FINAL

Bloomberg Transcript

Q1 2015 Earnings Call

Company Participants

- Constantine P. Iordanou
- Mark Donald Lyons

Other Participants

- Amit Kumar
- Charles J. Sebaski
- Ian J. Gutterman
- Jay Arman Cohen
- Kai Pan
- Meyer Shields
- Michael Nannizzi
- Ryan J. Tunis

MANAGEMENT DISCUSSION SECTION

Operator

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

Before the company gets started with its update, management wants first to remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the federal securities laws. These statements are based upon management's current assessments and assumptions, and are subject to a number of risks and uncertainties.

Consequently, actual results may differ materially from those expressed or implied. For more information on the risks and other factors that may affect future performance, investors should review periodic reports that are filed by the company with the SEC from time to time.

Additionally, certain statements contained in the call that are not based on historical facts are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The company intends the forward-looking statements in the call to be subject to the Safe Harbor created thereby.

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

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

Constantine P. Iordanou {BIO 2397727 <GO>}

Thank you, Kathy, and good morning, everyone, and thank you for joining us today. Over all these years, I thought I was the guy with the beautiful accent, but I think Kathy has put me to shame today. We had a good first quarter as the earnings were driven by excellent reported underwriting and investment results.

Our gross written premium grew by 1.3% in the quarter, while our net written premium shrunk by 8.8% as growth in our insurance and mortgage businesses was offset by a decline in our reinsurance writings. Changes in foreign exchange rate reduced our net written premiums on a U.S. dollar basis by approximately $32 million or 3.4% of our volume in the quarter.

On an operating basis, we earned $1.17 per share, which produced an annualized return on equity of 10.2% for the 2015 first quarter versus a 12.1% return in the first quarter of last year. On a net income basis, Arch earned $2.16 per share this quarter, which corresponds to a 15.8% return on equity on a 12-month trailing basis.

Return on equity based on net income has averaged approximately 400 basis points higher than operating ROE over the past four years. Of course, net income movement can be more volatile as these earnings are influenced by changes in foreign exchange rates and gains and losses in our investment portfolio. These effects have been more noticeable as we have increased our exposure to alternative asset classes and have remained focus on a total return strategy where some components of total return are classified below the line in our results.

Reported underwriting results were excellent as reflected by a combined ratio of 87.5% and were aided by low level of catastrophe losses and continued favorable loss reserve development. Net investment income per share was flattish for the quarter at a $0.55 per share, which is down $0.01 sequentially from the fourth quarter of last year. Our operating cash flow was $16 million in the quarter as compared to $197 million in the same period last year, and Mark will elaborate further on its components in a few minutes.

Our investment portfolio performed well with a 205 basis points gain on a local currency basis and because of FX movements, 111 basis points when measured in U.S. dollars. Our book value per common share at March 31, 2015 was $47.80 per share, an increase of 4.9% sequentially, while book value per share grew by 15.1% from March 31, 2014.

With respect to capital management, we continue to have capital in excess of our targeted levels, and in the first quarter, we repurchased 2.7 million shares for an aggregate purchase price of $163 million. We've increased M&A activity in the sector, we continue to evaluate opportunities such as acquisitions of other business units, people and renewal rights transaction. As you know, we prefer to deploy our excess capital back into our business. But as of today, these efforts have not come into fruition.

Currently, competitive conditions make profitable growth in our traditional lines of insurance and reinsurance difficult to achieve. The insurance segment gross written premium grew by 5% in the quarter over the same period of last year, primarily as a result of the renewal rights agreement entered into last year in our alternative markets lines and modest growth in our excess and surplus casualty lines associated with our contract binding business.

Net written premium in our insurance segment was essentially flat in comparison with the same period a year ago as reductions in our professional lines, energy and marine lines and the termination of one of our programs offset our growth in all other lines.

In the primary markets, in which our Insurance Group participates, we continue to obtain rate increases in most lines of business at approximately the same level as we observed last quarter. Competitive conditions in the property sector have negatively affected primary property rates and accordingly our U.S. premium volume in those lines.

In our reinsurance segment, softening pricing and continued pressure on terms and conditions led us to reduce reinsurance writings by 6% on gross written or 1.7% decline if it was expressed in local currency. The decline, though, in net written premium of 21.5% was influenced by cessions to Watford Re, which formed in the last days of the first quarter of 2014, but also reflects increased purchases of retrocessional protection in an opportunistic way.

Our mortgage segment includes primary mortgage insurance written through Arch MI in the U.S., reinsurance treaties covering mortgage risk written globally, as well as other risk-sharing transactions mostly in the U.S. Gross written premium in the mortgage segment was $60.5 million for the first quarter of 2015 or a 26% increase compared to the first quarter of 2014, while net written premiums grew by nearly 20% over the same period to $51.9 million. Our U.S. mortgage operations acquired in late January of 2014 produced a little more than half of the segment's net written premium in the first quarter with $24 million of net premium written emanating in the credit union channel, while the bank channel produced $4 million in premium written for the quarter.

As of March 31, 2015, we have approved more than 644 master policy applications from banks and more than 190 of these banks have submitted loans for our approval. Of these master policies, 37% represent national accounts and the balance is consisting of regional banks. Of the top mortgage originators for conforming mortgage sold to the GSEs, which mortgage insurance is usually bought, we now have approved master policies with each of the top 15 lenders, and 21 of the top 25, and continue to make progress with the rest of the banking groups. Mortgage reinsurance premiums written declined in the quarter as a new transaction agreed upon during the first quarter should begin to contribute to premiums written towards the end of next quarter.

On the other hand, net earned premium rose 13% over the same period a year ago as earned premium on quota share agreements written in prior periods usually produce as a stream over a 6-year period to 7-year period. We also continue to see opportunities in GSE risk sharing transactions, which were primarily responsible for the $7.7 million of other underwriting income for the 2015 first quarter versus $800,000 in the same period of a year ago.

Arch participated in $490 million of insured limits via Freddie Mac STACR transactions in the first quarter of 2015. No premium is reported for these transactions as current accounting treatment requires us to use derivative accounting. We expect risk sharing transaction issued by Freddie Mac to receive insurance accounting treatment on a prospective basis for all in-force and also new transactions in the near future. While some of our business lines are seeing very competitive pricing conditions, Arch diversified mix of business and our willingness to exercise underwriting discipline should allow us to generate acceptable returns in the current competitive environment.

