Q1 2016 Earnings Call

Company Participants

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

Other Participants

- Amit Kumar
- Charles Joseph Sebaski
- Ian J. Gutterman
- Jay Cohen
- Jay Gelb
- Kai Pan
- Mark Dwelle
- Meyer Shields
- Michael Nannizzi
- Vinay Misquith

MANAGEMENT DISCUSSION SECTION

Operator

Good day, ladies and gentlemen and welcome to the Arch Capital Group First Quarter 2016 Earnings Conference Call. As a reminder, this conference is being recorded.

Before the company gets started with its update, management wants to first remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the Federal Securities laws. These statements are based upon management's current assessments and assumptions and are subject to a number of risks and uncertainties. Consequently, actual results may differ materially from those expressed or implied. For more information on the risks and other factors that may affect future performance, investors should review the periodic reports that are filed by the company with the SEC from time-to-time.

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

I would now like to introduce your host for today's conference, Mr. Dinos Iordanou, Mr. Marc Grandisson, and Mr. Mark Lyons. Mr. Iordanou, you may begin.

Constantine P. Iordanou {BIO 2397727 <GO>}

Thank you, Abigail. Good morning, everyone and thank you for joining us today for our first quarter earnings call. We're staring the year on a good note, our first quarter, it was terrific from virtually all perspectives. Our reported combined ratio was excellent at 87.1%, which was aided by low level of catastrophe losses and continued favorable loss reserve development in each of our segments. Investment returns were also very good, as our fixed income portfolio benefited from the interest rate declines we saw in the first quarter.

There are no significant changes in the property, casualty operating environment from last quarter, although there are some signs that reinsurance terms, especially ceding commissions maybe bottoming out. Within the insurance sector, we saw slight deterioration in terms and conditions, while the mortgage insurance industry remains quite healthy. We're in a market where the importance of cycle management, not only in preserving capital, but also maintaining balance sheet integrity is paramount. Navigating through this phase of the cycle requires that our underwriters remain disciplined, opportunistic and laser-focused in execution.

Within the reinsurance segment, we are focusing more on special situations that utilize our underwriting expertise and capital strength and our ability to respond quickly. In our insurance segment, we continue to focus on less volatile, smaller accounts, both in term of limits, but also account size and with reinsurance purchases helping us to reduce the volatility on large accounts and our high capacity business. The operating environment in the mortgage insurance space remains healthy and we are generating excellent returns and continue to make significant progress in this segment. Marc Grandisson will give you more details in all of our segments in a few minutes.

On an operating basis, Arch earned $145.7 million or $1.17 per share for the first quarter of 2016, which produced an annualized return on equity of 9.7%. On a net income basis, we earned $149 million or a $1.20 per share for the 2016 quarter, which results in a return of equity of 6.4% on a trailing 12-month basis. Remember that net income movements can be more volatile on a quarterly basis as these earnings are influenced by changes in foreign exchange rates and realized gains and losses in our investment portfolio. Group wide, our gross written premium increased by 6% to $1.39 billion in the first quarter over the same period in 2015, while net written premium rose 3.7% to $977 million, driven primarily by growth in our mortgage segment along with modest growth in our construction and alternative market business within the insurance segment.

Our investment results were excellent on a relative basis and acceptable on an absolute basis, given financial market conditions. Net investment income per share for the quarter was $0.57 per share, up $0.04 sequentially from the fourth quarter of 2015. Despite volatility in the investment and foreign exchange markets in the first quarter of 2016, on a local currency basis, total return on our investment portfolio was a positive 1.48% as returns on our fixed income investments were partially offset by declines in our alternative investment portfolio. Including the effects of foreign exchange, the total return was 1.82% in the quarter, a healthy result.

Our operating cash flow was $257 million in the first quarter as compared to $16 million in the first quarter of 2015. Mark Lyons will discuss the cash flows in more detail in a few minutes. Our book value per common share at March 31, 2016, was $49.87 per share, a 40% (sic) [4.3%] (07:14) increase sequentially from the fourth quarter of 2015.

While some segments of our business have become more competitive, we believe that group-wide and on an expected basis, due to our mix, the present value ROE on the business written in the 2016 underwriting year should produce ROEs in the range of 10% to 12% on allocated capital.

Before I turn the call over to Marc Grandisson, I would like to discuss our PMLs, which remain essentially unchanged from January 1. As usual, I would like to remind and point to everybody that our cat PML aggregates reflect business balanced through April 1, while the premium numbers included in our financial statements are through March 31, and that the PMLs are reflected net of reinsurance and all retrocessions.

As of April 1, 2016, our largest 250-year PML for a single event remains in the Northeast at $494 million or about 8% of common shareholders equity. Our Gulf of Mexico PML decreased slightly to $438 million and our Florida Tri-County PML increased slightly to $385 million.

I will now turn it over to Marc Grandisson for comments on market conditions, before Mark Lyons discuss our financial results. And after their comments, we will take your questions.

With that, Marc?

Marc Grandisson {BIO 4369887 <GO>}

Thank you, Dinos. Good morning to all. We continue to face the challenges of softer pricing as the property casualty industry continues to report favorable prior-year loss development, and benefiting from below average cat losses, which obscures, we believe, the adequacy of risk-adjusted rates in the property market.

However, in every market, there are some dislocations present and we remain vigilant in our efforts to seize those opportunities that become available. On the positive side, as Dinos mentioned, the recent actions by a few large participants in the marketplace may help to usher in a more disciplined environment in the casualty area in the near future.

P&C rates are declining in the mid-to-low single-digit range, but there are pockets of rates strengthening. Our challenge is to be confident that current rate levels are sufficient on an absolute basis. On the other hand in mortgage insurance, which I will refer to as MI from here on, rates remain very healthy despite indications that they appear to be declining in light of the new rate cards filed by some of our competitors. Despite the headline, we believe that on a risk-adjusted basis, the aggregate effective grade levels of MI providers are actually higher due to a shift in the quality of the risk assumed.

