at 93.4%.

No state's risk-in-force represents more than 10% of the portfolio and our U.S. primary mortgage insurance company is operating at an estimated 9.5 to 1 risk-to-capital ratio at year end 2014. The other segment, which is effectively Watford Re reported a 101.6% combined ratio for the quarter, a nearly $91 million of net written premiums and $53.6 million of net earned premiums. As a reminder, these premiums as posted reflect 100% of the business assumed rather than simply Arch's approximate 11% common share interest.

Our joint venture Gulf Re produced a $5 million loss for the quarter, due to an unusually high frequency of large technical risk losses stemming from the Middle East. This is reflected in the income statement within the other income line. Effective October 1, 2014, Arch agreed to acquire complete ownership of Gulf Re and has also instituted a loss portfolio transfer, including an unearned premium reserve transfer, and established an ongoing 90% quota share agreement for new and renewal business.

Final approval of the acquisition terms is pending with the Dubai Financial Services Authority. The total return of our investment portfolio was a reported positive 85 bps in the 2014 fourth quarter, reflecting positive returns on our equity, alternative investment and investment grade fixed income sectors, partially offset by the impact of the strength in U.S. dollar on most of our foreign denominated investments.

Excluding foreign exchange, as Dinos has mentioned, total return was a positive 134 bps in the 2014 fourth quarter. And on a full 2014 calendar year basis, the total return was a positive 321 bps and excluding foreign exchange, the return was a positive 426 bps, led by our alternative and equity sectors. Our embedded pre-tax yield before expenses was 2.18% as of year-end, compared to 2.21% at September 30, while the duration of the portfolio lengthened slightly to 3.34 years from last quarter's 3.28 years. Fixed income duration fluctuates due to tactical investment decisions as opposed to long-term strategic shifts. The current duration continues to reflect our conservative position on interest rates in the current yield environment.

Reported net investment income for this quarter was $72.6 million or $0.56 per share versus $72.2 million in the 2014 third quarter or $0.53 per share and versus $67.1 million or $0.49 per share in the 2013 fourth quarter. As always, we evaluate investment performance on a total return basis and not merely by the geography of net investment income.

Interest expense of $12.7 million has returned to the quarterly run rate after last quarter's adjustment that we discussed for a certain loss portfolio transfer. Our effective tax rate on pre-tax operating income available to our shareholders for the fourth quarter of 2014 was an expensive 1.7% compared to an expense of 8.3% in the fourth quarter of 2013.

The full year of 2014 effective tax rate on pre-tax operating income was 2.4% versus 4.8% for calendar year 2013. 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 $7.03 billion at the end of this year, up 0.7% relative to September 30 and up 7.4% relative to year end 2013.

During this quarter, as Dinos mentioned, we purchased nearly 3.6 million shares at an aggregate cost of approximately $202 million, bringing our full year repurchases to $454 million. These repurchases occurred during the third quarter and fourth quarter since we repurchased no stock in the first half of 2014. Our repurchases during the year were accomplished at an approximate 1.25x multiple to average book value. Furthermore, approximately $887 million remains under our existing buyback authorization at year end 2014. These share repurchases in the quarter had the effect of reducing book value per share by $0.29 and $0.59 for the entire year.

Our debt-to-capital ratio remains low at 12.8% and debt plus hybrids represents only 17.4% of our total capital, which continues to give us significant financial flexibility. As Dinos has already said, we continue to estimate having capital in excess of our targeted position, Dinos has already commented on book value and changes in book value, so I see no need to repeat that.

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

Q&A

Operator

Thank you. Please, stand by for your first question. And your first question comes from the line of Sarah DeWitt, JPMorgan. Please proceed.

Q - Sarah E. DeWitt {BIO 18946247 <GO>}

Hi. Good morning.

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

Good morning, Sarah.

Q - Sarah E. DeWitt {BIO 18946247 <GO>}

I wanted your view on the recent consolidation in the industry and what are your thoughts on the implications of that from a competitive standpoint. And do you feel the need at all to be bigger perhaps it sounds like $10 billion is the new minimum?

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

Well, first, the consolidation. I think, is positive for the business. You eliminate some competitors, you are creating larger enterprises and hopefully more responsible enterprises from a pricing and risk taking point of view. So in all-in-all I think I view that as positive. There will be less, what I would call, desperate competitors doing things that they can be extremely competitive in the market. So on the size question, I don't - yes, if you are a tiny company, you might have disadvantages, but I don't know if $5 billion or $10 billion is the new norm.