Group-wide, on an expected basis, we believe the ROE on the business we underwrote this quarter will produce an underwriting year return on equity in the range of 10% to 12%.

Before I turn it over to Mark, I would like to discuss our PMLs. As usual, I would like to point out that our cap PML aggregates reflect business bound through April 1, while the premium numbers included in our financial statements are through March 31, and that the PMLs are reflected net of all reinsurance and retrocessions.

As of April 1, 2015, our largest 250-year PML for a single event was essentially flat and it was in the Northeast at $550 million or 9% of common shareholders' equity. Our Gulf of Mexico PML decreased to $495 million at April 1, and our Florida Tri-County PML decreased to $396 million.

I will now turn it over to Mark to comment further on our financial results and after his comments, we'll be happy to take your questions.

So with that, Mark, you have the floor, my friend.

Mark Donald Lyons {BIO 6494178 <GO>}

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

That being said, the core combined ratio for the quarter was 87.5% with 0.6 points of current accident year cat related events that of reinsurance and reinstatement premiums compared to the 2014 first quarter combined ratio of 84.6%, which also reflected 0.6 points of cat related events.

Losses recorded in the first quarter from 2015 events net of recoverables and reinstatement premiums totaled $4.6 million, primarily emanating from our insurance exposures in Australia. The 2015 first quarter combined ratio reflected 7.8 points of prior year net favorable development, net of reinsurance and related acquisition expenses, compared to 9.5 points of prior period favorable development on the same basis in the 2014 first quarter. This result in a current core accident quarter combined ratio excluding cats for the first quarter of 2015 of 94.7% compared to 93.5% for the comparable quarter in 2014.

In the insurance segment, the 2015 accident quarter combined ratio excluding cats was 95.1% compared to an accident quarter combined ratio of 94.9% a year ago. The reinsurance segment of similar accident quarter combined ratio excluding cats was 94% even compared to 92.6% in the comparable quarter last year.

As noted in prior quarters, the reinsurance segment results reflect changes in the mix of premiums earned, including a lower contribution from property catastrophe and other property businesses. The proportion of the reinsurance segment's net written premiums that is property or property cat related dropped from 33.2% to 30.2% quarter-over-quarter, but falls further to 24.7% when Gulf Re premiums are removed. As you may recall, Arch assumed a UPR and loss portfolio transfer and incepted a 90% quota share treaty last quarter, which resulted in the explicit recording of business from Gulf Re through our income statement.

Previously, Gulf's underwriting results were recorded in other income under our 50% joint venture arrangement. Our expectation is that regulatory authorities will approve this acquisition in the second quarter of this year. The mortgage segment 2015 accident quarter combined ratio was 94.1%, compared to 84.3% in the comparable quarter last year. This increase is predominantly driven by the substantial change in mix resulting from the January 2014 acquisition of our U.S. primary mortgage operations.

The insurance segment accounts for roughly 13% of the total net favorable development this quarter, and was primarily driven by shorter-tailed lines from the 2010 to 2013 accident years. The reinsurance segment accounts for approximately 84% of the total net favorable development this quarter, also excluding associated impacts on acquisition expenses with approximately two thirds of that due to net favorable development on short-tailed lines concentrated in the more recent underwriting years and the balance due to net favorable development emanating from all years, but primarily from the 2003 to 2010 underwriting years.

Similar to prior quarters, approximately 67% of our core $7.2 billion of total net reserves for loss and loss adjustment expenses, our IBNR and additional case reserves, which remains fairly consistent across both the reinsurance and insurance segments.

The core expense ratio for the first quarter of this year was 34.5% versus the prior year's comparative quarter expense ratio of 33.9%, driven by an increase in the operating expense ratio of 2.2 points, partially offset by a decrease in the net acquisition expense ratio of 1.6 points. This increase in the operating expense ratio component reflects mostly a decrease in net earned premiums and also continues to reflect the addition of our U.S. mortgage insurance operations, which is operating at a higher expense ratio until that business reaches steady-state.

Moving to the segments, the insurance segment improved to a 32.1% expense ratio for the quarter compared to 33.1% a year ago, primarily reflecting a lower net acquisition ratio driven mostly by improved ceding commissions and quota share contract ceded.

The reinsurance segment expense ratio increased from 32.1% in the first quarter of 2014 to 33.8% this quarter, primarily due to a lower level of net earned premiums. The mortgage segments expense ratio will continue to be high until proper scale is attained, as I've mentioned previously.

The ratio of net premium to gross premium for our core operations in the quarter was 71.9% versus 79.7% a year ago. The insurance segment had a 70.7% ratio this quarter compared to 74.7% a year earlier. This lower ratio, which implies increased reinsurance ceded stems primarily from the second quarter of 2014 SPARTA renewal rights transaction that brought more alternative markets captive business on the books. Absent this impact, the net-to-gross ratios are roughly flat quarter-over-quarter for the Insurance Group. In the reinsurance segment, the net-to-gross ratio was 71.8% in this quarter compared to 85.9% a year earlier, primarily reflecting increased property and property cat retrocessions and increased cessions to Watford as a reinsurer.

Shifting gears, our U.S. insurance operations achieved a 2% even effective renewal rate increase this quarter net of reinsurance. As commented on last quarter, the pricing environment is quite different for short-tailed versus longer-tailed lines. Our short-tailed lines of business had an effective 4.5% renewal rate decrease for the quarter compared to a 3.5% effective renewal rate increase for the longer-tailed lines, both on a net of reinsurance basis.

Rate increases on these longer-tailed lines continue to be above our view of weighted loss cost trends. Looking more deeply, some lines incurred rate reductions, such as an 8.5% rate reduction in property lines and 3% in our high capacity D&O lines, while others enjoyed healthy increases such as a 9% increase in our Captive Agents businesses and 8% increase in our lower capacity D&O lines, 7% in accident and health, 6% in our high access workers' compensation business.

Also certain lines continue their achievement of strong cumulative rate increases, for example, our lower capacity D&O lines have now achieved 15 consecutive quarters of rate increases and have, in fact, secured double-digit increases for two thirds of those 15 consecutive quarters.

The mortgage segment posted an 88.5% combined ratio for the calendar quarter. The expense ratio was expected, continues to be high on the operating ratio related to our U.S. primary operation and will remain elevated until that pre-mentioned proper scale is achieved.

