Barclays Capital Global Financials Conference

Company Participants

- Mark Lyons, EVP, CFO & Treasurer

Other Participants

- Jay Gelb, Analyst
- Unidentified Participant, Analyst

Presentation

Jay Gelb {BIO 21247396 <GO>}

Good afternoon, everyone. I'm Jay Gelb from Barclays. It's our great pleasure today to have Mark Lyons from Arch Capital. Mark is Executive Vice President and Chief Financial Officer of Arch Capital Group. Arch is based in Bermuda and writes commercial insurance, as well as reinsurance, on a worldwide basis with a focus on specialty lines. Arch has one of the best long-term track records in the property and casualty insurance industry. And with that, it's my pleasure to turn it over to Mark.

Mark Lyons {BIO 6494178 <GO>}

Thank you, Jay.

I'm glad to see that I was able to pack the house here today. So anyway. Thanks very much.

So I think we have 40 minutes today. I'm going to try to keep it to 25 minutes on the innate presentation. I think there's some audience feedback aspects and then we'll go to Q&A unless Jay wants to torture me with questions along the way, too.

What we're going to hit today is go over some -- I'll say the boring stuff. We'll go over some financial information. Then we'll skew it a bit and we'll get into our book of business and how it's shifted over time and how that's contributed to our performance and I think our multiple differentiation. And then we'll get into the market, what are we seeing right now and how do we view that.

So when we get to the Q&A, hopefully I have as much A as you have Q. So we'll see.

Oh, yes. I put this up here. This is the -- every presentation must have legalese in it that no one reads and everyone ignores. Okay.

All right. Now, Arch strategy. Some of this stuff I view as pretty basic. The major bullet points being we diversify our risk exposures. I call that Insurance 101. That's something I think -- one-note tunes. It's not something that we believe in. Instead, we believe in a diversified product set, a diversification between insurance and reinsurance and diversification in a geographic perspective.

Underwriting is the whole key. People are the key and we focus on talent-intensive rather than labor-intensive businesses. And we have a couple exceptions to that. You could say surety is -- has some labor associated with it. But the market niches you're in still require that kind of intellectual thinking.

We evaluate risk constantly on an individual level, as well as concentrations throughout the portfolio from a risk management perspective.

Active cycle management we view as one of our hallmarks. I always make the analogy on little league. If the coach would always say to the shortstop, charge the ball. Do not let that ball bounce and take a bad bounce in front of you. You control the play, don't let the play control you. And we think the same way when it comes to the marketplace. We can be proactive in it. We change mix of business, we change our capital allocation and we change our net positions and we do that continuously.

We also have an Underwriting Committee of the Board, which is very intense, reconciles various points of view and we rotate lines of business throughout it. But the Board is very, very active in our risk management and our underwriting management.

Our conservative balance sheet is almost our conservative accounting policies, whether it's revenue recognition, whether it's loss reserves, whether it's our investment portfolio, whether it's recognition of things. From a reserve standpoint, we tend to recognize adverse results sooner than we recognize favorable experiences.

We have low financial leverage, that we'll hit a little bit later. And strong liquidity. And on the financial leverage I'll make a reference to our capital structure because, from the outset, our Board was thinking of matching audio/video to have -- if you're going to have an underwriting company, make sure the capital structure supports being successful in that regard.

Our financial highlights quickly on the Second Quarter. We have a return on average equity of almost 11% for the quarter. The combined ratio from a calendar quarter basis was 87.4%. On an accident quarter basis, excluding Cats, it was at 91.7%. That's our blend between our insurance and our reinsurance facilities.

Book value due to interest rates movement on fixed-income instruments dropped 2.3% in the quarter. But was still up from 7% from June of the prior year. We had cash flow from operations of roughly $183 million and we had total GAAP capital of $5.6 billion at June 30th and we had market cap of roughly $7.1 billion.

This is the point I said I'd reference later on our structure and our leverage position. You can see on a pure debt perspective it's only 7% of capital. And debt and hybrids are at 12%. So I think there's two important takeaways there. One, the initial structure. The Board from the outset did not want to lever up, have a lot of debt to service across all years of the underwriting cycle and possibly have marginal deals be rationalized to be good deals in order to get cash flow in to service the debt. We never wanted to be in that position and that's why we keep it so low, firstly.