As far as we are concerned, it's quality that we're looking for not size, quality in underwriting talent and ability and not size. We have enough size as a company. Our market cap is approaching $8 billion. We have over $7 billion of net capital. And for that reason, we're more focused to do things that make sense for Arch and our shareholders rather than focusing what size our company is.

Q - Sarah E. DeWitt {BIO 18946247 <GO>}

Okay, great. And then on mortgage insurance; could you update us on your long-term outlook for that business? Is it still reasonable to think it could be 15% of your earnings in five years, particularly given some of your comments around some increased competition in particular lines?

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

Your first question, yes, I think it can be 15%, even maybe 20%. Don't forget, we have a global mortgage business; it's not just the U.S. primary MI. There is the risk-sharing transaction that they're coming from the GSEs. And as I mentioned in my prepared remarks, they're allocating a larger portion of that to the insurance, reinsurance market instead of just a capital market and also they're increasing their purchasing. A lot of these transactions - they're protections that Fannie and Freddie buys for their 60 LTV to 80 LTV loans. We don't require bylaw to have mortgage insurance.

In addition to that penetration with the bank channel, even though it has been extremely good, we have signed 19 out of the top 25. But it takes time to start receiving and underwriting and binding that insurance. With these channels and - we are more optimistic today than I was a year ago that not only the business is still very good despite some competition in one tiny segment of the business.

The upfront paid single premium is not a huge part of the business. It's a significant part, but if there is competition there, we don't need to underwrite business that doesn't fit our return characteristics, and we'll go to other places. But overall, I'm very optimistic about what we have told our investors about the prospects of the mortgage business for Arch; it will be a significant part of our business, even though it'll take a few years to get to steady state.

Q - Sarah E. DeWitt {BIO 18946247 <GO>}

Great. Thanks for the answers.

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

And you're quite welcome.

Operator

Thank you. Your next question comes from the line of Michael Nannizzi from Goldman Sachs. Please proceed.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Hi. Thank you. Just a couple of more quick ones on the MI business, can you tell us, what percentage or what's the breakdown of the U.S. MI in terms of force that's either that single premium versus the typical monthly business?

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

I don't have that number on top of my head. But, Mark, can you get the number and then we'll give it to you. Our guys in Walnut Creek will know that in a second and half. I just don't have it on top of my head.

Q - Michael Nannizzi {BIO 15198493 <GO>}

That's fair, totally fair.

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

Yes. We don't have the rate in front of us, so we can certainly get it.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay. Yes. I mean, and I guess, when you think about like the base for thinking about your growth in that franchise, I would imagine is more the monthly business. How should we be thinking about the potential growth of new insurance written from here on, I mean given some of the master policy developments and some of the other items, just because aside from just the top line impact, that's obviously going to have an impact on the operating leverage in that segment.

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

Well, I'll give you a macro answer to it. Everything points to what we originally said to you guys that we expect to be north of 10% market share and it will take us at least three years to get there. And that has not changed in our minds, based on what we see. It took us about three quarters longer than I thought to close a transaction. So in essence, we lost at least six months maybe nine months from our original – I'm an impatient guy, so I saw things close a lot faster than they did. But dealing with a lot of different entities and constituencies, it took us longer to close. But I think we're catching up on it, because I've been more optimistic as we've built the sales force. We've about 60 people nationwide and also the reception that we've received from the originators and us entering the segment.

So 19 out of top 25 is a big accomplishment in almost five quarters since we've been in operations. It will take time as those mortgages calm, because when you underwrite a mortgage you do it. And then you wait for all the premium to come and it comes over the next six years, seven years. And that's why you see there is a little pressure on us now on the expense ratio. But at the end all the business we write is good business. We like the return characteristics of it, and we're patient with it, because that's the nature of the business.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. Great, thank you.

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

Yes, I would just add to that that outlook is dependent on the view and what emerges on a macroeconomic front on construction building a new housing starts and originations where that trajectory goes. But U.S. is kind of a general question as well on macro, so about recent developments one of which would be the FHA pricing for example. And that may not be negative for the industry. I mean that's overwhelmingly focused in a differential sense really in lower FICO and higher LTV quadrants if you will...

Q - Michael Nannizzi {BIO 15198493 <GO>}

Right.

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

...which is more traditionally the FHA wheelhouse anyway.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. Fair. Thank you. And then just when thinking about the insurance segment and kind of the growth that we saw in 2014, it is impacted by, I think it was impacted by the SPARTA renewal rights deal in the second quarter, which is not attributable. How should we think about that? Should we be sort of killing that out as we look forward or should we be assuming that continues to be part of the premium base in forward years? And on that same note, how should we be thinking about premium trends excluding that transaction on a forward basis? Thank you.