The net written premium of $51.9 million in the quarter is driven by the $27.9 million from our U.S. primary operation and $24 million even of net written premium from our reinsurance mortgage operations as Dinos mentioned, which also includes the 100% assumed quota share PMI's 2009 to 2011 underwriting year as part of the acquisition of the CMG companies and the PMI platform.

As Dinos also has mentioned, this segment had $7.7 million of other underwriting income for the quarter versus approximately $800,000 in the first quarter of 2014. This change was primarily due to an increase in the risk sharing transactions, which are triggered as derivatives and mark-to-market each period. This quarter included approximately $3.5 million of catch-up income as a consequence of the timings of when GSEs incept the insurance product versus the corresponding capital market security.

At March 31, 2015, our risk-in-force up $10.6 billion includes $5.7 billion from our U.S. mortgage insurance operations, $4.2 billion to worldwide reinsurance operations and $619 million through risk sharing transactions.

Our primary U.S. mortgage insurance operation down $1.8 billion of new insurance written during the quarter, which represents the aggregate of original principal balances of all loans receiving new coverage during the quarter. The weighted average FICO score for the U.S. primary portfolio will remain strong at 734 and the weighted average loan-to-value ratio held steady at 93.3%.

No state's risk-in-force represents more than 10% of the portfolio and our U.S. primary mortgage insurance company is operating at an estimated 9.3 to 1 risk-to-capital ratio as of the end of the quarter. The other segment, i.e., Watford Re reported a 100.3% combined ratio for the quarter, a nearly $125 million of net written premiums and $72 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. The total return on our investment portfolio was a reported positive 111 bps in the first quarter, primarily reflecting positive returns in our equity and non-investment grade fixed income sectors, partially offset by the strengthening U.S. dollar, and most of our foreign denominated investments. Excluding foreign exchange, total return was a positive 205 bps for the quarter. Approximately, 90% of invested assets are in U.S. dollar denominated investments as of 3/31/2015.

As Dinos mentioned, the impact of the strengthening U.S. dollar on our net written premiums was a reduction of approximately $32 million, which was split $23 million affecting our reinsurance segment and $9 million affecting our insurance operations. The foreign exchange impact on other components of underwriting income was not material.

Our embedded pre-tax book yield before expenses was 2.21% as of the end of the quarter compared to 2.18% as of the year-end, while the duration of the portfolio remained virtually flat at 3.35 years.

The current duration continues to reflect our conservative position on interest rates in this current yield environment. Reported net investment income in this quarter was $70.3 million or $0.55 per share versus $72.6 million or $0.56 per share last quarter and $67 million or $0.49 per share in the corresponding first quarter of 2014. As always, we evaluate investment performance on a total return basis and not merely by the geography of the net investment income.

Cash flow, cash flow from operations on a consolidated basis, including the other segment was materially lower than prior quarters, as Dinos mentioned, specifically 57% lower than the corresponding first quarter of 2014. This was caused by several factors, the most significant of which are, one, reduced premium inflows net of the commissions; two, increased reinsurance cessions and the ceding commissions where appropriate, an increase in the cash outflow associated with net paid losses, which includes payments on deductible and captive losses, as well as some unusual large claims; and fourth, an increase in the operating expenses including bonuses, U.S. mortgage expenses and some non-recurring expenses associated with certain business opportunities.

This quarter's level of operating cash flow, however, should not be viewed as a new run rate due to the timing issues and non-recurring impacts. Our effective tax rate on pre-tax operating income available to Arch shareholders for the first quarter of this year was an expense of 3.9% compared to an expense of 1.7% in the first quarter of 2014. Fluctuations in the effective tax rate could result from variability in the relative mix of income or loss projected by jurisdiction. Our total capital was $7.19 billion at the end of the quarter, up 2.3% relative to the prior year end. During this quarter, we purchased 2.7 million shares at an aggregate cost of $163 million. These repurchases represent a multiple of 1.28x of the quarter's average book value and had the effect of reducing quarter ending book value per share by $0.26. On the other hand, the effective foreign exchange on book value was a gain of approximately $0.25 per share as the benefit of restating insurance and reinsurance liabilities outstripped the decline in non-U.S. denominated investments.

Our debt-to-capital ratio remains low at 12.5% and debt plus hybrids represents only 7% even of our total capital, which continues to give us significant financial flexibility. As Dinos mentioned, we continue to estimate having excess capital above our targeted position and additionally, $724 million remains under our existing buyback authorization as of the end of the quarter.

Book value per share is now $47.80 at the end of quarter, up 4.9% from year-end and 15.1% relative to year ago. And this change in book value per share this quarter primarily reflects the continued strong underwriting performance and investment returns.

So with these introductory comments, we're now pleased to take your call – take your questions. Kathy, we're ready for the questions period.

Q&A

Operator

The first question comes from the line of Michael Nannizzi, Goldman Sachs.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Thank you, thanks for that. Just one question - a couple questions I had. One was on the decline in cat premiums in the reinsurance segment. I was a little surprised that the underlying didn't change more, just given I expect that that business probably booked at a lower loss ratio. Were there other - I'm sure there are other mix issues that are impacting the underlying measures, so I just wanted to get some context on that, if I could. Thanks.

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

Well, first, our approach to the cat business was to maintain as much of that business with our client base, so in essence, be committed to the client base who purchases. And then we looked at the risk characteristics of that portfolio and where we felt it was advantageous for us to buy retrocessional cover to protect our book, we chose to do so. So that was the approach for the quarter. We believe that some segments of the cat business is still depending part of the curve you are on is profitable at very good levels meaning, mean - mid-teens ROEs. And then on some other parts of the curve, they might be in the mid-single digits, which in our view, we don't want to end the right cat business with an expected return of mid-single digit. So that's, in essence, been our approach. Mark, I don't want to - do you want to add anything else to that?

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

Yeah, sure. I'll just add that - and you, by your - the way you phrased your question, you kind of answered it. This clearly is a mix difference beyond the pure cat aspect, as Dinos mentioned. And then an example of that would be, we seldom talk about it other than the fabulous results is the facultative group, which adds fabulous results for the quarter, but not quite as fabulous as the prior quarter. So you get a little bit of mix differences and in the case of property businesses, the combined ratios can move. As far as longer and medium-tailed businesses, the combined ratios associated with those are consistent with what you'd expect in a declining market, inching up higher and simply a mix that caused the quarterly result to be what it is.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. And then - and should we think about in terms of like the capital intensiveness of your business declining as you continue to maybe mix away from more capital-intensive business in reinsurance, did that have an impact on your appetite for buybacks in the quarter, or maybe the amount of capital that you're willing to allocate to those sort of activities?