Staying with our MI segment, which as you may recall, includes primary operations in the U.S. and mortgage reinsurance globally as well as a GSE risk-sharing transactions portfolio. We estimate that the market's MI new insurance written or NIW was down about 10% in the first quarter of 2016 versus the fourth quarter of 2015. In spite of this, Arch continues to increase its presence in the sector. Overall, our Arch MI segment grew its gross written premium this quarter by 21% over the fourth quarter of 2015 and 84% over the same quarter last year. The growth came primarily from new GSE risk-sharing transactions as well as from a reinsurance contract with one of the major Australian lenders that we discussed last quarter.

Our U.S. MI unit continues to increase its share of the market. Excluding the GSE transactions, we estimate that we continue to gain market share at a pace of approximately 2 percentage points per year since our acquisition of the U.S. MI platform. At March 31, 2016, our total MI segment risk in force was $12.8 billion, which includes $7.2 billion from our U.S. MI operations, $4 billion from worldwide reinsurance operations and approximately $1.6 billion from the GSE risk-sharing transactions we wrote.

Our primary U.S. MI operation increased its NIW $2.9 billion during the first quarter of 2016, of which approximately 69% came through the bank channel and 31% via our credit union clients. Seasonally, the first quarter 2016 for credit union production typically runs lower than the other three calendar quarters. The amount of NIW from credit union this quarter is consistent with what we recorded in the first quarter of 2015.

Our bank channel business continues to pick up steam and is becoming a larger contributor to our production and RateStar is the primary driver of this growth. We introduced RateStar less than five months ago and to-date, we have rate filings approved in all but three states. Through March 31, 2016, 1,142 customers have elected to use RateStar. Over 50% of our commitment in the first quarter were obtained through RateStar. We have seen many positive signs since its launch. The increase in our application volume is very encouraging and points to our clients seeing value in our differentiated pricing framework. RateStar is proving to be an effective tool in differentiating Arch relative to its competition, while maintaining or exceeding our targeted average return of 15% ROE.

We believe that our combination of high ratings, superior customer service and product innovation will allow us to continue growing.

I will turn now to our primary P&C insurance operations in the United States, which currently represent approximately 80% of our global insurance operations. We saw a more stable rate level change at 10 basis points effective rate increase this quarter versus the 140 basis points decrease last quarter, excluding the effective ceded reinsurance. However, that 10 bps increase is somewhat misleading since it is queued by one large professional liability program that renewed at a plus 7% rate increase in the quarter. Without the benefit of this program, our overall rate change would be a rate decrease of 80 bps. We believe that we were able to recapture some of that rate erosion, once we considered the purchase of our reinsurance coverages.

Our insurance operations in the UK, which represents around 17% of the insurance segment is still pressured from a rate perspective. Rate decreases across all our product lines were 4.6% this quarter. We continue to actively manage this portfolio towards the more attractively priced lines.

On a group wide basis, our insurance units premium written increased 4% in the 2016 first quarter versus 2015 on a gross basis, while they increased 1% on a net basis. We continue to adjust our mix of business and are generally able to buy reinsurance on more favorable terms. Ceded premium increased 11% in our insurance group this quarter over the same period last year. Mark Lyons will provide more perspective on this in his commentary.

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

Finally, let's turn to our reinsurance group. Our teams are being reactive and selective consistent with our long-stated strategy of cycle management. Most lines of business, especially the ones with good results continue to see rate decreases in a 5% to 10% range. There are however several lines that are experiencing some level of rate increases. A recurring question our team faces when looking at such areas is whether that positive rate change is enough to allow us to achieve an adequate return.

As an example of this, we continue to struggle with large U.S. casualty placements. There is increased demand by buyers in the market for quota shares, but we have been unable to write a significant new transaction at an appropriate return.

Our reinsurance gross premium written declined by 1% for the first quarter of 2016 versus 2015, while on a net basis we were down 8%. Our property cat gross written premium for the 2016 first quarter was down over 10% as we continue to exercise underwriting discipline and benefit from improved terms on retrocessional treaties. Most of our efforts in the underwriting areas are currently directed to UK motor, specialty liability products and niche areas such as professional lines, excess motor and cycle changes.

With that I'll hand this over to Mark to cover the detailed financial results. Mark?

Mark Donald Lyons {BIO 6494178 <GO>}

Great. Thank you, Marc and good morning to all. As was true on previous calls, my comments to follow will be on a pure Arch basis, which excludes the other segment that being Watford Re, and I'll continue to use the term core to denote results without Watford Re and consolidated when referring to results including Watford Re.

This quarter our core business mix based on net written premium changed as follows, are relative to the first quarter of 2015. The insurance segment reduced from 58% to 56% of the total. The reinsurance segment shrunk from 37% to 33% and the mortgage segment grew from 5% to 11% of the total. This shift in mix continues to reflect our view of the market and the relative return expectation each segment provides.

As far a longer term view of our mix changes, I would point out that four years ago, in the first quarter of 2012, within the reinsurance segment, the property cat line represented 26% at net earned premiums, whereas this quarter it is down to only 6.9% of earned premiums and this was accomplished through 71% reduction in net earned premiums over the four-year period. Yes, 71%.

The insurance segment similarly reduced its property at marine net earned premiums by 38% over that same time period. Both actions reflect our view of severe margin compression in the property cat space.

Okay. Moving on to this quarter's financial results, the core combined ratio for the quarter was 87.1%, with 0.5 point of current accident year cat-related events compared to last quarter in 2015 of 87.5% combined ratio, which reflected 0.6 point of cat-related events. Losses recorded in the first quarter in 2016 from cat events totaled only $4.2 million, stemming mostly from within our reinsurance operation.