Secondly is the ability to allow us to lever up when market conditions really dictate. We don't need to dilute common shareholder. We could go to debt markets and have a fair amount of flexibility. In fact, we look at it this way. We could probably lever up, without having rating agency issues or bank covenant issues, probably another $1.25 billion. If it's really justifiable for that, we'd push that premium-to-surplus ratio maybe 1.5-to-1 on that marginal difference and we'd -- at the right time of the cycle to take a higher net. So all told, we could probably write another $2 billion of gross on the additional debt capacity that we could put out without diluting common.

On the liquidity side, it's just a couple quick bullet points. You can see we have a lot of short-term investments. We have $13 billion investable assets. So you can see roughly 30% of that we view as highly liquid, which is about $4 billion.

Our business outlook. I love how we like -- we call this business outlook. But it's a trailing 12 month view.

Unidentified Participant

(Inaudible; microphone inaccessible.)

Mark Lyons {BIO 6494178 <GO>}

Yes. So I'm apologizing to myself. Let's see what I can do to correct that in my verbal comments here. Okay.

So the net premiums written is 60%/40%. That's the year ended June 30. It's skewed a lot more towards the insurance group on a gross basis. It's closer to 70% insurance, 30% reinsurance. The reinsurance group has a few retros here and there. But the insurance group keeps about a 72% net as of now and that explains the differential gross and net.

Client location. You can see it's about two-thirds out of the US with Europe right behind it. You could almost say that, between the US and Europe, it really controls the whole ballgame. And our Canadian and Bermuda operations, Canada growing, Bermuda stabilizing, are rounding out influences. But the markets and the kinds of clients that go there are radically different between those two.

Line of business you can see is pretty well diversified. This is an ACGL view. So this combines insurance and reinsurance. You'll see that property exposed and property cat is about 29% all told. That's pretty radically different between the insurance and the reinsurance sector. The reinsurance sector gets most of our PML and therefore has most of the property exposure. The insurance group worldwide is under 20% of its total net volume being property cat exposed.

Okay, capital management. This is just a generic slide to really reflect, that they allow me to comment on, the drivers and effects of cycles. You can see at various points, depending upon your view of returned or combined ratios, when you should put the pedal to the metal and write a lot of business, when you should be very defensive in nature. And where the points of inflection occur and you have some opportunities starting to accrue.

Depending on where we are in the cycle, we allocate capital differently. We will have PML allocations that change. Our mix of business and the drivers and the instructions we give people on the customer-facing gross premium changes. And of course it affects our reinsurance purchases to protect the insurance group, depending on where we are in the cycle.

And lastly. And I think just as importantly, our underwriters are very keenly aware of this because they have an underwriting year base incentive compensation plan that truly aligns the interest of the shareholder with the incentive compensation. Because if it's an underwriting year, put your money where your mouth is, multiple calculation type plan.

This slide will start to migrate us into a little different kind of conversation. In totality, you can see that the year-end 2012, if you look across at the top, we were roughly $3 billion of net written premium. It was about $3.8 billion of gross written premium. The proportions, with the green being the reinsurance group and the -- or lighter blue, I guess, being the reinsurance group and darker blue being the insurance group, that really from about 2006 forward the insurance group was relatively flat; had some movement up in recent years. Whereas, in totality, the reinsurance group you could see much more of an opportunistic bend across.

I think what gets lost in the sauce sometimes is that there's been some pretty material changes within the insurance group itself as to -- between these mixes of business. And to illustrate that, we'll do a comparison of just 2010 through 2013, which characterizes our worldwide insurance businesses into these buckets. I'll explain what they are in just a moment. But you'll notice the shifts.

First, the buckets are low volatility, stable positions, opportunistic or defensive. And you can see over that three-year period low volatility on a gross written premium basis went from 34% of the worldwide book to 40%. Stable positions went from 18% to 22%. Defensive went down from 26% to 20%.

What's in these businesses? Low volatility businesses are our A&H businesses, lenders businesses, contract binding businesses, some of the programs we have; low limit, high frequency oriented businesses that are much more predictable.

