Q2 2015 Earnings Call

Company Participants

- Constantine P. Iordanou
- Mark D. Lyons

Other Participants

- Brian R. Meredith
- Charles J. Sebaski
- Ian J. Gutterman
- Jay A. Cohen
- Jay H. Gelb
- Josh D. Shanker
- Kai Pan
- Meyer Shields
- Michael Nannizzi
- Ryan J. Tunis
- Sarah E. DeWitt

MANAGEMENT DISCUSSION SECTION

Operator

Good day, ladies and gentlemen, and welcome to the Second Quarter 2015 Arch Capital Group Earnings Conference Call. My name is Krystal and I will be your operator for today. At this time, all participants are in listen-only mode. We will conduct a question-and-answer towards the end of this conference.

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

I would now like to turn the call over to your host for today, Dinos Iordanou and Mark Lyons. Please proceed.

Constantine P. Iordanou {BIO 2397727 <GO>}

Thank you, Krystal. Good morning everyone, and thank you for joining us today. Our second quarter earnings were driven by solid reporter underwriting results, while investment returns were impact by the recent rise in interest rates. On a group-wide basis, our gross written premium declined by 8% in the quarter while our net written premium decreased by 10.5% as underwriting actions and rate decreases in our insurance and reinsurance businesses offset growth in our mortgage business.

Changes in foreign exchange rates also reduced our net written premium on a U.S. dollar basis by $22 million or approximately 2.4% of our volume in the quarter. On an operating basis, we earned $146 - $146 million, or $1.16 per share for the second quarter which produced an annualized return on equity of 9.9% for the 2015 second quarter versus 11.2% returned in the second quarter of 2014. On a net income basis, Arch earned $0.88 per share this quarter which was lower than operating income, primarily due to foreign exchange and realized investment losses. On a trailing 12-month basis, net income produced a 10% return on equity. Net income movements on a quarterly basis can be more volatile as these earnings are influenced by change in foreign exchange rates and gains and losses in our investment portfolio.

Our reported underwriting results remain solid as reflected in our combined ratio of 87.9% and were aided by a low level of catastrophe losses and continue favorable loss reserve development. Net investment income per share for the quarter was $0.53 per share, down $0.02 sequentially from the first quarter 2015 due to the short-term effects of share repurchases on investable assets during the quarter. Our operating cash flow was $232 million in the second quarter as compared to $254 million in the same period last year primarily reflecting reduced net premiums writings over the past six months. Our book value per common share at June 30, 2015 was $47.49 per share, a slight decrease from March 31, 2015 and an increase of 8.6% from the $43.73 per share at June 30, 2014.

With respect to capital management, we continue to have capital in excess of our target levels, and in the second quarter we repurchased 3.2 million shares for an aggregate purchase price of $199 million. I would like to take this opportunity to review our philosophy on capital management. As always, our preference is to deploy capital in our businesses. However, if business conditions don't allow us to earn our target returns, we will look to return excess capital to our shareholders either through share repurchases or special dividends. Generally, we prefer share repurchases which benefit shareholders over the long-term by increasing earnings per share. However, when our shares trade at a premium to book as they have for some time now, we have to be prudent in those decisions.

You have seen the grid on our website, but the essence of this chart is that when we repurchase our shares at a premium to book value, our objective is to earn back that premium for our shareholders over a reasonable period based on the expected returns that we can achieve on equity. Now, whether we can earn that premium back or not is dependent on how quickly the company generates earnings. One can have a different point of view on this, but in the current environment we think that after three years, our crystal ball becomes very foggy. Current competitive conditions make profitable growth in our traditional lines of insurance and reinsurance difficult to achieve and not surprisingly, the industry is experiencing an elevated level of M&A activity.

In anticipation of your questions, I would like to take a moment to reiterate our thinking with respect to acquisitions. We like to investigate opportunities presented by the marketplace, but our preference is to invest first in the recruitment of people and teams with specialty expertise that will complement our product platform. Our second choice would be renewal rights transactions, and last, are acquisitions of business units. We consider acquisitions of business to be the most difficult because by their nature, they involve greater uncertainty.

The criteria that we use in evaluating potential acquisitions have not changed. First and foremost, the business should be complementary to our long-term strategic goals. Second, there needs to be a cultural fit, does management have similar DNA to Arch? That's very critical and very important to us. And third, is the balance sheet transparent and we can get our arms around it? When all those three conditions are met, then we look at price last. As respects to price, similar to our approach on share repurchases, we consider, among other things, the length of time and the relative certainty it will take to recover any premium to book value paid.

With respect to overall market conditions, it is starting to feel like the late 1990s where reinsurance is available at attractive prices, and where favorable terms to the buyer are easily obtained. We have not yet seen significant erosion in the insurance business, with the exception of certain lines which I will discuss in a moment. We believe however, that the ability to buy reinsurance on favorable terms will eventually lead to more competitive conditions across the insurance business.

As I indicated, there are several areas in the insurance sectors that are experiencing increasingly severe price competition. They are E&S and large global property markets, professional liability lines including D&O especially in foreign markets, as well as marine aviation and energy. In all these business lines, we have significantly reduced our exposure.

At Arch, underwriting discipline has always been the foundation of our success, and it will continue to be the number one priority and focus of our management team. Over our history, we have built underwriting systems and controls which allow us to monitor not only changes in premium rates, but also changes in terms and conditions. We believe that our culture and systems, in combination should allow us to better navigate phases of the property casualty cycle.

Turning back to our quarterly results. The insurance segment gross and net written premiums on a constant dollar basis fell 11.1% and 10.7% in the quarter, compared to over the same quarter in 2014, partially due to the timing of certain renewal businesses obtained in a renewal write transaction in our alternative markets business that we have discussed in previous calls.

In addition, volume was affected by underwriting actions in our international and program units. Mark will comment further on premium volume in a few minutes. In our reinsurance segment, softening pricing and continued pressures on terms and conditions led us to reduce on a constant dollar basis net written premium by 8.3%. In addition, purchases of retro protection reduced net premiums volume in the quarter.

Our mortgage segment includes primary mortgage insurance written through Arch M.I. in the U.S., reinsurance treaties covering mortgage risk written globally, as well as other risk-sharing transactions. Gross written premium in the mortgage segment were $68.6 million in the second quarter 2015 or nearly 24% higher than in the same quarter of 2014. Net written premium grew 22% over the same period to $61.7 million.

Our U.S. mortgage insurance operations acquired in late 2014 produced approximately half of the segment's net written premium in the second quarter with $24 million of net premium written in the credit union channel, where the bank channel produced $7 million of premiums written for the quarter.

We continue to make good progress in the expansion of the bank channel, and have approved more than 748 master policy applications from banks, and more than 264 of these banks have already submitted loans for our approval. Of these master policies, 40 represent national accounts and the balance are regional banks.