The 2016 first quarter core combined ratio reflected 6.4 points of prior-year net favorable development, which is net of reinsurance and related acquisition expenses compared to 7.8 points of prior period's favorable development on the same basis in the 2015 first quarter. This results in a 93% even current core accident quarter combined ratio excluding cats for the first quarter of 2016 compared to 94.7% in the comparable quarter last year.

In the insurance segment, the 2016 accident quarter combined ratio, excluding cats was 95% even, essentially unchanged from the accident quarter combined ratio of 95.1% a year ago. The reinsurance segment 2016 accident quarter, ex-cats was 94.3%, similarly comparable to the 94% even ratio in the 2015 first quarter.

Moving over to mortgage, there accident quarter combined ratio was 71.9% in the quarter compared to 94.1% in the first quarter of last year. As I have said in the prior calls, it's important to remember though, that the concept of accident year is more of a P&C concept and not a mortgage insurance concept due to their accounting conventions.

Now, as previously stated, the ACGL core accident quarter combined ratio dropped 170 basis points quarter-over-quarter, yet insurance and reinsurance segment ratios were virtually flat with last year's respective quarter. This is driven by the mortgage segment as its inherent strong level of profitability is becoming a higher proportion – a proportional contributor to our overall results.

The insurance segment accounted for roughly 11% of the total net favorable development in the quarter, net of associated acquisition expenses, and this was primarily driven by shorter-tailed lines from the 2012 to 2014 accident years and longer-tailed lines from the 2003, 2004, 2008 and 2012 accident years. The reinsurance segment accounted for 84% of the total net favorable development in the quarter, with approximately three quarters of that due to net favorable development on short-tailed lines concentrated in the more recent underwriting years and a remaining portion due to net favorable development on longer-tailed lines, primarily from the 2003 through 2011 underwriting years.

The mortgage segment accounted for approximately 5% of the favorable development, which translates to a 4.4% beneficial impact on their loss ratio this quarter, resulting primarily from continued lower claim rates from the CMG business we acquired in 2014 and from the PMI quota share we assumed within that transaction covering the 2009 to 2011 book years. As was the case last quarter, some of this favorable development benefit is offset by the contingent consideration earnout mechanism negotiated within the purchase agreement. And as a reminder, this contingent consideration impact is reflected in realized gains and losses and not within underwriting income.

The core 34% even expense ratio for the first quarter of this year was 50 basis points lower than last year's comparative quarter of 34.5%. Overall, the expense ratio though was aided this quarter by roughly 75 basis points through the release of an overestimated year-end 2015 bonus accrual. The insurance segment expense ratio improved 90 basis points for the first quarter of 2016, reflecting both a lower net acquisition and operating expense ratio. When one adjusts, however, for the aforementioned bonus accrual benefit, the expense ratio would be nearly 50 bps higher, however still an improvement over last year's comparative quarter.

We, as managers, continue to focus on the total expense ratio though, as mentioned previously, since the sliding of costs and benefits within net acquisition and operating expense ratios can be somewhat artificial, and ceding commissions are recorded in the net acquisition line and not allocated to every operating expense category that they represent. The reinsurance segment expense ratio increased 120 basis points this quarter, primarily reflecting a 6.6% lower net earned premium base.

I will note though that the reinsurance segment's expense ratio this quarter was 100 basis points lower than sequentially in the fourth quarter of 2015. The ratio of net premiums to gross premium for our core operations in the quarter was 70.2%, which is a decline from 71.8% a year ago. The insurance segment had a lower 68.8% ratio compared to 70.7% a year ago, driven mostly, as was the case last quarter, by increased sessions on a larger alternative markets book, increased sessions on capacity-driven product lines as Dinos mentioned and a reduction in our P&C Program business which had been kept overwhelmingly net and still is kept overwhelmingly net.

The associated average fee commission ratio on quota share treaties improved another 200 basis points in the U.S. In fact, quota share treaty cede commissions have improved from 2012 to now by over 500 basis points in total, and the improvement ranges from plus 600 basis points to plus 1000 basis points for some product lines.

Some of this net acquisition improvement, however, is masked by the growth of businesses using captive reinsurance arrangements. Many of these carry no or marginal front-end commissions. So the associated ceding commissions are lower since there are generally no front-end commissions to be reimbursed. Moving to the reinsurance segment, the net-to-gross ratio was 66.6% in the quarter compared to approximately 72% a year ago, primarily reflecting cessions to Watford Re and other third-party retrocession.

The mortgage segment, in addition to premium growth that Marc mentioned earlier, had approximately $4 million of other underwriting income in the quarter from risk-sharing transactions receiving derivative accounting treatment and $7 million of underwriting profits associated with risk sharing transactions, receiving insurance accounting treatment. Over time, it is expected that more income will continue to emanate from transactions receiving insurance accounting treatment. The total return on our investment portfolio on a local currency basis was a reported positive 148 bps in the quarter, reflecting positive returns in fixed income investments, both investment and non-investment grade, partially offset by negative returns in the equity and alternative investment portfolios.

On a U.S. dollar basis, total return was a positive 182 bps in the quarter. Over 80% of the portfolio was comprised of fixed income investments; the embedded pre-tax book yield before expenses was 2.07% as of the end of the quarter and duration remained fairly consistent at 3.56 years versus 3.35 years at the end of 2015 first quarter. Dinos already mentioned reported investment income per share, so I won't go into that, other than as a reminder that we evaluate investment performance on a total return basis and not merely by the geography of net investment income.