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

Yes. As a matter of fact, usually, historically, I would say that in the third quarter, we refrained of buying back shares even when we have big buyback programs on the basis that it's the cat season, and when we were committing 20% or 21% or 22% of our equity capital to a single event – to a single 250-year single event. That is changing and as you saw with the numbers we have reported, we're in the sub-10% of capital in any one zone. And for that reason, I think, buyback opportunities are not going to be limited to the second quarter, but also in my view in the third quarter because the cat PML aggregations we have and the excess capital that I have – we have in the company they are such that I don't worry too much about an unusual event that it will cause us a significant harm during the third quarter.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Great. Thank you. And then just one quick one, just in terms of thinking about Watford and the reinsurance business, I mean, should we be thinking that your gross premiums might stick around where they are, but that we'll see just the cessions line just increase as you sort of toggle the premiums between those two segments? Is that how we should be thinking about it or if reinsurance market conditions continue, should we expect to see gross premiums decline as well? And thank you for all the answers.

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

Yeah. Mike, good question. It is a difficult one to answer because it is the vagaries of the marketplace that drives that as to what we might balance (32:38) and what might be natively written on Watford paper versus written by Arch, Re Arch, insurance and ceded. So it's really hard to say what that direction might be just like – I'd make a similar comment on any one of our units that it's hard to predict it. So I'd really prefer to not give a strong direction response on that. But all I can tell you is that we continue to be really happy with the flow, the kind of business we're seeing, and the sources of that business.

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

It's hard to predict the future. I don't know where the market is going to go. At the end of the day, every single reinsurance transaction we do is based on the return characteristics. If it fits for Arch first, that's our priority, we put it on our paper, and we retain the risk. And if it doesn't, but because of additional potential investment return in Watford, it fits their model, then we will put it there. And that's the guiding principles that we have and we have been operating since the formation of Watford, and that will not change. So, trying to predict where the market is going to be is a dangerous – it's a dangerous proposition, I don't know, I don't know where the reinsurance market will be six months or a year from today. My instructions to our troops and I think, we got great underwriters, all we got to do is look at their performance over the last 10 years, 12 years is behave prudently in the market that has been given to you, and make the prudent underwriting decisions and don't focus just on volume, just focus on return. And that's our guiding principles.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Great. Thank you so much for the answers.

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

You're welcome.

Operator

The next question comes from Amit Kumar of Macquarie.

Q - Amit Kumar {BIO 19777341 <GO>}

Good morning and congrats on the quarter. Just a few questions on the MI segment. The first question is on the discussion on the STACR program, clearly that's a meaningful number this quarter. How should we think about that opportunity, I guess, going forward?

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

It's – I'll make three points and I'll turn it over to Mark. He knows the numbers better than I do, but well as well.

Q - Amit Kumar {BIO 19777341 <GO>}

Time will tell.

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

The – it's lumpy business. However, the incentives for both Fannie and Freddie have been increased. Their targeted amounts have been increased, as I think, we talked in the last quarter significantly by 50%. Last year, the GSEs, they had a target of $90 billion each. This year's target is $150 billion for Fannie and $120 billion for Freddie, which we believe, they're going to reach as they reached their goals last year. So in essence, they're going to be more in the marketplace. Of course, they can use the cash market, the bond market or they can use the reinsurance MI market for those transactions. We were the innovators of these target transactions. The first one we did, it was a combination of effort between us and Freddie Mac. And their incentive is to put more and more of that business into different sources of private capital pools, including the reinsurance market. So it's going to be lumpy, we don't know how many of these opportunities that are going to be there, that they're going to come away. But we believe they're going to be at an increased level from a year ago and depending on pricing, we will continue to participate and that's the best I can tell you because I...

Q - Amit Kumar {BIO 19777341 <GO>}

Yeah.

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

We're not magicians, we can't predict the future.

Q - Amit Kumar {BIO 19777341 <GO>}

Yeah.

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

But we feel confident that STACR light transactions will be more in 2015 than they were in 2014.

Q - Amit Kumar {BIO 19777341 <GO>}

Got it.

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

Yeah. I'd just add to that.

Q - Amit Kumar {BIO 19777341 <GO>}

Yes.

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

Because I think you're trying to understand some of the mechanics of it is the – as you know, there is some capital market securities and there is the insurance piece. And the capital markets kind of, as I've alluded to in my prepared remarks, the capital markets incept quicker and the corresponding insurance transactions tend to get bound three months to nine months later. So it has a built-in delay, yet that the GSE still wanted to incept identically and concurrently with the capital markets products. So once we buy, we may have three months, six months or whatever of catch-up premium that we have to book. So any given quarter could have some component of catch-up given that we continue to have a stream of these STACR transactions as per Dinos's comment.

The other way you should think about it is, think about the notional loans that make these tranches up as sub – just like a subject based on a tree. You have a rate that applies to it, however, these subject base declines over time. So each of these STACR deals have a 10-year maximum, but the average life is probably closer to seven years to eight years. But you have a declining base to which these monthly rates are applicable and it declines basically through prepayments, people moving, refis, here are the normal reasons why these things would roll off. So that mechanically, I think, that's how you have to think about.

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

Yeah. And to make your life a little more difficult for your modeling, right now, all these is accounted as derivatives that's the $7.7 million that we talked about in other income. But we're hoping soon they're going to be converted to insurance accounting, so you're going to have maybe a little more clarity, because we'll be reporting premiums, but we don't know exactly when that is going to happen and it's going to be done on a prospective basis for all new contracts, but also for existing ones. Because don't forget, everything we bound last year or this year, it would still have a life for six years, seven years into the future. So it will get a little more complicated and I feel bad for your models, but eventually you're going to get it, when we get it.

Q - Amit Kumar {BIO 19777341 <GO>}

No, life is complicated. Just one more question and I'll take the rest offline. If I look at the loss ratio for the MI segment and if I compare that with some of the other, I guess non-legacy MI player, what the guidance they gave and your presentation from March, is your loss ratio running higher because it just shows the level of conservatism? Or is there more to it?