We also continue to see opportunities in GSE risk sharing transactions which produced $3.7 million of other underwriting income for the 2015 second quarter versus $1.2 million in the same quarter of 2014. No premium was reported for these transactions as current accounting treatment requires us to continue to use derivative accounting. We fully expect that future transactions involving Fannie Mae and Freddie Mac will receive insurance accounting treatment. Although competitive pricing conditions have intensified a bit, Arch's strong balance sheet, diversified mix of business, and our willingness to exercise underwriting discipline should allow us to continue to generate acceptable returns. Group-wide on an expected basis, we believe the present value ROE on the business we wrote this year for six months will produce an underwriting year return on equity in the range of 10% to 12%.

Now, before I turn it over to Mark, I would like to discuss our cat PMLs. As usual, I would like to point out that our cat PML aggregates reflect business bound through July 1, while the premium numbers included in our financial statements are through June 30, and that the PMLs are reflected net of reinsurance purchases and retrocessions. As of July 1, 2015 our largest 250-year single event PML was essentially flat, and is in the Northeast at $541 million or approximately 9% of common shareholders' equity. Our Gulf of Mexico PML increased slightly to $522 million at July 1, and our Florida Tri-County PML stands at $445 million, a slight increase.

I will now turn it over to Mark to comment further on our financial results, and when Mark concludes his prepared remarks, we will come back and take your questions. Mark?

Mark D. Lyons {BIO 6494178 <GO>}

Great. Thank you, Dinos and good morning to all. As was true on last quarter's call, my comments that follow today are on a pure Arch basis which excludes the other segment, that being Watford Re, unless otherwise noted. As in previous calls, I will be using the term core to denote results without Watford Re, and the term consolidated when discussing results including Watford Re.

Okay, now with that said, the core combined ratio for this quarter was 87.9% with 1.9 points of current accident-year cat-related events, net of reinsurance and reinstatement premiums compared to the 2014 second quarter combined ratio of 86.2% which reflected 1.8 points of cat-related events. Losses recorded in the second quarter from these cat events, net of recoverables and reinstatement premiums totaled $15.9 million versus $16.5 million in the corresponding quarter last year. This quarter's cats primarily emanated from U.S. spring tornado and thunderstorm events and some Australian weather activity.

The 2015 second quarter core combined ratio reflected 9.2 points of prior year net favorable development, net of reinsurance and related acquisition expenses compared to 9.4 points of prior period favorable development on the same basis in 2014's corresponding quarter. This results in a core accident quarter combined ratio, excluding cats with the second quarter of 2015 of 95.2% compared to the 93.8% accident quarter combined ratio in the second quarter of 2014.

In the insurance segment, the 2015 accident quarter combined ratio, excluding cats was 97.6% compared to an accident quarter combined ratio of 95.9% a year ago. This 170 basis point increase was driven by 120 bps in the loss ratio and 50 bps in the expense ratio, with the loss ratio increase reflecting higher large-loss attritional activity than in the second quarter of 2014 emanating primarily from aviation more and offshore energy claims. Taking this increase into account, the insurance segment accident quarter loss ratios were nearly identical this quarter versus the second quarter of 2014. The reinsurance segment 2015 accident quarter combined ratio, excluding cats was 94% even compared to 92.1% in the corresponding quarter of 2014. As noted in prior quarters, the reinsurance segment's results reflect changes in the mix of premiums earned, including a lower contribution from property cat and other property businesses. One should also note that this quarter, we did receive regulatory approval for the acquisition of Gulf Re and accordingly, have consolidated Gulf Re's results as a subset of the reinsurance segment, whereas previously, it was accounted for under the equity method as a single line entry, although its impact was immaterial this quarter. This reclassified business falls within the "property other, a property excluding, a property cat line" in our financial supplement.

The mortgage segment 2015 accident quarter combined ratio was 77.4% compared to 84.9% for the second quarter of 2014. This decrease is predominantly driven by continued low levels of reported delinquencies benefiting the loss ratio associated with the CMG business we acquired in 2014, along with better underlying credit risk on business written since the acquisition.

The insurance segment accounted for roughly 24% of the total net favorable development this quarter, excluding the associative impact on acquisition expenses, and this was primarily driven by shorter-tailed lines from the 2011 to 2014 accident years, with some contributions from longer-tailed lines spread primarily across older accident years.

The reinsurance segment accounted for approximately 75% of the total net favorable development in the quarter, with approximately 37% of that due to net favorable development on short-tailed lines concentrated in the more recent accident years, and the balance due to net favorable development on longer-tailed line primarily from the 2003 through 2009 underwriting years.

Similar to the past, approximately two-thirds of our core $7.3 billion of total net reserves per losses loss adjustment expense are IBNR in additional case reserves, which continues to remain fairly consistent across both Reinsurance and Insurance segments.

The core expense ratio for the second quarter of 2015 was 35.1% versus the prior year's comparative quarter expense ratio of 32.8%, driven by an increase in the operating expense ratio of 210 bps, along with an increase in the acquisition expense ratio of 20 bps. The increase in the operating expense ratio component reflects a 6.5% decrease in net earned premiums, a 5.7% increase in operating expenses, which also continues to reflect the addition of our U.S. Mortgage Issuance operations, which, as we said in the past, is operating at a higher expense ratio until that business reaches steady state.

However, as I will get into shortly, it is best to look at the expense ratio in totality rather than by each component separately due to accounting for reinsurance ceding commissions.

The Insurance segment expense ratio increased 50 basis points to 32.5% for the quarter compared to 32% even a year-ago. The net acquisition ratio decreased 10% whereas the operating expense ratio increased 60 basis points. This separation, as mentioned earlier, is artificial since reinsurance ceding commission reimburse ceding companies not just for frontend acquisition expenses but also for the overhead associated with running the primary business, plus in most cases an overwrite in addition to these reimbursements.

It has been the convention to categorize the entirety of reinsurance ceding commissions in the net acquisition line, whereas a portion of these commissions contemplate operating and unallocated loss adjustment expense reimbursements but are not classified there. So, the increased ceding commission actually provide offset to the operating expense ratio, which is why I said initially, looking at things in totality, deal with those issues as opposed to swapping it for one place to another.

The Insurance segment net acquisition ratio reduction primarily reflects material improved treaty ceding commissions on an earned basis associated with quota share contract ceded. It's important to note though that on a written basis, the frontend gross commission ratio worldwide actually increased 40 basis points whereas the average cede commission ratio improved substantially by 260 basis points.

Taken together, this increased treaty commission benefit overcame the increase in the gross commission, resulting in a 60 basis points net commission improvement. Again, on a written basis.

Lastly, one has to reflect the premium tax component, which is a part of the net acquisition expense but is not considered to be commission expense. That increased approximately 40 basis points quarter-over-quarter. That's mostly a function of mix. This reflects traditional premium taxes, second injury funds, guarantee funds cost, et cetera, which also, though, signals some shift from non-admitted paper to admitted forms as the market softens.