Core cash flow from operations was $257 million in the quarter versus approximately $16 million in the first quarter of 2015. Last quarter, as you may recall, had cash flow operations being affected by a reduction in gross premiums collected, timing shifts of reinsurance premiums cessions and paid and deductible recoveries. Core interest expense for the quarter was $12.6 million which is consistent with our longer term run rate.

Our effective tax rate on pre-tax operating income available to Arch shareholders for the first quarter was an expense of 6.6% compared to an expense of 3.9% in the first quarter of 2015. This quarter's 6.6% effective tax rate has approximately 100 basis points of a non-recurrent discrete item out of our European operations. Fluctuations in the effective tax rate can result from variability in the relative mix of income or loss reported by jurisdiction. Our total capital was $7.3 billion at the end of this quarter, up 2.9% relative to December 31, 2015.

Our debt to capital ratio this quarter remains low at 12.2% and debt plus hybrid represents only 16.7% of our total capital, which continues to give us significant financial flexibility. We also continue to estimate having capital in excess of our targeted positions. Book value per share was $49.87, which is 4% increase over year-end and 4.3% relative to one year ago. This change in book value per share primarily reflects the company's continued strong underwriting performance from all segments and improved investment returns.

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

Q&A

Operator

Our first question comes from Vinay Misquith with Sterne, Agee. Your line is open.

Q - Vinay Misquith {BIO 6989856 <GO>}

Hi, good morning and congratulations on beating numbers, one of the few companies to do so.

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

Thanks.

Q - Vinay Misquith {BIO 6989856 <GO>}

The first question is on the new opportunities because of market dislocation. If you could discuss that, that would be helpful. Thanks.

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

Well, Marc talked about some unusual transactions that we see on the reinsurance side, doesn't mean we're going to do any, but we see more requests. So that means there is clients out there that they have special needs. On the insurance side, we continue to focus on small, medium-sized accounts. I believe we have built the infrastructure around the country. We – recently, we, in our binding authority business, we also opened another new office in Scottsdale, Arizona. So we're putting a lot of focus in trying to find these profitable segments for us. But let me reemphasize; we always look for bottom-line results first and we look at premium growth second. At the end of the day, you can't focus just on premium growth; of course that's not the case with our mortgage business; that business we like a lot and we try to grow it as fast as we can. So Marc, you want to add to it or...?

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah, absolutely. On the insurance side, I believe that we've seen an increase in submissions over the last quarter or so because some of our competitors have decided to exit some lines of business; there have been some mergers and acquisitions. So we are seeing some movement; this is not widespread, but it's certainly starting to occur and we're seizing the opportunity whenever we can and whenever we think it's appropriate. Yes.

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

One area we're not participating and I want to – it seems that the flavor of the month now or the year is broker line slips here and there so they can have control over the pen, et cetera. That doesn't fit well with us. We have not participated in any of these because at the end of the day, you can't have the title underwriter and give it to somebody else. Either you're going to underwrite or you're not. With our troops, I want us to have the ability to underwrite ourselves.

Q - Vinay Misquith {BIO 6989856 <GO>}

That's fair; that's helpful. The second question on mortgage insurance, if you could give us some metrics about how well RateStar is doing. I think you said 50% of the submissions were coming through RateStar. But do you think it's actually driving more submissions to Arch because of that? And any anecdotal evidence would be great.

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

Yeah, it's – if you look at it from a submission point of view, let me give – our first quarter, it was 50-50. If I look at April, it's up to 68-32. So – and it's been trending like this; so RateStar has only been out there for five months. So I don't know where it's going to go, but it's more significant when I look at our submission activity from the bank channel. The bank channel is predominantly RateStar; now maybe eight of 10 submissions in April that was coming from that.

On the Credit Union channel, it's still in the 50-50 range. So that's where the trajectory is going. The NIW, it was 44%, 45% I think in the first quarter out of RateStar price business; but it was – in April, it was 61%. So, that tells you that more and more of that business is moving to the place that we wanted to move because we have a lot of faith in the way we price the business. Marc?

A - Marc Grandisson {BIO 4369887 <GO>}

Vinay, essentially there's a huge increase in submission; we believe it's in the order of 50%, 60%, if you look last quarter of 2015 versus this first quarter. And the vast majority of that pickup was through the bank channel, so just to give you an overall sense in the quarter.

Q - Vinay Misquith {BIO 6989856 <GO>}

Yeah, that's helpful. And Marc, if you could also clarify about rates. I mean I think you mentioned that the risk-adjusted rates are actually higher now for this rather than lower.

A - Marc Grandisson {BIO 4369887 <GO>}

Yes, because of...

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

Well, we expect that ROE on the business is higher than our rate card.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. And even from a competitive standpoint, you've not seen the competitors sort of step in and do something similar?

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

Right now, the rate card seems to have stabilized. In some, we – there are rumors. The only thing I can comment to you Vinay is there are rumors that some people will be expanding their rate card or doing the risk-based pricing approach that we have. But we have no way of knowing what's going to happen right now. But right now, it seems that the rate card has been stabilized where it is right now.

A - Marc Grandisson {BIO 4369887 <GO>}

But our future, Vinay, it's going to be RateStar. We like re space approach to it, looking at many characteristics of a particular mortgage and trying to get the right price for the exposure that we have and we continue to refine our approach with that. I have a lot of resources committed to that effort, which is no different than what we do on the P&C side, to begin with.

Q - Vinay Misquith {BIO 6989856 <GO>}

Great, okay. Thank you.

A - Marc Grandisson {BIO 4369887 <GO>}

You're welcome.

Operator

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

Q - Amit Kumar {BIO 19777341 <GO>}

Thanks and good morning and congrats on the results.

A - Marc Grandisson {BIO 4369887 <GO>}

Thanks, Amit.