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

Well on SPARTA and those kinds of captive deals, I think you should be viewing that as a resident and therefore inclusive on your view, on your relative comparisons, you have to control for it because it explains a lot of the differences. But remember there's not a lot of big nets on those deals, because of the way they're structured, where you write and you cede the bottom rather than traditionally ceding the top, on actually as you are ceding the bottom. So the premium stick to the ribs is 22%, 25%, 27% things of that nature. So the short answer is, you should continue to view that, I think as resident within the book of business going forward. Your second point, refresh me.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Just so we back that out and we think about the remainder of the book. How should we think about, are we thinking about an 8% to 10% sort of trajectory on the remaining business, is that sustainable? I mean are you seeing enough business where you can continue to run that?

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

Well, Michael, as you know we never give forward guidance on these things. However, the part of a premium growth attributable to rate growth, as I commented on, third-party lines continue to still have traction there, it's challenging in property, which is why you see really across the enterprise property volume – traditionally property cat volume dropping, really on both sides of the coin.

So it could be a function of what we can do on our mix, I think we'd demonstrated we did a pretty good job of shifting and managing it. But in terms of what the markets give us, that's what we react to. So I really can't and I don't think I'm equipped to tell you whether it would be 8% or 7% going forward.

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

Our principle here is to underwrite business that meet return characteristics and, we don't spend a lot of time thinking about, oh we got to grow by 5% or 10% or shrink by 5% or 10%. My old boss says, Mr. Market is Mr. Market and he will tell us what it is. Hopefully we'll make good decisions in operating in that market. So not knowing where our rates are going to go and not knowing what the competition might heat up or is, you got all these transactions. The M&A activity, usually in our business one plus one never equals two. There are going to be slices of bread and breadcrumbs falling off the table, we'll be there to pick it up. We're not bashful, that's how I grew up. I was eating breadcrumbs, when I grew up. So at the end of the day, it's a hard question, because we really don't focus on it.

But I can tell you, we still like the primary insurance business, yes, the market is more competitive. I don't think we lost ground as you saw between the third quarter and fourth quarter, just a little bit on our first quarter numbers aren't in, but I get monthly reports and our first quarter was not as projected to be disappointing as some people were predicting. It just happened as we thought it was going to happen. So, you can cook all that and then come up with your own projection. And if you allow me, I have that number for you guys on the split between – on the MI business, the single premium volume for the industry is about 13% of the total. So 87% is monthly's and about 13% is upfront single premium.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Dinos, that's for the industry or for your...

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

For the industry, for the industry. Yes. We do little in the single premium sector. As I said, we reduced significantly in the fourth quarter because of the competitive pressures.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. Great. Thank you for the answer.

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

...13% of the business in general, right.

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

And Michael, before we leave that point, one thing you can pretty much think about is that and we've been harping on this for a while, just back to your Insurance Group question is that continued emphasis on mix towards smaller account low limit business where you have more strength of price and strength of terms of conditions is likely to continue, and if the continued high capacity commodity business continues in its current pace that will continue to shrink.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. Very helpful. Thank you both.

Operator

Thank you. Your next question comes from Vinay Misquith from Evercore. Please proceed.

Q - Vinay Misquith {BIO 6989856 <GO>}

Hi, good afternoon. The first question, Dinos, I don't recall whether you mentioned about the January 1 renewals just how you guys did?

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

No. I was making a comment a little bit the January 1 renewals, we didn't see a significant change with the numbers that we mentioned. Long-tail lines, rate increases in the 2% to 4% range and property continued to be losing ground in the 5% to 10% range. We reduced significantly on the reinsurance property cat. You saw our PMLs go down significantly. Volume-wise, I think we did okay, lost some volume here and there. We got some new business, but it's too early. So we're not - because of our Insurance Group and also our Reinsurance Group participating in a lot of these small enterprises so to speak, looking to underwrite the same kind of business our Insurance Group underwrites. Our business is more spread throughout the year and is not heavy January 1, but I was not disappointed with January 1.

Q - Vinay Misquith {BIO 6989856 <GO>}

Sure, but modestly down would be, I mean normal for us to expect. Correct?

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

Yes, yes.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. The second question is on the reinsurance margins, I mean the accident year combines have been coming in very strong, so is that because of now business mix as the towers transaction and some of the higher loss issued transaction go away? And so should we be looking at the last two quarters average as the base for the future?