These overall net acquisition improvements, however, will continue to be felt as these ceded written premiums are earned over the next few quarters.

The Reinsurance segment's expense ratio increased from 30.9% in the second quarter of 2014 to 35.5% this quarter, primarily due to the lower level of net earned premium, a higher level of treaty cede commission associated with bound contracts, and a slight increase in operating expenses.

The net acquisition ratio increased to 160 basis points due to market forces, whereas the 300 basis point increased in the operating expense ratio is almost exclusively driven by the 18.4% reduction in net premiums earned.

The ratio of net premiums to gross premiums for our core operations in the quarter was 71.3% versus 73.2% a year ago. The Insurance segment had a 68.3% ratio, which was very comparable to the 67.9% a year earlier, whereas the Reinsurance segment had a net-to-gross ratio of 73.9% this quarter compared to 83.1% a year ago, primarily reflecting increased property and property cat retrocessions and increased sessions to Watford Re as a reinsurer.

Shifting now towards the market, our U.S. insurance operation saw an 80 basis point effective rate decrease this quarter, net of reinsurance. As commented on the last couple of quarters, the pricing environment is quite different for short-tailed versus longer-tailed lines. Our short-tailed first party lines of business had an effective 6.5% rate decrease for the quarter compared to a 1% effective rate increase for the longer-tailed third party lines, both on a net-of-reinsurance basis.

Rate increases on longer-tailed lines in the aggregate have now dropped below our view of weighted loss cost trends.

Looking more deeply, some lines incurred rate reductions such as the 10.5% decrease in property and a 5% decrease in high-capacity D&O lines while others enjoyed healthy increases such as plus 6.5% in our lower capacity D&O line, 5.5% in loss sensitive construction, and 3% in our program business. Also, as I've mentioned on prior calls, our lower capacity D&O business lines have now achieved 16 consecutive quarters of rate increases.

Now, turning to our continuing market cycle management, the Insurance group worldwide reduced net written premiums in the volatile line of E&S Casualty, E&S Property, Global Property and Professional Liability in excess of 20% quarter-over-quarter. By contrast, lower volatility lines of contract binding, travel and surety expanded north of 15%, partially offset by a decline in program business due to underwriting actions.

Professional liability is down due to our continuing reduction of the European exposures, plus a subset of SME professional business changed its common ex-date, or expiration date, from June into July.

One anomaly to be aware of is in the U.S. alternative markets business, as Dinos alluded to, which on the surface appears to have had a 25% reduction in net written premium but in reality, back in the second quarter of 2014, when a previously discussed renewal rates agreement was completed, most risk wanted to attain Arch's A+ paper as soon as possible and we're bound with odd time policy terms that are now naturally renewing throughout the balance of the year.

The Reinsurance group only had 8.9% of its net earned premium, represented by property cat this quarter. And property cat net written premiums were reduced by another 15% quarter-over-quarter. Property other than property cat or excluding property cat had a net written premium increase of just shy of 4% this quarter. However, this was driven by our property facultative unit.

Additionally, the Reinsurance group reduced net volume in motor quota share, trade credit and crop hail by at least is 20% in response to the market conditions.

The Mortgage segment posted a 75.3% combined ratio for the calendar quarter. The expense ratio, as expected and as denoted earlier, continues to be high as the operating ratio related to our U.S. primary operation will remain elevated until that proper scale is achieved.

The net written premiums of $61.7 million in the quarter was driven by $30.6 million from our U.S. primary operation, as Dinos mentioned, and $31.1 million of net written premiums through our reinsurance mortgage operations.

This segment also had $3.7 million of other underwriting income in the quarter versus approximately $1.2 million in the second quarter of 2014 due to risk-sharing transactions which were treated as derivatives and mark-to-market each quarter. You may recall that that type of income in last quarter sequentially was around a little north of $7.5 million, which incorporated some catch-up premiums that aren't reflected in this quarter.

At June 30, 2015, our risk-in-force of $10.7 billion includes $6.1 billion from our U.S. mortgage insurance operation, $3.9 billion through worldwide reinsurance operations and $684 million through risk-sharing transactions. Our primary U.S. mortgage insurance operation bound $2.7 billion of new insurance written during the quarter, which was approximately evenly split between bank and credit union clients and which statistically represents the aggregate of original principal balances of all loans receiving new coverage during the quarter.

The weighted average FICO score for the U.S. primary portfolio remains strong at 735 and the weighted average loan-to-value ratio held steady at 93.2%. Those states risk-in-force represents more than 10% of the portfolio, and our U.S. primary mortgage insurance company is operating at an estimated 9.7:1 risk-to-capital ratio as of June 30, 2015.

The other segment, which is still as of now is exclusively Watford Re, reported 103.8% combined ratio for the quarter on $120.2 million of net written premiums and $107.2 million of net earned premiums. As a reminder, these premiums reflect 100% of the business assumed rather than simply Arch's approximate 11% common share interest.

As for business sourcing, approximately 40% of the $128 million in gross written premiums this quarter was written directly on Watford paper, with the remainder ceded by Arch affiliates. It should be noted, however, that this sourcing mix can vary materially quarter-to-quarter.

The total return on our portfolio was reported negative 4 basis points on a U.S. dollar basis in the quarter, primarily reflecting declines in our investment grade fixed income portfolio driven by rising yields and widening spreads, partially offset by positive returns in our alternative investment, equity and non-investment grade sectors.

Total return also benefited from the weakening U.S. dollar on most of our foreign-denominated investments. Excluding foreign exchange, total return was a negative 38 bps in the quarter. Our embedded pre-tax book yield before expenses was 2.07% as of the end of the quarter compared to 2.18% at December 31, 2014, while the duration of the portfolio shortened to 3.05 years.

The current duration continues to reflect our conservative position on interest rates in the current yield environment. However, movements in duration are not necessarily indicative of longer-term strategy or of the insurance/reinsurance portfolio composition due to this duration statistic being reported on a single day balance sheet view.

Reported net investment income in the quarter was $0.53 per share or $67.2 million versus an identical $0.53 per share in the 2014 second quarter or $72.5 million. As always, we evaluate investment performance on a total return basis and, as such, invest in asset sectors which may not generate net investment income.

Cash flow from operations for the quarter on a core basis excluding the other segment was approximately $232 million compared to $254 million in the second quarter of 2014.

This was caused primarily by reduced premium inflows net of commissions and net of reinsurance sessions.

Interest expense for the quarter was $4 million even, which is a significant reduction from the last two quarters and from the corresponding second quarter of 2014. This reduction is due to a favorable adjustment involving a certain loss portfolio transfer entered into effective January of 2013.