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

Well, your reference point - well, our loss ratio was in the mid 20s. But underneath that, that continues to have improvement on basically our relative delinquency percentages and things like that. That continues to drop. So - but remember, you've got other things going on, we are reporting a segment total. So we are seeing in the U.S. MI declines, but you also have any readjustments associated with our reinsurance divisions - our reinsurance mortgage transactions that come through. I think prior quarter, we had, I think, some reevaluations favorably on a reinsurance contract in this win made - one big deal may have gone the other way. You're going to get a little bit of the noise, but I think the key core of your question is that you're continuing to see improvement in delinquency and claims in the U.S. MI book, and the answer is yes.

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

And when you compare those numbers with the other public numbers from the U.S. MI business, we are as good or even slightly better than that. However, when you're getting through the reinsurance sector, we have a little more flexibility on the reserving side to be conservative. And I rather do that than be very aggressive on those ratios. Because at the end of the day, early on in any business and depending if it is the P&C business or the MI business, you pick, it's (42:00) a self-grading exam, and your real exam comes when the real results come. So, that's been our approach in everything we do. And if I have the opportunity to be a bit conservative, I will take that opportunity than the alternative.

Q - Amit Kumar {BIO 19777341 <GO>}

Got it. That is the Arch philosophy. Thank you so much.

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

Yeah. Don't forget, we have excess capital. We're not capital constrained. So in essence, we've got a lot of flexibility there.

Q - Amit Kumar {BIO 19777341 <GO>}

Got it. I'll stop here. Thanks for the time.

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

You're welcome.

Operator

And the next question comes from Kai Pan of Morgan Stanley.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you. And the first question is on the cats. Do you have any potential exposure to Nepal earthquake, the Baltimore riots as well as some other large losses like Pemex?

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

I can never say none because I don't know every contract we wrote that is minimal. My phone hasn't rang and nobody whisper anything. And usually, I'm the first to know. So...

Q - Kai Pan {BIO 18669701 <GO>}

Okay. That's great. Then on the insurance side, you mentioned the casualty line pricing still outpacing loss cost trend, so – but we haven't seen that flowing through in your underlying combined ratio. Just wondering, are we going to see that in the near future?

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

Well, actually, you have seen it, depends on your time period over which you're looking. But clearly, the core ex-cat accident year combined ratio and loss ratio has improved. It may have been relatively flat or move a couple tenths here or there from the corresponding quarter and that just makes some noise.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. So you continue to see that, is there overall for insurance segment because what I see here is really flattish, but you do expect that given the pricing in casualty lines?

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

Yeah, but – what you got – you see, you got to look at the components. When you're losing 8% to 10% rate on property, which is a low attrition, a loan loss ratio business, so that has to move up.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. So there is that...

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

So at 45%, you might go to 52%, 53%, maybe 55%. And then you get the improvement on the other. So when you do it as a mix, it might be offsetting some of the gains. So maybe it's not that visible to you, because you got to look at the mix. We're reporting the numbers as we see them, we look at the segments, some of the low loss ratio business has been declining for us, because rates have been actually declining significantly, it's not that we are not trying to hold on to that business, but we do. But that mix also has to be taken into consideration to see if our casualty loss ratios have improved by more than a couple of points over the last, I would say, six quarters, seven quarters.

Q - Kai Pan {BIO 18669701 <GO>}

Okay, that's great. Then on MI, I just want to follow up on that. As you say, at what premium level do you think you can reach to kind of, I don't want to call, a steady state, but more reasonable to leverage your expenses?

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

I don't think about it in that fashion. I think we are going to reach probably a steady state in approximately three years, because you do two things. One, you have a minimum fixed expense that requires for you as you are building up the business, but also depending if that business built fast or slower, you have the ability to also adjust your staffing as you go along. I would think we are not going to be at a steady state on the MI business until probably the end of 2017, so probably 2018 will be our first year that we'll say, hey, this is our steady state numbers.

So that's the way I think about it and I think our people think about it about the same way. Having said that, internally, we look at the profitability of the business as we do with everything that we do independent of sector to open it. If I'm making on underwriting decision today, what is that going to mean for the shareholders because the shareholders, that they are forever, and that's the way we view shareholders, we don't view them all today they are with us and tomorrow they are going to trade and get out, I view every dollar of capital that's given to me that I have to guard it, that is there forever and that's the way we think and that's the way we behave.

Q - Kai Pan {BIO 18669701 <GO>}

That's great. Lastly, if I may. If you look at the Watford investment return over the last few quarters, have been about the 3% to 4% annualized run rate. I just wondered could you give a little more color on the portfolio allocation as well as that, what kind of targeted return you have in mind.

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

Well, the portfolio, it's a fixed income - as we've mentioned before, it's a fixed income based portfolio and generally, lower investment grade or some non-investment grade and that - so that hasn't changed. It's more a function of the performance and what's rebounded in - really in this quarter. So there was really - Kai, no really change in the asset allocation to talk of.

Q - Kai Pan {BIO 18669701 <GO>}

And do you have any targeted return for that portfolio?

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

Well...

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

It's not us...

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

Yeah.

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

...who have a target return. And I think, Watford and Highbridge have target returns. They are – I believe, but you've got to check with them. I believe their target returns on an un-lever basis, it will be in the probably 5% to 6% and then on a lever basis, because they expect to put about 50% leverage on it. It will boost that return to high single digit. So that's their target returns over time. And don't forget, they're building up and they're trying to invest all the investable assets that they have, they're getting very close to that. But I think these are questions for Watford, not us. We're just a minority shareholder in that.

Q - Kai Pan {BIO 18669701 <GO>}

Great. Thank you so much for all the answers. Good luck.

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

Thank you.

Operator

The next question comes from Ryan Tunis of Credit Suisse.

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

Hey, thanks, guys. I guess my first question is probably for Mark, and it's a little pesky accounting one, just on understanding these STACR deals. But just trying to think of how to think of the normalized run rate here on the $7.7 million. I mean, should we think about it if you guys don't write another deal in the second quarter would that stay kind of around here? Or I think you mentioned $3 million of catch-up revenues; so it would be $3 million less? Or would it be zero? I'm just kind of trying to understand how lumpy is the profitability?

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

Well, again, without any forward looks and taking your assumptions saying there is nothing else written...

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

Right.

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

...on a go forward basis, what's on the books. The seven – let's round the numbers. The $7.5 million had $3.5 million of catch-up, so that's $4 million and then you need to apply your own persistency assumption of how fast those loans fall off, and that's (50:14) you have to apply a decay factor on that and that's your best way of doing it.