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

Well the improvement, as you mentioned in the fourth quarter, is clearly a function of mix. We've a lot of transactions that can come through, that can weight it one direction or the other. So it's kind of hard to say whether the averages of the last two quarter is representative, because that would exclude one-one business, because that's only the second half of the last year, but it's going to fluctuate, and it's going to be a function of mix. What I can tell you is that the ultimate projections of the same line of business in those two quarters really didn't change. It was simply the mixture of them that changed to weight down the fourth quarter to be lower than the prior quarter.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. That's helpful. And the mortgage insurance business, the tick up in the expense ratio, do you expect the dollars' worth of expenses to stay at these levels for next year this 2015 (45:45)?

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

No. As a matter of fact we expect expenses to be coming down as we're building the book. Also we had an unusual expense for this quarter on one transaction. We had a reinsurance transaction in the mortgage phase that we bound the cede and had an option to terminate and then we negotiated that option away. And it comes in as additional acquisition expense in that negotiation. So it's business that we like, it's business that will be very profitable for us, but in the quarter that you do the transaction you take the hit on the expenses. So you are putting the expenses upfront and then you're going to earn the premiums over the next six years, seven years.

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

So likely non-recurrent.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. Okay. That's helpful. And then just one so a 50,000 foot question, Dinos, there's been a transaction that was announced recently sort of take-under of a large reinsurer. Curious as to your thoughts as to why Arch would have not been involved in that transaction at a lower valuation?

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

Well, I mean we don't usually sit there or worry about who is going to show us a transaction or not. That transaction, it was negotiated by two parties. We had no knowledge of it; for whatever reason they didn't think we can be an attractive partner. But

I think you ought to ask them as to why they didn't approach us. But all I can tell you that we were not approach.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay, all right. Thank you, very much.

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

You're quite welcome.

Operator

Thank you. Your next question comes from the line of Ian Gutterman from Balyasny Asset Management. Please proceed.

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

Thank you. Dinos, my first question...

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

You must have done well, Ian, that you meet in the middle of the pack what is that back row stuff...

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

My New Year's resolution was to show up earlier, so I only was half successful with it.

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

Okay.

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

My first question is I'm surprised to hear the breadcrumbs comment. I thought you grew up on (48:17)?

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

Hey, listen, I grew up as a very poor kid, you know six siblings and my father was a cop. So not a big salary, but we made it.

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

I think the souvlaki helps with the term lumpy.

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

Yes.

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

So my first real question is, Mark, I thought I heard you say earlier, I just want to make sure I heard it right that you are able to get insurance to (48:45) treatment going forward on these GSE risk-sharing deals. Is that correct?

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

The feeling is that, that is sooner than later. Still details and finality to be worked out at all antenna, vibrating antenna tell us that, that is probably going to be a 2015 in that.

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

Okay, got it.

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

2015, and not end of 2015, probably this quarter, late of second quarter. There we work in the contracts to allow us to have insurance accounting on those contracts, on a perspective basis.

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

Right around the perspective. So relates to that is – I wonder – I guess I'm trying to piece things together here. It looks like you started a new subsidiary, Arch Mortgage Guaranty, that seems like it's designed for these transactions. Is that correct? That's what the purposes of that? And...

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

Well, it's designed to have flexibility, mostly to write mortgage insurance that they come from originators, banks and others that might not really require bylaw to have mortgage insurance attached to them. These might be jumbo loans, they might be other transaction. But the goal is to use that entity to provide more product and more flexibility in our toolkit for what we do, for all those originators, Ian.

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

Okay.

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

And some of the rationale that it could be – it sounds like it's packaged and sent on conforming loans to the GSE. This is stuff, where the banks are having native capital requirements, where we could provide some value.

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

Got it. Okay. I was wondering if there was a confluence, you're feeling that the need to set up this subsidiary, where it was sort of an indicator of faster growth potentially in that area and maybe the accounting as well as an indicator that perhaps be made on, on doing more these type of deals?

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

Well, I mean these buyers are going to be more sophisticated. I think credit risk is an issue. That entity has the highest credit rating in the business. And, when sophisticated buyers of the product, when they are buying protection for maybe their jumbo loans that they are not going to sell to the GSEs et cetera that will make a difference. So, that's the avenue that we chose to go down to show the strength of the group in obtaining an entity that it has, you know a high financial rating that it will make a difference for sophisticated buyers of the product.

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

Got it, interesting. And then my other question...