Q - Amit Kumar {BIO 19777341 <GO>}

Two quick questions on MI and thanks for being patient with us and explaining the finer nuances of the MI market. The first question probably ties back to Vinay's question on the broader space. Recently, the National Association of Realtors wrote a letter to FHA asking them to cut their premiums. If FHA cuts their premiums, does that change the entire sort of the private MI market or is that a different kind of – it's obviously a different risk; so it does not impact you that much.

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

Well, it depends what sectors, you're correct, a lot of what they write is the private MI companies do not. They write the low credit score, high LTV type of business. So depending what they do, it might or might not affect the broader market. It's tough when you have the government competing with you, but entirely totally different capital requirements. None of us, none of us or our competitors in the space would be allowed to operate with the capital ratios that they have. So I don't know – it depends what they do and then we'll see the effect that it will have on the marketplace. And by the way, thank you for the compliment, being patient; my guys here they say otherwise, so.

Q - Amit Kumar {BIO 19777341 <GO>}

The other question I have was in regards to the excess capital that you mentioned. There has been chatter in the marketplace obviously regarding the disposition of a large MI asset, one of the largest companies. At this stage of the cycle, Dinos, how do you look at growing organically and I'm talking about the MI piece versus looking at this obviously very large and game-changing property out there?

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

All I can say is we'll look at all avenues. Right now, our focus has been to grow organically. But given other opportunities, we will evaluate them. If they get presented to us, we'll evaluate them. At the end of the day, we get paid to put capital to work at an effective returns and that's where our entire team is focused on. And it's no secret that we do want to grow the exposure we have in the MI business.

Q - Amit Kumar {BIO 19777341 <GO>}

Got it, fair enough. That's all I have for now. Thanks for the answers and good luck for the future.

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

Thank you.

Operator

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

Q - Jay Gelb {BIO 21247396 <GO>}

Thank you. On the core reinsurance segment, I was somewhat surprised to see that gross written premiums were essentially flat. You mentioned some specialty opportunities. I was hoping to get a better perspective on whether you think that overall business might be flat from a premium volume perspective or maybe even grow this year.

A - Marc Grandisson {BIO 4369887 <GO>}

I don't know, you want to take that – I don't know about the rest of the year; it depends what we're going to be offered with. But in the first quarter, certainly seized opportunity in the few larger transactions that Dinos alluded to at the beginning and also couple of opportunities which I highlighted in my comments which are the UK Motor and some specialty liability, although not being very big, but if it's more nichey, more specialty in nature. So I would just say it's a reflection of – and UK Motor for instance. If you do a large quota share, you will have a lot more throughput in the quarter. So that's a great example as to what premium would actually be stable year-on-year.

Q - Jay Gelb {BIO 21247396 <GO>}

That makes sense, Marc. The other point I wanted to touch base on in reinsurance is the high level of persistent reserve releases. Can you give us some perspective on what continues to drive that favorable result?

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

Well, let me give it an attempt, and then I'll give it – I'm being surrounded by actuaries here. Marc and Mark, they're both actuaries. But we have a methodology; we haven't changed our methodology for the 14 years. To simplify, we try to pack the accident year based on what we believe we price the business at. And then the other thing we do is on long-tailed lines, if we see unfavorable, we recognize that early on, any unusual event where we ignore favorable, at least for three or four years.

So that has been our methodology, recognize bad news early, don't celebrate too early on your wins, and we follow the data. So whatever the data tells us quarter after quarter is that's what we report. Now, that was a guy who doesn't have an actuarial degree, so I'll turn it over to Marc or Mark, Mark Lyons to give you the more scientific answer.

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

Good. My scientific answer as a reformed actuary is I have nothing more to add.

Q - Jay Gelb {BIO 21247396 <GO>}

Thanks, Mark. The final question I have was on mortgage reinsurance. Clearly, there was a big benefit in 1Q from the Australian deal. I'm trying to think about on organic. I guess, organic is not the right word; but on a normalized basis, what do you think the growth rate could be in mortgage insurance? Could this be a $500 million gross written premium business within a year or so?

A - Marc Grandisson {BIO 4369887 <GO>}

Well, we don't know. And Australia is a market that's dominated by two or three players or four banks; so we have a major relationship with one of the top four. It's kind of hard to see where, if any, if we're able to grow relationships in other banks. But currently right now, we have a stable, very strong relationship there. And what you're seeing right now is a production – even though we call it reinsurance, it's really a slow business that we assume on a 100% basis. So it's really like insurance, if you will.

For the rest of the world, we are exploring all other geographical areas. Dinos and I are spending a lot of time trying to figure out what we could do in Europe, what we could do – I mean we already are in Europe, Canada and other countries. And this is sort of an ongoing – try to grow and use and take advantage of our expertise and strong knowledge and deep knowledge in the MI space to do more of it. It's really hard to see what it would be in two, three years' time. But for the Australian business, I think you get pretty much a good picture of our quality production.

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

Hey Jay, it's Mark Lyons here. Let me just add, the difference between binding the business and expanding it versus the accounting recognition of it. The Australian market is a single premium market. So if you got to really contrast that with the U.S., which is dominantly monthly, so it builds up and is recognized slowly. And by single, it's not like it's a single program writing a big bullet single, it's not the case. The underlying business, the business that it's reinsuring is a series of every homeowner having a single premium as they put it to play. So the recognition will be accelerated relative to the U.S., so you can't extrapolate that into something that may appear ultimately to be larger.

Q - Jay Gelb {BIO 21247396 <GO>}

That's helpful. Thank you.

Operator

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

Q - Michael Nannizzi {BIO 15198493 <GO>}

Thanks so much. Just a couple here, I think most of mine have been answered, but the ceded level that we saw in the first quarter that lifted from the first quarter of last year, I mean is this – you guys expect it to be ceding back to Watford or whoever in that sort of 30% range from here or was there anything unusual in the quarter?