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

Okay.

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

Let me give you a number and then you can do your decay factors yourself, right? The August STACR transactions we've done, they're pretty much last year, this year. They have $617 million of insured limit and our lifetime premium, it will be approximately $111 million, that's the lifetime premium over the period. Now, you can say it's going to take six years or seven years or seven years to eight years whatever, we believe that 2015, it's approximately – we don't do another transaction about $20 million that will average about $5 million run rate a quarter, that will decline a bit if we don't write any other transactions in 2016, decline a little bit in 2017 or until you get to around $111 million over the lifetime of the contracts.

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

Got it.

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

Yeah, the only clarification, because that's a good view Dinos gave you, but that's an ultimate view.

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

Yes.

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

First it's nominal dollars.

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

Yeah.

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

Secondly, it's ultimate. You were kind of asking a question on vagaries of timing and timing of catch-up, it's hard to predict quarter by quarter by quarter. Dinos is right, but it doesn't address the timing of when they're recognized.

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

Okay, that's helpful. And I guess kind of staying on the GSE deals, this one is a little more, I guess, higher level, but I guess up until now I think I've – you guys have said it or I've read somewhere, but 70% of the capacity has been, I guess, capital markets-driven. Do you guys have a view maybe looking out over the next two years to three years, how much of that comes to the MI side as opposed to capital markets?

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

We don't know that. I think that's a question for Fannie Mae and Freddie Mac. I actually – in 2014, it was 80-20. It was only on the first quarter of 2015 that it was 70-30. They determined that and they – and that's why it's so hard to predict. They view, I believe – they view the insurance, reinsurance marketplace as more of a steady capital where they view the capital markets as having unlimited capacity, but that capacity can be fickle. It can be priced very high at some points and very low at some other points. So it will depend on the pricing, they test the capital markets for us, they see what they can get from there. They test the insurance and reinsurance market, what they can get from there and they make those determinations. But they do have an incentive to broaden the base of private capital willing to take credit risk so they can de-risk the pool significantly. So they can go back to Congress and say, hey, we have de-risked the entire portfolio, so the taxpayer is only taking their very end tail risk, the Black Swan scenario, which I think is a good thing. It allows private markets to price it and take the risk and nobody has the unlimited capacity to take unlimited risk, only the federal government can do that. But that's the very end, the tail event that none of us has the ability to do.

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

Got it. And then I guess just quickly, my last one on the MI business, it looked like half of the NIW, it sounded like, didn't come from credit unions. I'm assuming it came from banks. I'm just interested, I guess, in kind of the breakout of that NIW, how much of that maybe came from your top five-type banks, how much of that came from some of the other nationals and some of – how much of it then came from the smaller guys. I don't know if you can give me that level of granularity but I'd be interested in that.

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

I don't have it in front of me that granularity. Maybe when we have – I think we have an Investor Day coming up in June 8, and probably we'll – I'll make a note and then we'll have a little more granularity to share with you there, right? Usually, we don't try to focus at this level of our development to specific originators. We're trying to get as broad as we can and sign as many of these originators. And as you saw, we're pretty happy with where we are. We have 15 of the top 15. I don't know what that top 15 is, but it might be maybe 60%, 70% of the market. Now, the question is how does that flow? The fact that you have connected all the pipes and you have all the agreements, it doesn't mean the water is flowing freely. It starts trickling in and then it accelerates, because all these things have to – there is a lot of work that needs to be done on getting the systems to work with each other and start getting the flow. So – but we'll give you more of a color in our – we're going to have our MI people doing a presentation and then we'll get into that granularity at that point in time.

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

That's helpful. Thanks so much. Thanks so much, guys.

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

Thank you.

Operator

The next question comes from Charles Sebaski of BMO Capital Markets.

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

Good morning or afternoon, I guess it is now. Had a question in trying to understand the ROE impact on the ceded business to Watford Re. So, we don't know exactly what it is but this quarter it seems like it's maybe $50 million of business ceded to Watford. And I assume that that's 10% ROE business like the rest of yours? But the income to you guys from Watford on the minority ownership and other fees and other stuff, how does that transition? How do you look at that? You go, okay, we transitioned $50 million of premium that's generating a 10% ROE, how does that return from Watford look relatively? And does that free up capital?

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

Well, you're starting with a premise that is incorrect.

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

Okay.

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

Right? If the $50 million had a 10% ROE, it will be on our books based on the investment returns we achieve.

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

Okay.

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

Don't forget, we have an A+ rating. It requires a different capital and also it requires through the rating agencies and regulators a different investment philosophy. Now, that business for us would have been maybe mid single-digit ROEs. By putting it into Watford, we are boosting the ROE because that set of shareholders are willing to take more investment risk. And the way you got to think about it is that they have at least, I would say, 250 basis points, 300 basis points investment advantage over a traditional PMC operation. Having that advantage on business that it has approximately 3.5-year duration and 70% is loss and loss adjustment expense. You can do the math.

You compound 300 basis points for 3.5 years for 70% of the premium and you're adding seven, eight points of ROE on an after-tax basis. So you take something that is in the six, seven, and it becomes 14, 15. So that's the way you got to think about it.

Now, five, six, seven is not acceptable to us, because first of all, it creates a lot of tension within our ranks, our incentive compensation for our underwriters is based on us achieving a minimum of 8% ROE. If we don't achieve that, I think we run home with empty pockets, our wives are really upset about that. So at the end of the day, there is a culture here. When we get to our underwriting that we got to hit on an expected basis, certain targets. If we don't hit it, that's when we go. Now, to do the math, we get - not utilizing our own capital, we get - well, 11% we get by utilizing our investment, which is our own capital. But of course, we get fees and we get profit commission through the backend, which is accretive to our shareholders because there is no utilization of capital for that. I haven't done the math on $50 million, but if you want me to do it, I can do it. And I have done - give you the arithmetic. But you can probably do the arithmetic yourself.

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

So I just - so that's what I thought. I mean, regardless of the initial premise of 10% ROE being wrong and it's mid-single digits. But when you see that conceptually, whatever capital was supporting that to begin with is now free and clear to go under capital management.

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

That's correct.

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

And the return then generated from the 11% ownership is a magnitude higher relative to now that freed up capital. Right? I mean, because it's for...

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

That's the right way to think about it. Yes.

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

With the investment return - long-term investment return leverage over a traditional insurer being realized.