Stable position businesses we frame as those where we have a hook. So for example, some risk managed businesses have been altered recently where they don't go out to the market every year. They don't shop it. They're looking for a carrier to have a three, four or five-year relationship with. Not a bound deal for three years. But have that relationship over that period of time. Firstly. So the buying behavior is conducive.

Secondly, there's generally a lot of service required on those accounts, whether it's ongoing up-front service, a policy issuance, because a lot of these deals are work comp, GL and auto, composite, (about three-line) deals, as well as ongoing service for collateral and other retrospective adjustments. And thirdly is the collateral itself. That's always a hook when you're holding the client's collateral as to -- for longevity.

So those businesses, we categorize those are stable.

Defensive, I'll jump ahead to that, is generally businesses that we finally got our underwriters to acknowledge are commodities. And that's generally where it is high-capacity businesses. So a lot of excess casualty capacity, hospital/professional liability -- man I hit this thing a lot. I got to stop being Italian here. D&O businesses, especially on the commercial side where you're putting out a big slug in capacity. That's what we view as being defensive because it is -- has more commodity characteristics.

And opportunistic is where the market allows us. And on the insurance group side, we view some of the property businesses as opportunistic, mostly because there's a minority of the P&L allocated there. Most of it's into the reinsurance group.

Okay. We've had this shift and we've talked about this on earnings calls and other times, to be purposely towards lower volatility business, which means we are far less dependent on complex, heavily (well-broked) Fortune 2000 business and into the -- much more of the middle market businesses.

So when you make that -- you see that kind of shift, that's evident. But it's much more exacerbated when you look at it on a net basis. On a net basis, for example on low volatility, over the same time period it went from 45% to now 50% of the book. And the stable position book in yellow is 21%. So 71% of our worldwide net premium, the businesses representing that, we view as low volatility and something that we have a good stable position and customer retention on.

The reason -- and if we flip back -- and you'll notice that low volatility in 2013 was 40% of the business gross. But 50% of the business net, is because all low volatility business we take massive nets on. And I mean 95% and north nets. So we believe in it. We think it helps stabilize the return on capital. It certainly helps stabilize the volatility around that average return on capital and we've been very successful at that.

Now, as is segmented in the next slide, I had mentioned that in the defensive category one of the lines is D&O businesses or professional liability businesses. They're very volatile. It requires generally a fair amount of capacity to put out. It has commodity characteristics. And as a result, we tend to reinsure that more, especially in softened part of the years of the cycle.

So why do we feel that way? Well let's just take a quick look at our friend from Schedule P, which is the US industry result. And what this shows from the right is the 2012 year, which is the greenest year and therefore the most immature year and more actuarial estimates than known claims. To the far left, where it's 2003, all evaluated as of 12-31. It says 2013. But since we're not there yet that's a typo. So it's 12-31 2012.

So the main part of this is to acknowledge that early on there's a tighter cluster when companies don't know as much. Everybody tends to have the same initial expected loss ratio. But as time goes by, claims emerge, they get reported, they get settled, the difference starts to emerge and the spread between them.

Most people tend to think of what's the difference in the volatility between accident years or between underwriting years, whereas there's a ton of volatility within between companies. And that's the difference between taking an index fund approach versus individual stock type approach. Underwriting does matter and this kind of scatter demonstrates that.

In 2012 you have roughly an 18 to 20 point spread, which is generally a lot more than you'd find in some of the past years. It's a 75 loss ratio point spread from the 2003 year. That's the more mature, more baked in and more definitive in its ultimate outcome.

Now, if I had put up Med/Mal here or I had put up occurrence-based line 17, other liability, it would be actually more pronounced than what I'm showing here. But it's an example of commodity businesses, high-capacity businesses that have this kind of variability within a year between carriers. And it's one of the reasons we reinsure it more and change our mix as the underwriting years go.

Moving over to this packed side. There's a lot happening here. Up top is really dealing with -- it's peer comparisons of returns of tangible book value growth versus return on equity. And the bottom is more of a stock view as opposed to a book value view.

The top left you'll see that we've compounded since inception 18.6% growth in book value, which has outstripped this peer group as defined at the very bottom.