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

Ian, I think one takeaway you should take, you should have with that whole insurance accounting thing is, I think it shows the level of desire and commitment on behalf of the GSEs towards the insurance and reinsurance sector that they are willing to invest the time and effort to and will be listening for the preferences of the industry to have insurance accounting. I mean they wouldn't go through all of this effort and time commitment if they didn't view us as a longer-term partner.

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

Well, that's kind of what I was doing outside, that's good to hear. And then just my other questions, switching gears, reserve releases and reinsurance obviously you know I think you expressed a lot of comfort with reserves but just it is interesting to me, the last two years have been your highest years of reserve releases at least dollar wise, I think in the history of the reinsurance company. And I guess I find that a little surprising just because, we think that the fat years being sort of the first five years of the company's formation and the last five years maybe being still very good but not as good. So is there anymore color you can give us as far as...

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

The only thing I can tell you, Ian, is that we have not changed methodologies. And we feel as confident about our aggregate reserve position today as we felt a year ago, two years ago or three years ago. So we let the numbers speak for themselves. I got a lot of quants in this company. I think pretty soon I'll be worried that they're going to fire me, because I'm the only guy who doesn't have an actuarial degree in the senior management. Grandisson, Papadopoulo, Mark Lyons, oh yes, Dave and I were the two orphans without the actuarial degrees. Everybody else has one. So...

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

Yes, but Dave doesn't have an aeronautical engineering degree.

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

I guess what I am wondering is, has there been a shift - maybe if we went back a few years ago, it was mostly, say, 2002 to 2008 years, has it shifted to where those have kind of run out of juice and now it is the 2008 to 2011, or is that sort of classic hard markets to releasing a lot and just the more recent years on top of it are reaching new heights. I'm just trying to get a sense of sort of a mix there.

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

Ian, I think it's a reinsurance question. I think we have commented this on prior quarters and you asked the full year question. The complexion of the releases on both the U.S. based reinsurance operation, the Bermuda based reinsurance operation has been towards, looking hard at the longer-tailed lines from the earlier years, going back to 2010, 2011, 2012, they were dominant by short-tailed lines and medium-tailed lines. It's longer-tailed enough for an insurance carrier, let alone a reinsurance carrier with the late reporting and excess of loss contracts and things of that nature. You got to wait longer. And now that we have waited longer, you're starting to see some of this come down, because the evidence is much more clear cut.

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

Got it. That makes perfect sense. All right. Thanks, guys.

Operator

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

Q - Kai Pan {BIO 18669701 <GO>}

Thank you. I just met the queue behind Ian. So, Dinos, before I let you go for souvlaki lunch, I have three questions. Number one is on capital management. So you said that there is a less deals out there attractive and also your PML at very low level, that your stock actually trading at upper end 1.3 time where you typically would like to buy below that. So how do you, sort of see a process here in terms of return to shareholders?

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

Well, we look for deals, if they make sense for us. We'll look, we still believe that share buybacks is an option and we also have the ability to do an extraordinary dividend, if we chose to release some of the excess capital. To tell you the truth, right now based on the, I wouldn't call it turmoil but based on the heat of activity, I'll wait to see what - I can't predict what is - what might or might not come our way that makes sense for us. And patience has been a virtue in this company and we continue to have patience. Believe me, we're cognizant that the money is not ours, it's shareholders' and we got to find ways to get it back to them if we have excess. But also we got to be prudent, that's why we have a conservative balance sheet with plenty of financial flexibility. We have excess capital, if the right deal comes along that is helpful, to creating value for our shareholders, we will look at it. If not, we will look at share repurchases and if we think that's expensive, then we look at extraordinary dividends.

Q - Kai Pan {BIO 18669701 <GO>}

Great. Second question on the January renewal, some argue that if the larger reinsurer actually has favorable pricing and terms, conditions. Do you see that, in the transaction you see?

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

No. I think the larger reinsurers and it's not just larger, we saw the financial strength rating. We'll get a look at the business and maybe get better signed lines. Occasionally, they might be private transactions that they might get preferential terms but they're not preview to anybody like when we do a private transaction, we don't go out and tell everybody what terms have we got. And likewise when others do private transactions, they don't go advertising them.

But I do believe those occasionally happen in the business. If you come with significant capacity and willingness to move quickly and do large deals, you will do it. That was a case with us, with (58:08), one big transaction we did. It was just us, nobody else. And I thought we got pretty good terms. So Berkshire does that, Swiss and Munich do that and they have their private deals. But I'm not preview to it. So I can't comment.