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

Okay. You say the 30%, because the 70% that's the growth.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Yeah.

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

Remember those session are dominated by the insurance group ceding overwhelmingly to third-party, unrelated third parties. You have increased retrocession on the property and marine that the reinsurance group will do. You have minor bits in the mortgage sector really as a function of the deal that was cut on, on the transaction. So the movement, yes, there is Watford sessions, but the level of Watford session is fairly consistent over the last couple of quarters.

The biggest lever is what the insurance group does and as Dinos has pointed out, they were just shy of 70% this quarter, but the growth in low volatility businesses that kept overwhelmingly net, and the high-capacity business that Dinos has talked about, and by high capacity we mean $25 million limits, things like that, those are going to be reinsured more because we can get more favorable terms. So we cut the aggregate net volatility of the total book as a result. But just keep in mind, Michael, it's the insurance group that drives that ratio.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay, got it. And then, other income primarily in reinsurance, I guess a little bit in insurance as well, that step-down in the quarter was – did that – those dollars just moved to a different line item maybe somewhere else. Was it geography or was there a change in the...

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

No, no, it's a great question. On the – think of it this way, quarter-to-quarter that other underwriting income in reinsurance was virtually flat. It's coming from the GSE transactions mostly. Last year, there was what we call catch-up premium on the difference between when the capital markets piece went out, that's done earlier, and then the reinsurance segment was done later and had to catch up because of the time gap between them. So that was roughly $3.5 million of catch-ups. That's the first thing. The second thing would be occasionally, we call it periodically, we reevaluate that ethnicky (46:31) loss portfolio transfer, and in that year's quarter there was an adjustment, whereas this year's quarter there was not.

Q - Michael Nannizzi {BIO 15198493 <GO>}

I see, okay. So but now that we're all caught up then, we should be reverting back to the pattern that we were experiencing previously?

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

For the derivative-oriented transactions, for the GSEs in reinsurer – in the mortgage, the answer would be yes. Ethnicky (47:05), it depends when we deem a change is needed.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Sure. No, I understand.

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

Derivate accounting for those transactions will be deescalating and going to zero over seven years, right? So every quarter they're going to be slightly a little less, a little less until it gets extinguished seven years out or so.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. The main point being that other than this timing change you mentioned in the first quarter, nothing has really changed as far as that's concerned.

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

No, that's correct. Yeah.

Q - Michael Nannizzi {BIO 15198493 <GO>}

All right. And then in reinsurance, so the expense dollars and other operating expense declined in the quarter sequentially. I was just curious if the transaction or the item that you mentioned in insurance was relevant in reinsurance as well, Mark, or was there something else there?

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

I am sorry, was that an operating expense question or acquisition expense question?

Q - Michael Nannizzi {BIO 15198493 <GO>}

Operating, other operating, yeah.

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

Oh, Operating. I think the quarter and within the segments as well in total was kind of affected by the bonus accrual take down that I mentioned. So I would expect the run rate to be a little, marginally higher on a ratio basis.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay. So is the order of magnitude similar to what you mentioned on the insurance side in terms of...

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

Within spitting distance, yeah.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay, that's fair enough. Okay, great. Thank you so much.

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

Which is as good as I get.

Q - Michael Nannizzi {BIO 15198493 <GO>}

As a reformed actuary.

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

Yeah, thank you.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay, got it. Thank you.

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

Thanks, Mike.

Operator

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

Q - Kai Pan {BIO 18669701 <GO>}

Thank you, and good morning.

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

Good morning.

Q - Kai Pan {BIO 18669701 <GO>}

First a quick one. Do you see any potential impact for the second quarter cats?

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

The second quarter cats, yeah, I mean we have some reported losses. I don't know how big the impact is going to be. Mark, you have more of a feel for that?

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

Right, as you know, a lot of the stuff is pretty fresh. It just happened. And it's a series of events, it's not a single event. So you can appreciate that we're still accumulating some of that. I think from a 10,000 foot view down, it's more likely that there is insurance exposure, then reinsurance exposure out of our UK operations I would think. But our view at this point Kai is that across all of those aggregated together, it will still be contained within our cat loss. So we don't view anything unusual in that regard emanating from it.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. What's your sort of cat loss assumptions.

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

Our cat loss would be just shy of $40 million.

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

$40 million a quarter, $40 million a quarter.

Q - Kai Pan {BIO 18669701 <GO>}

Okay, that's great. And then stepping back on the mortgage insurance, couple of years ago, Dinos, you mentioned that these could be becoming the third of leg of the stool, but looking back at the premiums it's only less than10% of your overall premium, but if you look at the underwriting results, it's more than 20% now, so it's very meaningful. I just wonder were the growth in these markets faster than your other two segments or even sort of like exaggerate or basically both your underlying margin as well as ROE will be growing faster than it has been?

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

You got to look at it from a lot of different perspectives, even though premium is not the right measure for mortgage insurance, because the accounting model is totally different, the way the business comes in is totally different, right? I write a mortgage today and I'm going to be receiving premium over the duration of that mortgage which is usually seven years or so. So you got to look at it from capital consumption and you got to also look at it from the return point of view, and yes, I think we're on pace based on what we wanted to create a third revenue stream for the company and a third earning stream for us. And I wouldn't be surprised that depending what happens on the P&C reinsurance that from an earnings point of view, they might be even more than one-third. They might go to 40%, 45%.

On the other hand, P&C can turn in a couple of years and it will be - we don't - we do look at it from a risk management point of view as to how much exposure we have in each one of the sectors and do we feel comfortable with that, vis-à-vis our balance sheet or do we need to buy reinsurance behind it or bring other capital providers into it. We know we're close to any of those decisions. We believe that we still have a lot of room to grow on the mortgage business. Marc, you want to add something.