This deposit accounting transaction had a downward re-evaluation in the quarter of the underlying ultimate loss, which resulted in an $8.4 million reduction in interest expense. As you may recall, there was a similar adjustment for this in the third quarter of 2014. However, the run rate interest expense which includes approximately $12 million from Arch's senior notes and a variable amount of Arch's revolving credit borrowings and some other items is expected to be under $13 million per quarter for the foreseeable future. However, re-evaluations of the underlying ultimate loss attributable to this loss portfolio transfer will occur periodically and could potentially produce significant further adjustments.

Our effective tax rate on pre-tax operating income available to Arch shareholders for this quarter was an expense of 3.9% compared to an expense of 3.6% in the second quarter of last year. There was no tax catch-up this quarter as the tax rates on pre-tax operating income were identical for both quarters of 2015. As always, fluctuation in the effective tax rate can result from variability in the relative mix of income or loss projected by jurisdiction.

Our total capital was $7.03 billion at the end of the quarter, which is virtually flat with total capital at prior year-end but down 2.1% relative to total capital as of March 31 of 2015.

During this quarter, we repurchased 3.2 million shares, as Dinos mentioned, at an aggregate cost of approximately $199 million. These repurchases represented a multiple of 1.32x of the quarter's average book value and had the effect of reducing quarter-ending book value per share by $0.39. Additionally, approximately $525 million remained under our existing buyback authorization as of the end of the quarter.

The effect of foreign exchange on book value was a loss of approximately $0.22 per share as the negative impact of restating insurance and reinsurance liabilities outstripped the gain in non-U.S. denominated investments.

Our debt-to-capital ratio remains low at 12.7% and debt plus hybrids represent only 17.3% of our total capital, which continues to give us significant financial flexibility. And we also continue to estimate having capital in excess of our targeted position.

Book value per share was $47.49 at the end of the quarter, down 0.6% versus the prior quarter and up 8.6% relative to one year ago. This change in book value per share this quarter primarily reflects unrealized losses and foreign exchange impacts from fixed income securities, which exceeded the company's continued strong underwriting results.

Although there was a lot of activity this quarter affecting book value, we shouldn't lose sight of the fact that the $0.31 per share drop in book value can be totally explained by the $0.39 per share impact of our share buyback this quarter.

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

Q&A

Operator

Our first question will come from the line of Michael Nannizzi from Goldman Sachs. Please proceed.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Hi, thanks. Hey, Mark, just one question I had on the Watford premiums, maybe you alluded to this in your comments, was the premiums there were higher than the ceded premiums out of the Reinsurance business. Did business come from somewhere else or was there some accounting there just to be aware of?

A - Mark D. Lyons {BIO 6494178 <GO>}

Well, no. I mean we did say that 40% of that was natively on their paper, so it wouldn't have been ceded from any Arch affiliate. And there was a slightly higher contribution from the Insurance group this quarter than the Reinsurance group. I think that answers your question.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Yeah, got it. Great. Thanks. And then in terms of the expenses, I mean you talked about the G&A ratio coming up just from a denominator effect of premiums being lower. I mean is there a level where you want that to be or you're comfortable kind of letting the business pulling back and taking appropriate underwriting actions and holding on to your infrastructure just for the potential for conditions to change and being able to leverage that infrastructure again down the road?

A - Mark D. Lyons {BIO 6494178 <GO>}

Well, Dinos and I both have an opinion on that. I'll go first on it. It's a balance beam. There's things that you need to be mindful of and be efficient and make the right tough decisions, and there's other areas you have to recognize you might be going into bone and muscle. I mean as Dinos says, our business is to make decisions. You don't want to lose that decision-making ability. So there's some level of carrying intellectual property we're willing to have irrespective of what it does to the expense ratio.

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

No company went bankrupt or had significant problems because of expense ratio. Most of the companies, they have difficulty with results is due to loss ratio. So in echoing what

Mark said, anything that is dear to us, and dear to us is our underwriting capability we have as a corporation, we will protect that. Of course, we will be prudent managers and try to manage expense with that parameter.

So at the end of the day, if it comes to what we call muscle, which is underwriting capability and knowledge, that it might not be fully usable at this point in time, we will retain that because we make decisions for the long term, not the short term. And when things we can eliminate and they don't have a long-term or short-term effect to what we do, we'll be prudent managers, too, and do so so we can get a more reasonable expense ratio. So, that's our philosophy and that's what we're going to practice as a management team.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. I mean as far as reinsurance is concerned and the view there, still at this point the changes that are taking place in the market are cyclical so you'll make that sort of bone/muscle decision according to that as sort of a baseline?

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

Absolutely, absolutely. Because at the end of the day, there is wonderful things you can do in a good market in reinsurance but you need to have the capability. And I think we have proven that our reinsurance team is one of the best in the industry over the last 12 years, 13 years. All you got to do is look at their performance.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. Thank you for that. And if I could, just one quick one on the MI. Is it possible to break down what the underlyings were or what the loss ratio was even on a stated basis between the MI reinsurance and the flow business, the U.S. MI business, or are they relatively similar?

A - Mark D. Lyons {BIO 6494178 <GO>}

We can do that. Let's see. You're going to make me dig, Michael.

Q - Michael Nannizzi {BIO 15198493 <GO>}

I'm sorry.

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

He's going to give you specifics, but I can tell you the reinsurance business was slightly better...

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay.

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

...than our own MI business for the simple reason, most of our reinsurance business that we wrote is in the very best years in the business. This is 2011, 2012 and 2013 commitments.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Right.

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

So, do you we want to get more specific, Mark?

A - Mark D. Lyons {BIO 6494178 <GO>}

Yeah, yeah, I'll do more directional than order of magnitude.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Fair enough.

A - Mark D. Lyons {BIO 6494178 <GO>}

But the U.S. operation continues to improve, per our comments with the good improvement in delinquencies. The reinsurance was lower still, and a lot of that is due to a calendar quarter effect of recognizing favorable results on reinsurance treaties issued a couple of years ago.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it.

A - Mark D. Lyons {BIO 6494178 <GO>}

Because you don't have gigantic earned premium numbers coming through a calendar quarter, so you make a change on a prior treaty on an exception-to-date basis and it can move the numbers.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got – and then, real quick. Any impact from the PMI quota share reinsurance program in 2Q results or is that embedded in the reinsurance discussion you just gave?

A - Mark D. Lyons {BIO 6494178 <GO>}

There was no real impact from that.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay, great. Thank you so much for all the answers.

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

You're welcome.

Operator

Our next question will come from the line of Sarah DeWitt from 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>}

On the mortgage insurance business, you showed some nice growth in the quarter in terms of the U.S. risk-in-force. And now that you have all the key bank approvals, do you expect a positive inflection point in the risk-in-force in the second half of the year? Or could you just talk about how we should think about the trajectory on the growth?

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

Well, it will be a steady improvement. Not only you have to get to – to sign up the banks, but eventually you got to make sure that from a IT point of view, all the pipes, they're open and we're starting to receive that.