Q - Kai Pan {BIO 18669701 <GO>}

Great. My last question actually circling back to the merger acquisition topic, you said strategically you're probably – you have the size to compete in the marketplace. But even where your stocks trading at versus some of your peers, would you be waiting to consider for financial reason to be creative to shoulder basically more on a financial basis?

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

We don't like to do just purely financial transactions because in the long run, that doesn't create a lot of value. What creates a lot of value is, what are you purchasing, the talent you're going to purchase, the ability to deploy that talent to write more business over the next 5 years to 10 years. In my view, it's not just what investment banks they do is , they come with their little books and they say, oh, this is accretive and all that. To me that's financial engineering and gobbledygook. At the end of the day, what am I buying? Am I buying something that is – am I buying something that is going to create value over the long run or I'm just going to get book down for two years and trying to get synergies and I've tried to do this. And then my business is and the profitability of that business goes south.

It's a lot of characteristics, you got to look at, that's why whom you buy, how you buy, beyond the financials. How the two organizations can mesh together and believe me, I'm not a fool, I know any transaction even if we do it or somebody else, you got to be prepared to say one plus one is not going to be two.

It's going to be something less than that, but potentially can be 2.5% and 3%, five years from today. And if I can see that, that's a transaction I'm going to do, because at the end of the day, that's transformative and it allows us to grow the business and create value for shareholders. And you can look at it just from the financial engineering point of view.

Maybe I'm naïve, but that's the way my brain works, and at 65 years I'm not going to change it, right?

Q - Kai Pan {BIO 18669701 <GO>}

Great. Well, thank you so much for all the answers.

Operator

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

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

Yes, thanks for keeping it a little late and taking my call. Dinos, both in 2005 and 2011, arguably you earned your cost of equity capital in those years, whereas most companies and your peer lost money, given that in a year like 2014, you're running an 11% ROE. What do you think Arch's results look like in a heavy, heavy catastrophe year? And what do you think happens to the peer group? Are your competitors taking risks right now that will make opportunities for Arch in the future?

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

Well, it's hard to talk about the competitors, because I don't know what they are doing with their portfolios. I mean I can talk about mine. I can tell you on a heavy cat year, our losses, they're going to be much more manageable, because our PMLs have come down. I'm not so sure, all of my competitors, they haven't done similar things, we have. I think some of them, who've been in the business for a long time and the good underwriters, they have utilized what's available in the marketplace, because there is a lot of new capital that came in that particular sector, the property cat sector.

And there it's purely an opinion. If you think that you'll be positively arbitraging and you're going to improve your book, you're going to buy protection, because you think that the economics are favorable to you, but you got to be cognizant, I mean in years you buy protection, sometimes you look like a fool too, because if there is no cats, any price is a good price for those who sell it. On the other hand, as Warren Buffett says, you don't really know who is naked until the tide goes out. And in our business the tide goes out, when you have a super cat. And let's face it. Florida has been quite now since Wilma. Wilma was 2005; I would never have predicted that we would've had 10 years of no cat activity in Florida.

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

But the one thing you could say and it's not forward-looking, but it's looking backwards and making your judgments from there. Your 2005, 2008 and 2011 years because of the way cat is underwritten here and managed here, they were partial earning events for us. There was never any capital impairment issue, that's the first thing.

Second thing is you heard Dinos report that in the current environment, we have our all-time lowest PML relative to equity. So we're shrinking it, we've demonstratively shown in a tough cat years, which is all your question if something really happens, we performed, I think better than most peer groups, because of that, but that's looking backwards not forward, but I think it's instructive.

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

Okay, well. Good luck and then we'll talk to you again soon.

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

Thanks, thanks, Josh.

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

Hey, Josh, you still there?

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

Yes, I'm here.

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

Yes, just one thing I want you to know is we have a new exhibit in our financial supplement that we're calling the Shanker Exhibit. That deals with our effective tax rate, because you're one of the guys that drum that up last quarter, given Watford. So if you go back and look at page 31 of the supplement, it uses all the information on the segments of page 11 of the supplement, where it starts with that's something you know, which is Arch's core operations, and rather than starting with consolidated with Watford in it, it starts with Arch's core operations and layers on top of that the Watford contribution. So you can see how the effective tax rate is calculated.

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

Yes, so, Josh, we put a name of street after you, so we did that next best thing, we gave a page after you.

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

I always get nervous when people are naming me after things, definitely it's usually not positive.

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

No, this is positive, this is positive.

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

Take care, thanks.

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

Bye-bye.