To the far right. And this will be a segue to some of our later slides, you'll see a few things. One, you'll see first off that Arch is in blue and -- I'm sorry, Arch is in green. No. That's right, Arch is in blue. And we generally have equaled or exceeded our peer comparison in every year.

However, I think one of the points of differentiation is, if you look at 2005, 2008 and 2011, we did not make major errors. We either had -- our peers either had negative returns or anemic returns. And we had lower than we'd like but acceptable returns. So it means our defensive risk management approach has worked. So when it's been a large cat year, we were not hurt as badly as our peer group. So that kind of differential on book value. And therefore on stock price, compounds itself over time. And we view the fact that we outperformed in non-cat years. But I think more readily so in cat years.

When you go down to the bottom left and the five-year stock performance, you could almost draw a line where you start to see the divergence of the multiple between Arch in blue and our peer group in green, which is roughly in the 2009 area, which means the market kind of looked back at our 2005 performance and our 2008 performance and started to say I guess there is a risk management differential here.

Now, a lot of the stock market is evaluated as of 4-1. This was a BofA ML slide so we didn't want to modify it. But we're trading at roughly the same multiple now that existed then.

Now, into market conditions. I think one of the reasons we had that kind of performance that we just talked about is that it's how we look at the same set of facts. Every management team is looking at the same set of facts and interpreting it in a given way. We may be interpreting it differently than many.

So what are we seeing right now? Well there's clearly -- there's ongoing improvement in the insurance group. The margins are clearly improving there. It's been led by the US. There's been improvements in other markets. European markets, however, Bermuda markets remain challenging. But about 70% of the worldwide group volume is emanating from the US where there's a stronger recovery.

I think one of the key segues, before we get lost in the sauce of this slide, is the segue thought of looking at things differently on our financial performance from the prior slide to what's going on now. So let me give you a few examples.

Specialty/casualty business and workers compensation business has been getting pretty meaningful pricing increases; in fact, of having rate on rate increases. Yet in our view it's still not enough to justify a capital allocation and a foot on the accelerator view into those lines of businesses. Others are going to look at that differently and -- but we don't look at relative changes. We look at absolute improvements implied by those relative changes.

Secondly as an example, more on the coverage side of the house, the Bermuda insurance industry, which is complex risks, has started to have some morphing changes in terms of conditions. I think one of the more notable ones is on the casualty sector, the excess casualty in particular.

There's been a shift towards four or five Bermuda competitors accepting Duty to Defend within the policy form contract. Duty to Defend means it's -- well, defense costs and it's outside the limit; outside the limit of liability, therefore unbounded. And when you get risks that go to Bermuda, they are complex organizations. They take reputational risk very seriously.

And it's not just that there's Duty to Defend. It's written with a No Right to Settle clause. So insurers who are buying into this can have the taxi meter go unbounded on defense costs associated with it, which is something I think is slipping through the cracks. It's an example of soft market, of changes. It's one of the reasons our Bermuda book is not growing. And I think it's a point of differentiation on who's writing that and who's not.

I mentioned US sector rate movement. Relative to 2006 as a base year, we've had movement in a lot of different areas. National accounts is a lot stronger. D&O business actually strengthened through 2009 and then softened again. Specialty casualty business from 2006 actually had dropped 30% from 2006. But has rebounded to be about 15% off those numbers. So improving. But not yet back to 2006 levels.

Excess casualty business is similar. That was down around 25% to 30% and now we think it's about 8% or 9% down relative to 2006 levels. We take a further differentiation there and we think the lead excess business is still underpriced and higher up in the tower and is approaching adequacy.

On the reinsurance side, as most of you are aware, cat reinsurance pricing has softened. Our view of the Second Quarter. And I think mostly on 6-1s and 7-1s that our effective rate change was down around 10%.

In our view, the influx of non-traditional capacity, which we estimate to be about 15% of the market, of the capacity coming through the market, is real. But has had a dampened effect on -- with more supply coming in. I think just as notably is our view of where that capacity has played in the past. That has been very high up in programs and that has now shifted, not completely. But directionally towards being lower in the -- on the loss curve and, therefore, the alternative capacity is now exposed; not just the severity. But also to frequency events.