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

Yeah.

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

Yeah. And so then on that basis or just that construct, how much business currently can you cede to, when you look at your book, if we look at this year, I mean what's the potential - obviously, there's changes in market and pricing, that can be ceded? Or is there a governor or a limit on in any given period how much business you can cede to them?

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

Yes, there's limitations on the basis of their capital base. When we cede business to them, they collateralize it for us on the expectancy. So in essence, there is limitations from their point of view as to how much they can write based on their capital base, independent if it's cessions from us or things they write directly into the market themselves. And of course, how much capacity they have on either LOCs or other collateral they have to put up depending where the business is emanating. But we – since it's a new company and it has quite a bit of capital, they have in excess of $1.1 billion in capital, they are – they got a size 10 shoe and a size 3 foot right now. So there is plenty of room for the foot to grow into the shoe.

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

And outside of your return dynamics in the reinsurance book, the mid-single-digit ROE profile, is that really the only limiting factor for you in ceding business there? It's just sort of this business is below our return threshold. Outside of that, there's no other, hey, we're not going to do more than this or there's – what other factors might be?

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

There is three scenarios here, okay? And I'll give you the scenarios. Let me start with the premise. We have an obligation, it's a contractual obligation as a matter of fact, I think, I don't know, a dozen or more of our employees are actually dual employees. They are employed by us and also they are employed by Watford. A portion of their salary is paid for them for activities that they do on their behalf.

Now, business comes to us, we underwrite it and we decide that it fits the Watford model, we put it there. Business originates from Watford, they're still in the market and then they use those employees and they say, hey, we source this, we got this phone call directly and underwrite this piece of business for us. That can take two paths. One path is the client, he might be a European client, will accept the Watford paper, or it might be a U.S. client or – and they say, well, we want Arch to issue the paper and let them reinsure back to you. So those are the three scenarios that happen.

In the first one, we determine the ROEs based on what we've seen. It doesn't fit our book, it fits theirs, we will put it there. In the other two scenarios, we've got an obligation to work the deals on their behalf, we work the deals. And in some cases, when I say, can we have a little piece of this because – and depending on how much of that deal they want to give us, we might even take it at Arch. Don't forget, our Arch takes 15% of those deals through the backend for underwriting consistency. So when I generate some activity for Watford that it was originated and it was Watford paper, not only I have 11% ownership in the company, but also I take a 15% quota share through the backend. So it's hard for you guys to look at all the components and even our reporting with the other sector sometimes might be getting a bit confusing to you, but at the end of the day, I'm trying to explain to you all the scenarios. And those are the three scenarios usually that happen on a day-to-day basis.

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

And the only thing I would add is a different cut of it by the line of business as opposed to the flow of business that Dinos was talking about. And it's been more decision upfront, not upon return characteristics as much as preservation of capital to not put a lot of cat business in there, because you could get unlucky and have a cash call early and you want that compound interest on a fixed income strategy to have the ability to work and compound. So if you have a big cash call early, you hurt the ability for that to happen. So that's the only other thing I would add.

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

And the longer the tail, the better the advantage they have. So the construct of that book is not to feed it with a lot of short-tailed business, that's not really where they have the advantage. The advantage is on longer-tail lines. Low volatility, more predictable combined ratios, longer tail. Hard to find, hard to do, but that's the premise.

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

Thank you very much for the answers.

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

You're welcome.

Operator

The next question (66:38-66:44) Meyer, your line is now live, Meyer Shields of KBW.

Q - Meyer Shields {BIO 4281064 <GO>}

Sorry about that. Hi. Two quick questions, if I can. First of all, I guess the corporate or other expenses were down about 30% year-over-year. Is that sort of decrease sustainable?

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

What I can tell you on corporate expense, we're not – I don't like overhead and I'm not adding to it. So I would say there would probably be steady. I haven't really focused on the delta this quarter to see if it was significant or not. But I can tell you we're keeping a very lean holding company staff. Mark, do you have any more detail on that?

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

Yeah. Yes, Dinos. On corporate expense, if we're categorizing it the same way, Meyer, it was down around 13% to 15%. And it was mostly driven by a reduction in stock option expense. So that depends on what people do and that will lead on – how it gets exercised and so forth. So I would say, we continue to look to push those down, but I wouldn't go crazy expecting a compounded benefit every quarter.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. That's helpful. Does the opportunity exist now that there are lower premium volumes in the reinsurance segment to reduce the expenses there?

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

Well, most of the expense on the reinsurance segment comes with ceding commissions, if you don't have the business, you don't have it. When you talk about the factory, which is all of our underwriters, I have no intention of destroying any – a high performing factory. We have great underwriters in our reinsurance business and we have every intention to keep every single one of them, because I'm not going to be running around finding them when I need them a couple years later. So, no significant reduction on, what I would call, personnel expense, et cetera, because I want to maintain those groups at the level we have them today. And they can produce significant earnings for us in the good times and basically, that's a pretty valuable piece of the company.

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

And, Meyer, we, as management and the board, both look at that delta, if you will, as it goes through as the cost of an option to keep that intellectual property ready, banked to explode when it's appropriate to.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. No. That makes sense. I just wanted to understand it. And lastly really quickly with the other underwriting income in mortgage insurance, are there any expenses associated with that or is that a net number?

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

The expenses there in the MI bucket and that is a clean number. When internally we'll look at it, we have a different set of numbers. But accounting requires you to report in a certain way. So we report all the MI expenses under the MI sector and the other income comes clean of any expenses.

Q - Meyer Shields {BIO 4281064 <GO>}

Prefect. Okay, thanks so much.

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

You're welcome.

Operator

The next question comes from Jay Cohen, Bank of America Merrill Lynch.

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

Thank you. A couple of questions, I guess, starting with the mortgage side. When the accounting – if and when the accounting changes for the STACR transactions, will the bottom-line impact be vastly different on a quarterly basis if you're accounting as insurance versus derivative?

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

No. No, it should be just more explosion of a single-line into a lot of lines. Written premium, earned premium, expense, acquisition costs, loss reserves, paid losses.

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

But bottom-line ain't going to change anything.

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

Okay. That's good to know. And I guess the other question, within the mortgage segment you do have these other operating expenses kind of moving up as you built out that business. When do they start to level off?