Operator

Thank you. Your next question comes from the line of Charles Sebaski from BMO Capital Markets. Please proceed.

Q - Charles J. Sebaski {BIO 17349221 <GO>}

Hi, thanks for holding out for me. Have a question about the, one on the insurance business and the E&S line, curious how much of the growth is due to the contract binding business, and what effect that business has on ROE versus combined ratio within the insurance segment.

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

Okay, good question. First half within the E&S Casualty section all of it is attributable to the contract binding...

Q - Charles J. Sebaski {BIO 17349221 <GO>}

Okay.

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

...operation. And when you compare 4Q to 4Q, that premium virtually doubled, just a little shy of doubling. So I think that gives you the magnitude and the contribution in that line. This is stable a book of business; it's kind of high renewal rate or persistency attached to it. It's lesser volatility, some of the growth though was due to some broadening limits may go up to $5 million where it may have been a lot of ones and threes. It's got some broadness, it has some non-cat property. So it's a more rich, a fuller offering and it's also reducing at the same time some of the contract exposure that they originally started with. So I think it helps the volatility, it accounts for virtually all of the growth in the E&S line. And I think it will operate as a ballast or a dampening on the volatilities of the other lines that the Insurance Group writes.

Q - Charles J. Sebaski {BIO 17349221 <GO>}

Does that run though at a higher steady state combined ratio, because that lack of volatility. I guess what I'm trying to understand is, as that grows the effect on the accident year combined ratios going forward should increase that at the same kind of ROE contribution?

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

Well what normally happens in business of that type, it usually gets little more expensive to acquire it. So the acq is higher and the loss ratio is lower on average in similar businesses. Because it's new to us, we are I think a little more conservative, so we're booking it at a level that time will tell what it is. So I think over time, it will perform better than where it's booked at this time. But as a general rule, it's a lower loss ratio and a higher acquisition ratio.

Q - Charles J. Sebaski {BIO 17349221 <GO>}

Okay. And then on the reinsurance side, the growth in Asia Pacific in the quarter, I guess just curious about what's the business line writing there and is there any kind of change, most of the PMLs on the U.S. basis, if there is any kind of PML pickup with Asia, Japan?

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

It's just a little bit of cat business, but we don't have big operations in Asia Pacific. It's minuscule of what we do.

Q - Charles J. Sebaski {BIO 17349221 <GO>}

Okay. I thought in the quarter on a premium written basis that it's picked up here somewhat to $70 million relative to $25 million last year and just relative to what the quarter is that seem like a big piece of it.

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

That was the adjustment of us buying Gulf Re 100%. So it's a one-time event and we bought the 50% we didn't own and you go in to the purchase accounting and that's what it's all about. It's no change in anything that we do and because Gulf Re is in the Middle East, all that is in the Asia Pacific region.

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

And in rough chart, just think of that as roughly $52 million of impact in the quarter on a net written basis that was – that influx that Dinos talked about.

Q - Charles J. Sebaski {BIO 17349221 <GO>}

Okay, perfect. Thank you very much.

Operator

Thank you. Your next question comes from the line of Meyer Shields from KBW. Please go ahead.

Q - Meyer Shields {BIO 4281064 <GO>}

Thanks. Two really quick questions; one in general, is the pricing level at Gulf Re comparable with legacy Arch?

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

Yes, I think our issue with Gulf Re was and that's the reason we bought 100% of it, is that it requires high limits to operate, they write a lot of peg risk accounts. And for a small company who has $50 million, $60 million in revenue, the purchase of reinsurance, it was totally disadvantageous to us. In essence, we paid a lot of money to reinsurance with zero recoveries over the years. And, finally, we convinced to restructure to our other partners, which we respect a lot. Because, then now, we can use our purchasing within Arch from a much bigger block of business, so the reinsurance cost is going to be down significantly.

Gulf Re, when you look at our net results, not anything to write home about, but the gross results, they weren't bad. And I'm not there to be producing for the reinsurance market. So as a standalone, it didn't make sense, it didn't grow to a size that they can leverage, the kind of capacity, they need to have and buy cheaply. They were buying excess of loss and believe me, we had tiny recoveries and over the years, we paid a lot of premium for that and we have the ability to restructure.

Also I think they were trying to do more quota share contracts, where sometimes, it makes sense to may excess of loss, but in a company that you're trying to build volume, you're looking for quota share and then even though, the excess of the loss might be a better structure and you can make more money. It doesn't show a significant premium.