So if we had another 2004 where we had four storms or 2005 where we had three storms, they are much more exposed because they're no longer upstairs. They're -- a bunch of them were down low. And so I guess what we'll really see with the risk -- assuming we have a couple of cat events, we'll see how the risk/reward equation works out for them.

We -- I think we're one of the few. We actually dropped our cat volume in the Second Quarter relative to the Second Quarter of last year. We did it because of some of the rate -- effective rate changes. The absolute return is still acceptable. It did tail off. But some of the layers that the alternative markets or the non-traditional markets went down south at was not at pricing levels we found attractive and we let those go where we had been on those. So that changed our mix as well.

We're seeing some -- well, let me go back to that last bullet point. Premium -- on selective use of capacity. Now, our cat underwriters are defensive of this or aren't bummed out by this. They kind of like this because this is really roll-up-the-sleeves time. This is, okay, let's really compare across the board on these submissions. Where are we going to place the capacity? What are the characteristics of the ceding company? What's been the historical history of it? Let's -- every layer has a different return characteristic and let's really see where we're going to play. Let's narrow the lines where we need to. Let's offer capacity if we can up top if the -- if it's dropping from our return standards down below.

And so I think it's likely -- here's a forward-looking statement. I think it's likely that market conditions stay the way it is now and you'll see further declines in our cat volume as well.

Marine business is seeing improvements. But it's pretty localized to the jumbos like IGA. Other marine and offshore energy is still challenging at this point.

Our facultative operation, which is now roughly $130 million, $140 million a year, besides doing very well, is -- it's their risk selection and their attachment point management that keeps their margins the way they are. They've been enormously profitable for us. And even though the market's getting tougher, we don't see that waning.

What -- because we're -- we play on both sides, on the insurance side and the reinsurance side, where it's tougher on one area, it's a benefit for the other. So reinsurers have been enormously disciplined, probably since we've been in existence. But I think more steadfastly so as the market declined.

We're starting to see cracks in that as an industry statement across the board. And even though cat pricing, for example, has come down, I think mostly because of supply and how supply operates, we -- nevertheless, that can be an advantage for the insurance group.

The insurance group last year was getting -- depending on whether it was wholesale or retail property, was getting anywhere from like 7% to 12%. This year it's in the 3% to 5% range. Nothing to write home about from a gross perspective. However, when you compound that with the improved trends and conditions and cheaper pricing associated with outward reinsurance purchases, especially from a cat perspective, the net economics of an insurer's property book really increases dramatically. So even though some of the economics declined in the reinsurance group's cat, it is partially offset by the increase in ROE on your insurance group side.

Casualty lines remain competitive. There's two things happening, really. You've got ceding companies not really willing to share the profits that are now emerging because of -- I'll say hardening, not hard, hardening market conditions. After all, insurers have been putting the screws to them for about five or six years and not willing to just return it in kind.

And secondly, because of that leverage, that they might want to keep more net, there's more of a squeeze on proportional reinsurance to get another point or point and half of ceding commission above and beyond cost, which tactically drops down to the bottom line.

So you've got some of those going on. I can tell you from an Arch perspective that there are those challenges. But one thing you won't be -- see coming is what the insurance group takes advantage of, which is when we buy -- when they buy cat protection, it's not just on the property cat side. There is a lot of cat absorbency within the quota shares that inure to the benefit of the cat program and they do a great job buying that reinsurance.

So I think the thing that you need to know is, shifting from the insurance side that purchases that and looks to leverage that to the reinsurance side, the reinsurance side does not provide that. They do not bend on occurrence covers on the handful that have it. So the insurance group takes advantage of that. But the reinsurance group does not provide it.

Catastrophe pricing. You can just see on the relativity there that roughly year-to-date '13, which takes the whole year, you can see that the horizontal green line says that the pricing levels are roughly equal to 2006 after KRW and roughly equal to 1996. So it could fall a little bit more. In fact, if I was to superimpose 7-1s on top of that. And if it doesn't change, you'll see that line drop a bit more.

I think one kind of a summary summation of this is -- I almost feel like a consultant because all consultants have four quadrants. We can't live without four quadrants.