So, I wouldn't say you're going to see an abrupt change in that trajectory. But as you know with the mortgage business, every quarter adds, and we're pretty happy with the progress that our sales force is doing and also the business that we're receiving. We have received from 200-some, 270 banks applications to write the business. And we're still working. We're not at optimum pace yet. But I'll be happy when I'm receiving from all 700 or so. And I don't know how long that will take because these projects, they get into the IT departments and sometimes they take six weeks, sometimes they take six months. So, I can't predict that.

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

Okay, great. And then just from a high level in U.S. mortgage insurance, how are you winning? What do you view as your competitive advantage there?

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

Well, we're one of the highest-rated MI paper. So, like, from a credit point of view, we should be. And we have a terrific reputation on service. With everybody that we have done business so far, we're getting very, very, very good comments about our responsiveness and our service capability. So, the combination of those two, I think, it fares well for us for the long term.

A - Mark D. Lyons {BIO 6494178 <GO>}

And, Sarah, I would also add, we have Arch Mortgage Guaranty, which I tend to kind of phrase as like E&S carrier for the mortgage space, in that it will do jumbo loans and other things that are non-conforming.

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

Right. So, that's an additional service we give to all these banks for loans that they might retain on their books and they won't go to the GSEs. We have that capability, with a very – and let me reemphasize – very highly rated paper.

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

Okay, great. And if I could just get one more in. On all the consolidation we've seen in the industry, could you just talk about what the implications are of these for Arch from our competitive standpoint, and what innings do you think we're in in this consolidation wave?

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

As far as your baseball question, I have no clue. I don't see how – they come out of the blue and there is lot of dating and lot of marriages and all that. But I don't know.

From on an effect point of view, let me give you our view. Our view is that by consolidating on the primary side, you have less buyers or more concentrated buyers for reinsurance. So, I think that will put some pressure, probably further pressure on the reinsurance purchasing. Because the bigger the buyer, the more they buy, the more the leverage they have. And also, they can use even alternative structures, as we have seen with some.

On the insurance side, I view it as opportunities for the simple reason that history tells us that never in a consolidation of insurance operations one plus one equals two plus. It's usually one-and-a-half to one-and-three-quarters, and there is things that fall off the table. It could be people who want to make a change in their careers. It could be over-lining of lines and depending on coverages and the clients says, I don't want to put all my eggs in a bigger basket now. So, we're ready and willing and we have instructed our underwriting units to be a participant in that activity when it occurs and some of that will occur.

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

Great. Thanks for the answers.

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

You're welcome.

Operator

Our next question will come from the line of Charles Sebaski from BMO Capital Markets. Please proceed.

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

Thanks. Good morning.

A - Mark D. Lyons {BIO 6494178 <GO>}

Good morning.

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

I wanted to just talk about the ROE profile on a consolidated basis for you guys and how that plays into if more capital needs to be returned. I guess, Dinos, you've talked about for some quarters now that the current business return profile has been in the 10% to 12% range. And we have a period like this and I realized it's only basis points below that double-digit level, but at the low-end of that range in a period that's relatively light on cats and relatively strong and favorable development. How should we think about how you guys manage to the consolidated ROE profile and how much capital you need to hold and whether there's capital in MI that's kind of affecting that? That would help.

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

Well, let me take you back a little bit, because I think based on your question, I think you might be confusing underwriting ROE versus calendar reporting. We don't pay any attention to calendar reporting, because that's an accounting, and underwriters love accountants but they don't pay a lot of attention to it, right.

The ROE that we calculate is on underwriting basis, meaning how much capital I need to support this business and what is the return when I write a new piece of business. That's the way we base those numbers. So, prior-year reserve releases or additions will not affect that, et cetera.

The 10% to 12%, we calculate based on our pricing model that comes from pricing actuaries, the mix of business we have. And just to give you a little flavor is that we're very happy with our insurance business, especially on the small- to medium-sized accounts that are producing good ROEs. We're not so happy but you can eliminate all or some of our larger accounts for ROEs.

On the reinsurance sector, the ROEs, they've been very good for many years but they're coming down as the pressure continues, including – a big component of good ROE was the cat business but that now is not producing what we (49:00) expected for a high volatility line in ROEs. And then, we're very, very happy with the ROEs on the mortgage insurance.

So, we put that all in a hamper. Our actuaries go through that, and that's how we estimate the underwriting ROE. I'm not telling you that every single thing that we do has a double-digit ROE component. If that was the case, we would have better than the 10% to 12%. We got businesses that they're earning maybe 5%, 6% or 7%, and the question is should we get out of it or not. That's not an easy question. But usually, we'll look at what the prospects are over a longer period of time. And sometimes, you got to stay in those accounts and in those classes for a while at a lesser return in order for you to be a player when things to get better. So, that's the way we think about it. And it's all underwriting ROE calculations, not calendar year ROE.

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

Okay. No, I appreciate – I just was thinking, and I realize you guys look at it that way, I guess I was thinking of it in the view of if the underwriting ROE profile is 10% to 12% over a three- or four-year basis, it kind of ends up mirroring up with the calendar year. I mean if you're always writing 10% to 12%, over time the calendar year and the underwriting year should mirror each other, I guess. But I do appreciate the color.

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

If it was a steady 10% to 12% for all times, but I can tell you the underwriting ROEs in the 2002, 2003, 2004, 2005 years, they were in the 20%s plus, and that helped us to have mid-teen ROEs for some years when actually the underwriting ROE was in the low-teen.

So, we look at it both ways. But I can tell you, from underwriting decision-making and viewing the healthiness of our business, we're religiously looking at underwriting ROE. We allocate capital to our treaties. We allocate capital to our primary business by sector. And then, we have an expectation of return out of that based on our pricing, and then we calculate the ROE on that basis.

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

And I guess just one additional, and into the business, you mentioned that a couple of the programs were terminated this quarter. I'm just wondering what programs and how many programs are left, and what was going on that kind of said – was it an ROE? Was it just people? What happened? Because that has been one of the growth drivers for the insurance business and a couple of quarters where it's kind of slowed down a little bit? Thanks.

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

Well, with anything that we do, everything goes to an underwriting review once a year. I don't care if it's programs or D&O division or E&O division, et cetera. At that point in time, there is an actuarial indication as to what rates we're charging, what is the profitability of that book of business. And then, there is what we will call the rate indication. Then, there is a discussion with our partners. Our approach with our program business is that we want to be a profitable, but also we want our MGUs to be profitable. You don't have a partnership if one makes money and the other one doesn't, and vice-versa. We want all of our MGAs, MGUs, to be profitable and we want ourselves to be profitable.

And then, there is the discussion, this is the market, this is what we believe we should be charging, and sometimes there is disagreements. If the disagreement is large enough and we don't believe we can achieve that partnership going forward that both of us will make money, then we'll make the hard decisions and then we decide to part companies. And unfortunately, it did happened for two of our programs, that our rate indications and what we wanted to file and price that business in the marketplace was not in agreement with our partners, and they chose to go elsewhere.