So for that reason, we have made the changes. We send before we did the purchasing of 100% of the unit, we send our teams and we looked at every single account they underwrote et cetera and now they're coming under our underwriting authority of the guidance with the same auditing teams that we have. So they become a kind of a branch of ours in the Middle East, but the business we like, we got to structure the reinsurance in a much better form than we used to.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Pardon me, that's very helpful. And then very quickly, Mark, you mentioned that there were some investments in platforms in insurance, and reinsurance; is that spend going to continue in the near-term?

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

Well, the ones that have been done, it's on the A&H platforms and some expansion into other distribution in A&H and the contract binding and so forth. If we find opportunities, analogous to what we did with contract binding yes, that will happen, whether it's in the U.S. or in other parts of the world. So it's hard to say but we're always looking. And if we can find the pocket or some individuals with great market following, we're going to pursue those.

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

Yes, and you can see from the numbers, I think our Life Re, Accident & Health reinsurance team now is – I think it tripled in size in number of people. And these to me they're long-term investments in personnel and capabilities and the premium comes later. So I'm not when we find the talent, we're going to hire it and then we look for them to grow the book over time.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. I mistook it as a technology expense. That's very helpful.

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

No, no, no it wasn't. There was some technology expense, but it was - no this is maybe when you spoke we can clean our language, it's mostly people.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Perfect. Thanks so much for straightening me out.

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

Yes.

Operator

Thank you. Your next question comes from the line of Brian Meredith from UBS. Please proceed.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Yes, just to be quick here. So first, Mark, new money yields versus book yield in the investment portfolio risk and did you see some pressure here with where interest rates are?

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

I think we're close to rock bottom...

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

Yes.

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

...at this point. I want to congratulate you for being the caboose on the call today.

Q - Brian R. Meredith {BIO 3108204 <GO>}

I know, it is usually Ian, so I guess I get to replace him. All right. So that's near rock bottom and then the last question, just curious when you're setting your reserves or your loss picks right now, what kind of loss trend you are kind of assuming and has that changed much over the last, call it, year and then three years?

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

Yes. It has changed a little bit, I think, we still take a long-term view on trend. We don't just look at the last three years or five years. We do a 10-year study or so forth and let's face it, trends have been benign now for quite a long time. So that starts coming line by line into our thinking, but it's not something significant. It might be, I don't know, I'm guessing this, because I haven't sat with the actuaries to do a real comparison, what long-term trend was by line of business five years ago versus now. But I think it should be down at least a point maybe even a little more than that.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Great, great. And then I guess just on that. So near-term trend is obviously lower than kind of what you are putting up with respect to your kind of long-term trend assumptions when you are setting loss pics?

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

Oh, yes. I mean when you look forward, you're making some level of assumption line by line on what loss cost trend, what rate, effective rate changes you have achieved and what you think you might reasonably achieve.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Got you. Perfect. That's all I got.

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

The conservatism, Brian, that comes in the way we price business et cetera, it comes from two places; it comes with your assumptions on trend. Are you truthful to it and not jump and say trend is zero or negative, some people think in some lines or – and the other thing is where do you new money invested, are you using the risk free rate and you're willing to price your business with 1%, 1.5%, 2% return on new money invested and then see what the projections tell you. So that's where that conservatism comes. Other than that, like everybody else we knock doors, we find the new brokers, we kiss them on both cheeks, we love to see more business and we try to write as much as we can.

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

And, Brian, Dinos' point about a line of business, I mean just an example, some products you don't care where it is, a product liability, we don't know where the claims are going to be brought...

Q - Brian R. Meredith {BIO 3108204 <GO>}

Right.

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

...versus where they were manufactured, let alone durable goods, they could be anywhere. So a national view on that may make more sense, Workers' Compensation as the obvious local one, got to take local indemnity trends into account, local hospital cost, physician trends and things of that nature. Plus we're already talking about severity, there is frequency, there is really the pure premium that matters or the total loss cost trend.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Right.

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

And comp historically has been showing decreases in frequency and there was a blip in California I think for a year or two years but it has returned. And generally, our actuaries within the loss rating models and pricing models assume the negatives to be flat. So it's, to Dinos' point, a kind of longer-term view but it takes in slowly.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Perfect. Thank you. Appreciate it.

Operator

Thank you. I'd now like to turn the call over to Dinos Iordanou for closing remarks.

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

Well, thank you, all for bearing with us. We went a little over time, but it's all right. We'd get over time paid here, and looking forward to see you next quarter. Have a wonderful day.

Operator

Thank you. Thank you for joining today's conference. This concludes the presentation. And you may now disconnect. Good day.