So here you've got your return over this 10-year period and the standard deviation associated with it. And you want to be in the top left on these and that's where we are. So you can see that we have high returns and a more predictable because of the lesser standard deviation associated with it. So that's a lot of our peer group. Of course, on a go-forward basis the function of mix and how we react to market conditions.

So before having a summary to -- I guess, Jay, we're going to go to audience feedback first? Okay.

So here's the nutshell summary I think you should take away with. We've been disciplined across the cycle. We -- I think we have overt evidence of being disciplined. We've dropped our net volume in light of the businesses that don't hit return standards. We've dropped our gross volume. And even more in some cases, which is more difficult. That's like walking on a balance beam for our frontline underwriters because they're the one dealing with the market contacts and the brokerage force day in and day out and have to navigate that.

We've maintained a conservative balance sheet in leverage, as well as -- well, mostly leverage. Our risk-adjusted returns have been strong throughout our period. and we take pride in saying we're an underwriting company. That's what this is about.

If you look at the broad averages versus the McKinsey Study that looks at quartiles and quintiles of performance overtime, the insurance industry that takes on Corporate America's risk, just viewing it from the American perspective, you'd think would have higher risk-adjusted returns. But that's not the case. The returns are inferior to the S&P, number one. And number two, it's more volatile. So not as good and less volatile. That's the industry average.

But when you start looking at top deciles and top quartile, the difference isn't fun and games and leverage. The difference isn't asset performance. The difference is underwriting and that will always be the case. And that's where we place ourselves. That's where we always want to place ourselves and we hope the way that you view it.

So thank you for your time.

Questions And Answers

Q - Jay Gelb {BIO 21247396 <GO>}

Thank you, Mark. Let's turn it over to the audience response system.

Okay. The first question is, if you currently don't own shares of Arch or are underweight, what would cause you to change your mind? The options are listed one through five. And why don't we give folks around 10 seconds to log in and we'll check the results.

Okay, results are in. And the majority of respondents, 57% saying lower valuation. That's a high-class problem, Mark.

A - Mark Lyons {BIO 6494178 <GO>}

It is a high-class problem. It is a high-class problem. Well everybody has -- would have a different view of it. We actually anticipate as the cycle -- actually, irrespective of market conditions. So whether the cats occur, managing the cycle, if it's a continued marginal change in the market or a violent change in the market, we think we're going to come out ahead and actually increase that distance between us and our peers on the multiple.

Q - Jay Gelb {BIO 21247396 <GO>}

When you think about -- or in Arch the Board thinks about share buybacks, Arch seems to be in a small class of insurers that actually thinks about it in terms of payback period. Why don't you talk a little bit about that in terms of how you're approaching it on a valuation standpoint.

A - Mark Lyons {BIO 6494178 <GO>}

Sure, sure. As a general rule -- we have these rules of thumbs that we go. We're not boxed in by them. But as a general way we like to get a payback of the premium we pay associated with the share repurchases over a three-year period of time. So our forward look, it's not the historical look back, it's the forward look of what our returns would be over those periods. So in a perfect world, if we were trading at 133%, that would imply a 10% compounded annual underwriting year return on capital. And if it was -- if we were trading below 133% it would be a buy signal.

So right now we're trading at basically 146%. I didn't look today. But I know yesterday at 146%, which implies about a 13.5% return, pushing 14%. There's a couple of reasons that I think from a general share buyback point, Jay. One is we seldom buy back in the Third

Quarter because of wind season, firstly. Secondly, because of our mortgage insurance and some other things that we have that we're evaluating we may have need for some of that capital.

But from a valuation perspective, which is the heart of the question, at 146% and a 13.5% to 14% return, we don't think we're actually having our business at that at this level and therefore unlikely we'd have Fourth Quarter paybacks based upon the valuation due.

Q - Jay Gelb {BIO 21247396 <GO>}

Okay. Next question, please. The next question for the audience. Arch Capital is among the few insurers/reinsurers that does not pay a common share dividend. Should Arch institute a dividend?

All right. And the response here, two-thirds saying yes, one-third saying Arch's dividend strategy is not important. And none saying, no, Arch should not pay a dividend. Any thoughts on that?