A - Marc Grandisson {BIO 4369887 <GO>}

The only thing I would say, in terms of creating a third leg in the sense of very sustainable and profitable return on a return basis, I think we have accomplished that and we're really looking forward to do more of that in the future. From that perspective we're not really getting into the discussions as to how much it could be, would be. In the end, we're writing and looking at what we see every day and we are very pleased right now, and I think we've achieved at least establishing has taken a ground and creating that third flow, diversifying flow, I would add, to our core P&C reinsurance and insurance. So we're pleased with that.

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

Look, I think Marc went on to how little cat we write today versus what we wrote four years or five years ago. Things might change, but we always have - sometimes we shrink in areas that I don't like to shrink, but if there is no return, why be in it. Other times, you got to limit what you write because you're exceeding your tolerance from a risk management point of view. I can tell you right now I'm way underleveraged on the cat business. I wish the market was better for us to write a lot more in the cat area and maybe one day will be again and we'll be up utilizing quite a bit of capacity in that area. So that's the kind of thinking that goes through our heads. First, if it's profitable, let's write more until - we got a guy called Chief Risk Officer. He is another actuary, François, who rings the bell sometimes and he says – he is nowhere ringing any bells yet because our risk tolerance in every sector is well within what we like to have.

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

And Kai, I would just like to tie together that commentary with – on managing the cycle and exposure with the fact we had $4 million of cats in the first quarter. If we hadn't reduced our volumes, 71% since 2012, we probably would not be able to report $4 million, so it's got income statement aspects, price return aspects and balance sheet risk management.

Q - Kai Pan {BIO 18669701 <GO>}

Just to follow-up on the risk management, this might be a high-class problem for you guys. If the mortgage become a meaningful portion of your overall profit pool because of different accounting like a treatment basically you cannot smooth it out, for example, booking reserves, do you worry about sort of volatility to the earnings?

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

No, listen. There is two things that bring volatility to any book of business including mortgage. One is what I would call micro decision, that's the underwriting decision, that we control is within our hands. So we – and then the other volatility is macroeconomic changes, very high unemployment, which we monitor and see which direction. I would assign two-thirds on the micro and one-third on the macro and at the end of the day in our quarterly risk management evaluations and everything we do, we will look at those parameters to make sure that our compass is pointing us in the right direction.

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

And Kai, lastly I want to make sure, given the way you phrased the question, the accounting model as much as we criticize it, has nothing to do with our risk management evaluation. We project that to ultimate – like we do our PC lines, so we make persistency assumptions, claims, emanating from possible future delinquencies that are performing loans now and so forth. So just because it's the accounting model's flaws, it doesn't mean we follow that in our risk management evaluation.

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

Yeah. And we have a stress test model that we run, assuming certain economic conditions where the housing market might go, where unemployment might go, et cetera, and where interest rates are going to go. And then based on that, we see where we are with our book and where our book is growing to be.

Q - Kai Pan {BIO 18669701 <GO>}

That's great. Lastly on the buybacks now trading at – you bought back around 1.3 times for the first quarter of book value, now trading at more than 1.4 times, is that out of your comfort zone?

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

Well, I mean, if you ask me if I'm trading well, which is your assumption? No, I still think I'm cheap, but that's a CEO talking his own account, but having said that, we're very disciplined into when we put capital to work, independently we're going to buy our own shares or we're going to buy something else. It's got to be within that three year or so of tolerance that we got to recover anything we pay above book value and that's what's been guiding us both in – we try to invest in third parties or we're trying to invest our own stock. So in the – that's basically what we are.

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

And Kai I applaud your five-part question.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you so much.

Operator

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

Q - Jay Cohen {BIO 1498813 <GO>}

Thank you. Just a couple of questions. The first is, Mark, maybe just to make our lives a little bit easier, the reversal of these bonus accruals, can you actually give us the dollar number and where the location is?

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

It was roughly $6 million and change distributed all over, actually.

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

It was all three units and corporate, so it was, call it, $7 million.

Q - Jay Cohen {BIO 1498813 <GO>}

Okay. Next question, I guess I'm looking for a little bit of guidance or help here. There's some line items within the...

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

We don't give guidance.

Q - Jay Cohen {BIO 1498813 <GO>}

Call it help then, not guidance.

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

Okay, all right.

Q - Jay Cohen {BIO 1498813 <GO>}

For a non-actuary, not even reformed, how is that? Certain line items within mortgage insurance will jump around pretty dramatically quarter-to-quarter and you're looking specifically at the acquisition expense ratio. It's ranged from 33% to 13% just in the last six quarters. Any sort of range that you can put that in that we should be thinking about?

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

Well, on the traditional mortgage insurance, what we do in Arch MI and Walnut Creek is steady. It's your sales force every quarter et cetera. What - those numbers fluctuate on reinsurance transactions and on risk-sharing transactions. The cost with risk-sharing is it's very, very small because we have a small unit, a couple of people that they review those transactions in their home office and then they - and Mark and I when we and Andrew Rippert who got to approve all those, we don't allocate our stuff into it. It's at a corporate level.

A - Marc Grandisson {BIO 4369887 <GO>}

And Jay, the early business we had in mortgage were largely mortgage reinsurance contracts and transactions, then we migrated towards more of a mortgage insurance profile and that explains the ceding commission on reinsurance treaties right now on mortgage base are in the 28% to 35% range and we're not doing many of those or any - or at least not new as we speak, right.

Q - Jay Cohen {BIO 1498813 <GO>}

Got it. And so in quarters where you have a big reinsurance transaction, the acquisition expense ratio will look a little lower?

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

You go the other way...