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

Can you let us know what – yeah, please.

A - Mark D. Lyons {BIO 6494178 <GO>}

Yeah, Chuck, just for a little extra color. Those two programs annualized for about $45 million of gross written premium. We keep high nets on that, so it's not far from a net written premium number, firstly. Secondly – and they were pretty much even in terms of – they're both north of 20, 20 each.

One thing to keep in mind though is that this quarter, one of those programs is very heavy in the second quarter. So, it was to the tune of 50% to a total program. So, the loss of that program is going to be more felt in this quarter than any other quarter for the balance of the year from that program.

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

What kind of products were these programs? Are there any...

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

There was a...

A - Mark D. Lyons {BIO 6494178 <GO>}

Fast food was one. Prefer not to really get into it...

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

Okay.

A - Mark D. Lyons {BIO 6494178 <GO>}

...but the underlying products themselves are really package policies.

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

Okay.

A - Mark D. Lyons {BIO 6494178 <GO>}

It's – yeah.

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

Thank you very much for the answers.

A - Mark D. Lyons {BIO 6494178 <GO>}

Thank you, Chuck.

Operator

Our next question will come from the line of Jay Gelb from Barclays. Please proceed.

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

Thank you. On the M&A front, Dinos, you're very clear about focusing on adding teams of people and renewal rights transactions. And then, seemingly, third – way third down the list is acquisitions of businesses. Going back to even the recap of Arch in 2001, I don't think the company has ever issued shares for acquisitions. Is there any circumstances where you could see that occurring in the future given the massive phase of M&A in the industry?

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

Yes. We care a lot about our shares. It's our shareholders' value. But if the transaction is large enough and our cash capability, even though there is not significant leverage on the balance sheet. So, we do have borrowing ability to a certain degree. Depends on how big the transaction is, we will consider issuing shares. But that's the last consideration; not the first. We try, with all of our decisions, not to dilute our common shareholders. We don't like a lot of dilution.

A - Mark D. Lyons {BIO 6494178 <GO>}

And as a follow-up to that, the way – targeting back to Dinos' comments, think of it this way, that the recruitment of any goodwill or any excess premium you pay relative to what we do in share buybacks. So, if we're looking for three-year paybacks in share buybacks, where we know our operations, it's us. We know what's going on versus something that Dinos mentioned, with a lot more uncertainty, the three-year payback is in upper bound for recruitment of tangible book value hit towards an acquisition. So, we're very mindful of that.

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

Okay. That's in line with what I would have thought. Mark, with regard to that buyback comment, I mean you're in an enviable position of having a high multiple. The stock today, I think, is right around 1.5 times book, and I think that's starting to bump up against your tipping point on whether Arch does buybacks as opposed to special dividend. Can you give us your perspective on that?

A - Mark D. Lyons {BIO 6494178 <GO>}

That's exactly Dinos' comment about us being prudent in how we do it. At one side, I'll be honest with you, it's more of a stretch to do that unless you could find a profitable block trade or something.

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

But based on recent transactions, it's a cheap stock.

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

Agreed. Thanks very much.

A - Mark D. Lyons {BIO 6494178 <GO>}

I can't wait to read your report then, Jay.

Operator

Our next question will come from the line of Josh Shanker from Deutsche Bank. Please proceed.

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

Yeah, I want to get you guys out to souvlaki soon, so...

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

No, no. Today on the menu is moussaka.

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

I don't know it can compete with your mother's though, so I mean what can you do?

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

Well, my mother is in Cyprus unfortunately, so we got to deal with a local restaurant.

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

Okay. So, two questions. First of all, Mike Nannizzi asked a question about mortgage reinsurance versus mortgage primary. And you said in the margin, the reinsurance was more profitable because of the good accident years. If I think about reinsurance in general, companies have been bumping up (58:26) commissions. And when I talk to a lot of reinsurers, they say oh, our book, we use a lot of local players so we get better deals. I mean clearly, the large companies are going to arb you out. And when it seems that mortgage insurance is so profitable these days, how is mortgage reinsurance so profitable? Why aren't the large players charging to cede that risk?

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

For the simple reason that when these transactions, Josh, were taken – don't forget, in the mortgage space you make a transaction in a particular year and you have a stream of revenue that comes over six years, seven years. At the time that these transactions took place, we were providing very valuable capacity to people that they needed capacity. And for that reason, I think we had equal negotiating leverage as they did. They needed our capital as much as we needed the business, so that's a good combination. And for that reason, we got terms that they're not disadvantageous to them but they're not disadvantageous to us either.

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

Okay, that makes sense. Number two, Mark went through in detail on the expense ratio for the insurance business. Mortgage insurance has grown dramatically over the past 12 months, but expense ratio really hasn't come down. When should we think that's going to occur and why isn't that proportional with the growth rate of the new insurance written?

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

Well, the growth is starting to show, but don't forget also we had an acceleration of expenses because we were building these marketing team that is out there. We added in the last - I don't know - five quarters, some 60 people purely in the sales and marketing area.

I think now we're on a steady state. So when it comes to that, it's not going be a significant addition in personnel in our mortgage business. But as the volume starts going up, you're going to start seeing the reduction in the expense ratio.

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

And one last MI question. How should I think about growth in capital? Do you need to dividend money down into Arch Mortgage U.S. in order to fund future growth?

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

No, we gave you that number, Josh. I think now, we're operating at around 10:1. 9.7:1, I think, is the exact number.

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

And you can go to 15:1 if you want?

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

As I'm getting older, I don't like to be exact because I forget things, but - and we got a lot of room to go to 15:1. So I don't see us requiring to downstream capital into those operations for a couple more years until we - I think I use a size 3 shoe to a size 9 foot, we still got the opposite, a foot is size 3 and the shoe is size 9. We got a long way to go to fill it.

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

Yeah, you just have to walk carefully, though.

A - Mark D. Lyons {BIO 6494178 <GO>}

Yeah. Well, Dinos has a nice shoehorn.

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

Yeah.

A - Mark D. Lyons {BIO 6494178 <GO>}

But if you're asking more mechanically, is that there's money in the U.S. holding company that is there for when the need is. That's the mechanism through which they'll get it.

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

Okay. Well, thank you for all the answers. And good luck in the back half.

A - Mark D. Lyons {BIO 6494178 <GO>}

Thank you.

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

Thank you, Josh.

Operator

Our next question will come from the line of Ryan Tunis from Credit Suisse. Please proceed.

Q - Ryan J. Tunis {BIO 16502263 <GO>}

Hey, thanks. I guess my first question is probably just for Mark, it's a quick one. Just on the E&S MI, you were talking about the jumbo loans. Is any of that showing up in the insurance NIW – the mortgage NIW yet?

A - Mark D. Lyons {BIO 6494178 <GO>}

It's very, very tiny. So, it's really part of a value proposition that helps us. But as of yet, it doesn't have any material volume.