A - Mark Lyons {BIO 6494178 <GO>}

Yes. I assume that the 63% all have pension fund clients. But we -- as a general rule we view -- I guess two things come to mind. We view a dividend as shareholder management, not capital management, firstly. And secondly. But to a lesser extent, it's similar on a cash drain perspective because it's there across the years of the underwriting cycle. That's why our capital structure isn't loaded with debt. We don't like to have recurring outflows. We'd rather reinvest it back in the business.

Q - Jay Gelb {BIO 21247396 <GO>}

All right, great. Next question, please. Early in 2013 Arch announced plans to enter the US mortgage insurance market. How do you view this strategy? So let's get the responses.

Okay, definitely skewed towards positive here, 60% either saying meaningfully or somewhat positive. Only -- or 30% saying more geared towards negative.

Tell us a little bit about why you entered that business, Mark. And how you see it building from that on a go-forward basis.

A - Mark Lyons {BIO 6494178 <GO>}

Sure. Well if I view this as a pass/fail class with 60% being positive, I'd just have to say you look like a smart audience. I -- now you've confirmed it to me.

Well we thought it was really a perfect storm to get into it. You had few competitors. The ones that were remaining were damaged. You had rate levels increasing dramatically. You had massively tightened loan underwriting standards to which the MI attaches. The banking sector, the only people that could get loans were the people that didn't need them. So there were a lot of characteristics like that.

At the same time, you had the FHA wanting to depopulate their market share. They're supposed to be the insurer of last resort, yet they had roughly an 85% market share. And they've been depopulating it. But they're still in the 60s. So we don't know to the extent that that population is going to happen. But it's stated that they will.

So it's clear that the government wants to depopulate mortgage risk and they'd going that in a lot of different ways. There's also talk of requiring mortgage insurance at a lower level in some cases, which could increase the size of the pie available to the MI industry. Also, the FHA depopulation is shifting from public to private. So you have a -- not quite an oligopoly. But a finite number of carriers going after it, only some of which have -- are new or have newer capital.

Additionally, we -- getting approved. We got approved on the (inaudible) bankruptcy core. We're in the middle with the GSEs now and we would be the highest rated credit in the space when you would think that a counterparty -- in this line of business counterparty risk should be something taken seriously.

Q - Jay Gelb {BIO 21247396 <GO>}

Thank you. All right. So with that, let's open up to the audience if they have any questions. Yes, first--.

Q - Unidentified Participant

Just to follow up there, what's the timeline to get approval and (inaudible)?

A - Mark Lyons {BIO 6494178 <GO>}

Yes. It hasn't slid much. We've been saying the end of the year and we still think it's 4Q, early 1Q. We're going through the GSE approval process. Up until recently we were really Arch and GSE as creditor, now it's GSE as regulator. So we're going through that approval process with them now. Haven't seen anything that should make a major speed bump. It's just summer and trying to get government employees back in is -- we've just got to wait for that to--.

Q - Unidentified Participant

Is there a minimum capital commitment (inaudible)?

A - Mark Lyons {BIO 6494178 <GO>}

We're really waiting for the final capital requirements. They are not yet stated. We only hear whispers. We've been down in the DC meeting with the GSEs and the FHFA on multiple occasions and they're still in the process of it. All we're really concerned about is that any final capital standard is uniformly applied and it's a level playing field. And that more onerous -- we're not even a new entrant given that we have an existing operation with CMG, which is about $100 million a year. And PMI being the bank channel, actually has all the infrastructure built in. That's part of what we're purchasing.

So we still feel like it's on schedule. It might be a couple months slippage. But nothing material. Nothing that's going to impact 2013 year in a revenue sense.

Q - Unidentified Participant

How much capital do you think (inaudible)?

A - Mark Lyons {BIO 6494178 <GO>}

Well we'll do it -- well, we're going to have $200 million on day one because of CMG. Asset exchange in kind, basically. It's -- market conditions continue, we will feed it as dictated by the FHA, as well as the FHFA. So all I can tell you, it's going to be commensurate with what their demands are, as long as it's applied in a uniform way and not have uneven playing field on legacies versus newer companies.

Q - Jay Gelb {BIO 21247396 <GO>}

I'm afraid we're out of time. We're going to have the breakout session in the Bryant Suite. So with that, please join me in thanking Mark Lyons for his time today and Arch Capital.