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

Well, we are on a steady state now on dollar expenditure. Our marketing team is fully deployed. There is no significant positions for us to fill. So right now, it's just for them to go out and execute in the marketplace. But the buildup after we bought the assets from the CMG and the assets from PMI, it was to create this marketing team that we have, which is approximately, give or take a few heads, about 60 people. And we have reached that level now, we have filled every single key position.

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

So, I would just add to that depending on whether you're looking at quarter-over-quarter, you're looking serially, Jay, quarter-over-quarter you got the distortion because the first quarter of 2014 was only two months, not three months, which I think you know. But on the serial point of view, the one other tweak for what Dinos says is all the salespeople now on board is there is a split of the expenses of the U.S. MI staff that's kept net to us versus what goes back to PMI. And that changes as a function of the work that's done. So the simplest thing to think of is – and it varies by function, controllership and IT and so forth, but is a claim function. As claim inventory liquidates on that finite set of claims, the dollars associated with the claim function would shrink. And therefore Arch, as opposed to PMI, would absorb those. So that mixture changes over time and that's the only other tweak I would make to Dinos's comment.

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

Right. But based on activity, we have the ability to manage that, right? But the activity from us managing the PMI runoff, so to speak, it will diminish over the next three years, four years, five years. And now, it's a question, do we need all that personnel? And if we do, we'll keep them, because we're building our business versus allocating all that cost back to PMI.

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

Got it. Perfect. The last question was with Watford, Arch earned some fees for running or helping run Watford. Where do those show up in your reported results?

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

There is more than one place, but most of them at this point in an offset to acquisition.

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

Got it. Acquisition in your reinsurance segment?

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

Correct. Yes.

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

Well, M&A some of those are insurance (74:24).

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

Right. And don't forget Jay, profit commissions are not in that yet, right?

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

Right. Got it.

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

We've got to see that cook in (74:38) first.

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

Perfect. Thanks for the answers.

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

Sure.

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

You're welcome.

Operator

The next question comes from Ian Gutterman of Balyasny.

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

Dinos, I think the souvlakis are going to be gone, this call has gone so long here, but...

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

No, no, today – today, on the menu is keftedes.

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

Okay.

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

Keftedes is Greek meatballs.

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

Okay. I hope I'll have some of those in June.

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

Yes, you will.

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

Okay. Sounds good. Great.

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

Ian, we all learn something.

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

Yeah. So I guess my first question is the other specialty reinsurance has been declining at a fairly notable pace the past few quarters. Can you just give a little color on what specific lines in there are shrinking and maybe even what's left that remains, that's a big part of that line at this point?

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

Mark, do you want to handle that?

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

Yeah. Let me just pull something. Okay. The one obvious place is property cat, which...

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

(75:41)

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

And then we reduce significantly on the (75:45) quota shares oversea. That's another area. And then, it will give you more granularity. Mark?

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

Yeah. Because as you know, we are – I think our Reinsurance Group is good at finding opportunistic opportunities. And you get them, they hit a quarterly statement and they're really not renewable. So you may recall, we had conversations of some relatively large premiums a year ago's quarter that were opportunistic in nature. And those didn't repeat. So...

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

Got it. Okay.

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

...and that's where all those specialties are. There was also a bit of a falloff in some accident and health business. But I think predominantly, you can – besides what Dinos said, you focus in on these opportunistic transactions that were unique to the marketplace at that time.

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

Perfect. I just want to make sure on that. With the decrease in the cat exposure and the short-tail exposure, can you give us a sense of how much your cat load has come down on a model basis?

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

Let's see. Well, pretty material as you might guess.

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

Ian, do the calculations. I haven't done it. But go to the old PMLs and do the division between the new PML and the old and that will give you an indication as to what the – okay. And...

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

Okay. And I was wondering if that would work or not.

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

I would say, right now, if I would take a guess, it would be around $40 million a quarter or thereabout. So it will be about – I would say, instead of $200 million plus, it might be about a $160 million.

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

Got it. Okay. Thank you.

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

Again – listen, this is back of the envelope. I'm pretty sure from the back of the envelope, but there's no precision in that number.

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

No. That's okay. I was just trying to get a ballpark. Okay.

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

Yeah. It might be a $159 million.

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

Exactly. Point two. The other thing I was wondering on PML is, can you give us a sense of how different how much your gross PML has come down relative to your net PML, meaning, how much of the PML reduction is - there is an increased retro buying versus actually cutting the gross?

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

Well, the gross came down a little bit. It was maybe in the order of about 5%, 6%, thereabouts. And then most of the other reduction is reduced writings and also retrocession of buying.

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

Okay. Got it. And then my last thing before letting you get to your meatballs is ex the capital...

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

No keftedes, there is no meatballs in Greek language.

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

I know, I can't pronounce that, Dinos. I'm not as good - I don't have that dialect down yet. Just sort of as how to think about excess capital, right, I mean, obviously, with much less cat you should be able to write it at a different premium to surplus than you used to do, right? So, how should we - is there a good metric to think about, rule of thumb, for how to evaluate excess capital now...

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

There is no rule of thumb. We run the SMP model, of course, if you're writing less cat, the allocation to the cat business from a capital point of view is less. We factor that in into our excess capital calculation and then we make decisions off of that. I - listen, I got a guy, my Chief Risk Officer, François, François Morin.

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

Right.

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

He's got to do some work at some point in time. I got to ask him to do something. So he does a lot for us.

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

I mean if I were to just look at sort of the capital charge for your PML, how much that's come down and then, say, that's one part and then the other part would obviously be the difference between earnings and return of capital. Is that a fair way to look at it that essentially...

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

Yeah, it is and also you got to look at the mortgage side as we're deploying more capital, even though in the mortgage we're overcapitalized already, it's going to take us another – I don't know, six quarters maybe even longer to fill the shoe, but – so.

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

Okay. I guess what I'm dancing around, maybe I'll ask a little bit more directly. It seems like excess capital is getting to be – maybe I have to go look back to some of the times when it was really high, but it's maybe getting in the upper quartile of where it has been historically.

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

It's up there.

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

Yeah, okay. Got it.

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

But from a rating agency perspective to your point, pretty close to every dollar we have a reduction in cat PML, adds $1 to excess capital.

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

That's kind of what I'm getting at, okay. All right, great. Thank you, guys.

Operator

Thank you. You have no further questions. I would now like to turn the call over to Dinos for closing remarks.

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

Well, thank you all for listening. And we're looking forward to the next quarter. Have a wonderful day.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Good day.