Q - Ryan J. Tunis {BIO 16502263 <GO>}

And I guess, maybe looking out over the next couple years, do you have a view on how much that type of stuff could make up of the total U.S. MI business?

A - Mark D. Lyons {BIO 6494178 <GO>}

No. It's a real crapshoot of what's going happen macro economically.

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

And how these banks are going – it's very hard. The fact that we have that capability though, it opens doors and it allows for a better conversation as to what can we do for these banks beyond that, are you going be cheaper than somebody else?

Q - Ryan J. Tunis {BIO 16502263 <GO>}

Okay. And then, I guess for Dinos, just on expenses, I guess, in primary and reinsurance. Just trying to think about a level - is there maybe a level of growth that you think you need in the medium term to support your current expense growth profile? It doesn't seem (1:03:33).

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

No, no, we don't - we never really run the company in any segment, with the exception of MI because we think it's a very, very good time to grow, on a growth prospect. Now, having said that, you've got to match revenue with expense, as long as you don't cut muscle. And I will accept one point or two points higher expense ratio than normal, as long as I'm not losing underwriting capability because that underwriting capability can produce what it will cost you to maintain for a year or two years or three years in one quarter.

Let me remind you guys, in the 2002 year, our reinsurance operations produced on an underwriting basis, $790 million worth of premium and we had 22 people, right? And, it can come and I can tell you, the profit coming out of that was significant. So, at the end of the day, it's that balance and you got to make those hard judgments, but I can tell you, if I got good experienced underwriters, they don't have to worry about their jobs as long as with us. We'll find things for them to do, and if they don't, we'll have to ask them to play golf until the good market comes.

Q - Ryan J. Tunis {BIO 16502263 <GO>}

Got it. Thanks, guys.

Operator

Our next question will come from the line of Meyer Shields from KBW. Please proceed.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay, thanks. Mark, you mentioned that you can't necessarily infer anything strategic from the shortening of the portfolio duration. So can I put that as a more direct question? It also could reflect something. Is there any - should - is there anything that we should read from the second quarter change?

A - Mark D. Lyons {BIO 6494178 <GO>}

No, let me expand on it a bit. It is a point in time estimate as I mentioned, but we continue to have the same exact process where we look at the liability stream and we duration match it, and the - however, the assets underlying shareholders' equity are shorter. So, there's no fundamental change to the overall philosophy and the overall approach of matching losses or duration, which I think is the most important thing. So, there's going to be tactical moves that happen from quarter to quarter. So, I wouldn't look for some big theme.

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Q - Meyer Shields {BIO 4281064 <GO>}

Okay, that's helpful. And then, just a quick numbers question. When we look at the other expenses - I mean, this on a consolidated basis, it came in at $17.4 million, up almost 17% year-over-year. Was there anything unusual there, or is that a new good run rate?

A - Mark D. Lyons {BIO 6494178 <GO>}

Well, let's see. You have a slight increase in overall stock-related compensation expense. For old dogs like me that are retirement-eligible, there is a different accounting treatment of a quicker recognition of those kinds of things. And it's a series of - a bunch of tiny things. So, it's nothing I can asterisk for you that's a main driver.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay, thanks so much.

Operator

Our next question will come from Brian Meredith from UBS. Please proceed.

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

Yeah, thanks. A couple questions here for you. First, Mark, when you talked about rate on the portfolio, the minus 0.8%, you said that's net of reinsurance. What does it look like on a gross basis before reinsurance? And I'm wondering, the advantages you're getting and how that's looked over the last maybe year or two years so we can get a sense.

A - Mark D. Lyons {BIO 6494178 <GO>}

Yes, it's a little worse. But it's converging - now it could - it was really the benefit of property cat, really and some other debt that really grows the differential. So - but I can't get into exact numbers, it's a little bit worse on a gross basis, but that's exactly why you protect yourself with effective reinsurance.

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

Got you. And then the second question, looking at Watford Re, I'm just curious. Obviously, a lot of growth there on a year-over-year basis, it's relatively new. But are we getting to a point in the marketplace where even Watford is going to potentially have to pull back a little bit, given the rate competition out there?

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

Well, it will depend. It's the same underwriting process that we have for everything else we do, the only difference between what Watford will do versus what Arch will do is we believe that their ability as they take a little more risk on the investment side to produce a higher return on the investments gets factor in, but they can be - they're turning down business, too. So, without having something in front of me, an account to go through, is very hard to predict as to - and that's why we never predict volumes because the market can be very fickle, it can turn on a dime either way, it can get much worse quickly, and it can get much better quickly depending on what happens. Our projection is that it's probably is getting worse before it will get better. And for that reason, we're very, very careful in our underwriting processes. So, we don't have these kind of failures that we get too optimistic on the basis that things will change quickly, and then we can make it up in the future. We try to write accounts that in our view will produce an adequate return, and that's why you saw our volume going down a bit.

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

Right. Is there any business that you perhaps would have kept on Arch's balance sheet last year that now, all of a sudden is going to Watford's balance sheet because of what's going on with rates? Are we seeing that?

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

Yeah, there is some of that, yes, absolutely, that's why – and that was the purpose of us creating Watford instead of throwing that business totally out, at least it can go to a place that we get participation. We have an investment in it, it keeps us aligned in that, and also, we can benefit from the – on sharing some of the course because if you discard the business, you have no revenue at all, where if you're writing it, you're getting reimbursed for the cost of writing it, and then potentially, you have also the profit sharing in the backend. So, yes, there is some of that business that otherwise it would have been lost by us, it has gone to Watford, yes.

A - Mark D. Lyons {BIO 6494178 <GO>}

But be cognizant, Brian, that – remember, they have the – Watford has its own management team, and they have the ability on yea and nay on contracts, but let's roll forward year, it's possible Watford – forget Arch and Watford, so Watford itself may decide to not renew something that they found in the prior year because of ongoing rates suppression or yields nothing realize, something to that nature. So, it's not just an Arch sense, it's completely a Watford sense, and their valuation.

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

Great. Thank you.

A - Mark D. Lyons {BIO 6494178 <GO>}

You're welcome.

Operator

Our next question will come from the line of Jay Cohen from Bank of America. Please proceed.

Q - Jay A. Cohen {BIO 1498813 <GO>}

Yes, thank you. Most of my questions were answered. Just, I guess one question on the mortgage segment. The accident year loss ratio jumps around quite a bit quarter-to-quarter. It's a relatively new business, I understand that. At some point, should we expect that number to kind of settle down into a more narrow range going forward?

A - Mark D. Lyons {BIO 6494178 <GO>}

Hey Jay. Good question. The answer is accident year in mortgage business doesn't make much sense. It's – after all, it's the function of the delinquencies, and then claims emanating from the delinquencies. Until there's a claim, you can't even put a reserve up on it body, you can't anticipate performing loans becoming non-performing and having claims emanate from it. So we've railed against the accounting procedures. That's the (1:12:06) accounting in that business. So it's going to jump around. I think you...

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

I will focus much on the delinquencies. It's a better measure than anything else.

Q - Jay A. Cohen {BIO 1498813 <GO>}

Got it, that's helpful. Thanks.

Operator

Our next question will come from the line of Ian Gutterman from Balyasny. Please proceed.

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

Good afternoon Dinos. So I actually was going to ask something similar to Jay, so just to follow that up. Mark, can you just walk through a little bit – these mentioned was mostly the reinsurance loss ratio that came in lower and it sounded like there was some contracts that were reviewed. I guess, can you sort of walk through that process? Is that sort of an annual review, or was it just you got new information in the quarter and you reflected that, or sort of what led you to make a revision now?

A - Mark D. Lyons {BIO 6494178 <GO>}

Ian it's no different than any sector of our business. There's reserve reviews by the business unit actuaries that occur every quarter. And it just happened that those particular treaties had enough information and for-review points that it was going to develop more favorably, and it was recognized, so...

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

It's the reporting from the clients. When they're showing significant improvement, you can't ignore it, and they have shown significant improvement.

A - Mark D. Lyons {BIO 6494178 <GO>}

But just like the PC reinsurance side, it's completely analogous.

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

Well, that's why I was wondering. Was it reports from the client - it is a little bit different market.

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

Report from the clients showing significant improvement, yes.

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

Got it. So it wasn't that you guys went in and looked at the contracts on your own and decided to like lower the roll rate or something like that. It was that the incoming information was significantly better and that you had to adjust to that?

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

Yes, pleasant surprise for both them and us.

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

Perfect. And do you get that information from them quarterly or is that kind of a once a year thing or?

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

Quarterly.

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

Quarterly, okay. I just want to make sure there wasn't a seasonal nature to this, is what I was after. Got it, okay. .And then, just on M&A, one of the things that gets speculated upon is the ability for you or some others on the island to help sponsor an inversion of someone who wants to get offshore. A, just is that a meaningful rationale to do a deal that is - meet your criteria on other metrics, but maybe not as strongly as another deal that was better strategically and so forth, and didn't have it singled to it? And then, I have a follow-up on that.

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

Like I said, price and financial is the fourth item, so if the first three meet criteria, we'll get into the fourth. But - and by the way, our view is both in us purchasing something or somebody purchasing us because, unless your're my wife who says the house is not for sale, you're going to have the right price, the house is for sale, I'll sell my house if somebody gives me the right price. So, no emotion here. Our view is we are employed by the shareholders to do the best job for our shareholders, and there is nothing more to think about other than that.

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

Got it. And then, specifically, just to follow-up on the inversion specifically - I don't know how closely you guys have followed this. But I guess my understanding is that when

Treasury made those changes last year that, if a company like Arch were to buy a company in the United States and invert them that depending on how it was structured, there's chance Arch could lose its tax status. Is that your understanding that essentially, inversions are kind of on-hold until Treasury clarifies that language?

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

I have no idea because we haven't studied that, and I don't have any more insight to it, it's highly a legal question than a structure question, and – if you want more, I'll do some research on it and offline, we'll share our thoughts with you. But it hasn't come across my desk as a situation that I have to focus on.

A - Mark D. Lyons {BIO 6494178 <GO>}

That topic, we've really just focused on the fact that we recapitalized back in 2001 and all legislation and all proposals really had a grandfather clause. So I know you're asking a forward view, but our look and evaluation of that has been the preservation of what we have.

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

Yeah, yeah, I'm speaking do – if you wanted to do a transaction, there's no issue. There was some language I read about – I can follow up with Don offline, but that if you were to buy something, it could affect the status possibly, so I didn't know if that was a hang-up. That's all I was wondering, but I'll follow up with Don.

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

Well, if it does, it's part of the mix. You think I will do something stupid for my shareholders?

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

Of course not, just seeing if I was reading the language right, but you're not familiar, we can follow up offline.

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

The salt and pepper my mother uses has no stupidity in it.

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

All right, very good – I'll let you get to your lunch and so you can have your salt and pepper (1:17:28)

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

All right, Ian.

Operator

And our final question will come from the line of Kai Pan from Morgan Stanley.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you. And sorry for keeping you guys and really (1:17:40)...

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

Not a problem, Kai. Take all the time you want.

Q - Kai Pan {BIO 18669701 <GO>}

Yeah. So, first question on the underwriting margin going forward. It looks like the last price spot on long-tail casualty primary business, the pricing now below the cost trends. So are we expecting – so under reason basis, the underwriting margin will deteriorate. And anything in your power you can alleviate that or control that deterioration?

A - Mark D. Lyons {BIO 6494178 <GO>}

Yes, the answer is yes to both of those. We always talk about the mix of business, these guys are active cycle managers, whether it's within reinsurance or within insurance, and when you see it going negative, you can either drop some of your – attempt to drop some of your frontend volume but perhaps, as Dinos talked about earlier, the reinsurance market is in a place where you can get attractive terms, and can get some benefit on that on a net basis. So the insurance group will be looking for that change in mix frontend, and change in reinsurance to ameliorate some of that. So – and mix alone could change that, Kai. So, on the written basis, in a quarter or two quarters from now, even with no changes in reinsurance-seated programs, by the cycle management, that 1% could be a plus-2% or plus-2.5%.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. On the reinsurance side, and it looks like this quarter, you said actually, the accident year loss ratio ex-cat improved a little year over year. It's just because of lower level of losses or anything there?

A - Mark D. Lyons {BIO 6494178 <GO>}

Well, that was the insurance comment. The insurance comment where you control for the large threshold was really the same loss ratio second quarter – accident quarter, second quarter last year to second quarter this year. The reinsurance group, it did go up a bit, but that's the function of the mix of businesses because we're not writing the property cat. And we're near to the levels we used to in the past, which has a much lower expected loss ratio.

Q - Kai Pan {BIO 18669701 <GO>}

Okay, that's great. Then last question on the recently proposed IRS rules on PFIC, I just wonder if any comments, what are you seeing about Watford's status on that?

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

Like I said, I mean we will – Watford is an active insurer which – it assumes a tremendous amount of reinsurance. Their proposed rules are a work in progress, so we don't know the final rules, but we will continue to monitor that process and we have no – we don't believe there is problem for us complying with whatever rules they come up, because let's go back to the first thing – Watford is an active insurer that assumes a significant amount of reinsurance and it has significant of reserves.

Q - Kai Pan {BIO 18669701 <GO>}

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

A - Mark D. Lyons {BIO 6494178 <GO>}

Thank you.

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

You're welcome.

Operator

I would now like to turn the call back over to Dinos for closing remarks.

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

Well, thank you all for – we're looking forward to talking to you next quarter. And it's time for lunch.

Operator

Ladies and gentlemen, you may now disconnect. Have a great day.