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

This is assumed, not ceded.

A - Marc Grandisson {BIO 4369887 <GO>}

Correct, yeah assumed.

Q - Jay Cohen {BIO 1498813 <GO>}

Okay. So I'm still looking at, like this quarter the acquisition expense ratio within the mortgage segment was quite low and you did a large deal, maybe I'll take it offline with Don (01:01:04) after?

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

No, no, we did another big reinsurance deal.

A - Marc Grandisson {BIO 4369887 <GO>}

No. Exactly, Jay, I'm not sure which deal you're talking about.

Q - Jay Cohen {BIO 1498813 <GO>}

I thought you guys did a sizable deal in Australia on the – for the mortgage reinsurance.

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

So that's not a reinsurance transaction. As Marc said, it's really – it's a reinsurance in the legal sense of the term, but we're doing 100% of really flow business. And as Marc alluded to, that premium is earned over a very long period of time and the earned premium is actually very small as we speak. Even though the acquisition there would be high, it doesn't really flow through the balance sheet or the income statement as we speak. It will take time to get there.

Q - Jay Cohen {BIO 1498813 <GO>}

Got it. Okay. And that – those are my two questions, so thanks for the information.

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

Okay.

Operator

Thank you. Our next question comes from Charles Sebaski with BMO Capital Markets. Your line is open.

Q - Charles Joseph Sebaski {BIO 17349221 <GO>}

Good afternoon. Thanks for getting me in. I guess one follow-up on that Australian transaction. You say it's going to earn in over a long period of time, so despite the $43 million, we shouldn't see much effect on earned premium from that going forward for the next four quarters or five quarters, six quarters?

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

Yes, exactly right. I mean, just picture, just to make things simplistic. Picture every month being a $1 million single and then those singles, each of those $1 million has to be earned over, it's not many, over six years, seven years. So it's – the written recognition is going to be a lot faster than the earned recognition.

Q - Charles Joseph Sebaski {BIO 17349221 <GO>}

Okay. Also on mortgage, has there been any activity on GSE risk-sharing over the quarters, is there a pipeline or anything or is it kind of stagnant until something pops? I was just curious what the outlook looks like for that?

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

No, no. There is activity and there is a list of transactions that are coming down the pike. Marc, you have the detail on that or...

A - Marc Grandisson {BIO 4369887 <GO>}

So if you – and this is very clear in a quarter there were, I believe, three transactions, I believe. Yes, there were three transactions in the quarter. It is actually a calendar, Charles, that they are going to – there's a projection for the year that the GSE has shared with us. I'm not sure we are supposed to say anything, but you could track that they have – they are on a pace to do from our perspective now two to three a quarter for the next remainder of the year. So we've done three this first quarter and are working on some as we speak as well.

Q - Charles Joseph Sebaski {BIO 17349221 <GO>}

Excellent. And then finally on reinsurance, would appreciate you guys take some commentary in the market that the changing landscape in reinsurance means that smaller panels of reinsurers mean you have to stay at the table, maintain business. You guys have been contracting here. Do you believe that there is risk that over time you need to maintain some particular level of profile with cedents or can you keep contracting and still get back in opportunistically. I guess I'm trying to understand the...

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

Well, it's – listen, this is the – it's a great question. At the end of the day we have good ratings, good paper, we can be good partners, but I am not there to do it on a just relationship basis and not have a return. My responsibility is to have returns for my shareholders. I am not going to put that capital to work at a disadvantage on the hope that some future I'm going to make some money. If the deals make sense for us and our cedents we'll do them, if they don't, we don't and we'll look for something else.

This is a big market and we're still writing over $1 billion worth of reinsurance, maybe not all of it is what I would call the traditional quota shares for large clients et cetera, but we find little things here and there, mixed things here and there and we do it. Our people – believe me, they're working harder today than in a good market, because to find these small little nuggets, they got to process a lot of war, so they're shoveling a lot. At the end of the day, that's our approach.

We don't believe that we have to give our pen away through just purely, we ought to be making relationship only decision. Yeah, relationships are very important. We try to be as service-oriented as anybody else with our clients, give them our perspective about the market and pricing, we do underwriting audits, et cetera, we share all that information, but we got to do a transaction that it has adequate returns for us, otherwise, we won't do it. Marc, I mean, you run the reinsurance. I shouldn't be speaking on your behalf.

A - Marc Grandisson {BIO 4369887 <GO>}

The one thing I will tell you about our reinsurance portfolio is that it's not really the same as Mark alluded to, the same portfolio we had when we started. I think there's a lot of what we've been able to create on the reinsurance side, which sort of mirrors what has been done on the insurance side, is we try to get as the – not controllable, but as somewhat protected or the line of business that has a little bit of stickiness to it, more stickiness to it, because it needs more knowledge or more expertise. Property facultative is a great example of that. And in that segment, I think we are still very active, finding ways to grow and actually do more and be more relevant for our clients. So we're not beholden to the large placements, as Dinos mentioned, which is a good place to be.

Q - Charles Joseph Sebaski {BIO 17349221 <GO>}

Thank you much, guys. Have a great afternoon.

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

Thank you.

Operator

Thank you. Our next question comes from Meyer Shields with KBW. Your line is open.

Q - Meyer Shields {BIO 4281064 <GO>}

Thanks and good afternoon, everyone. Really quickly, the mortgage insurance operating expense number went up sequentially. I wasn't expecting that. Everything else was phenomenal, but is that the new run rate?

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

No. As Dinos mentioned, it's a segment. The segment is made up of pretty disparate operating expense contributors. Clearly, until we hit scale on the U.S. MI acquired piece, that's putting pressure on it. But the mixture of that with GSEs where the OpEx is marginal at best, and the reinsurance, again depending on the structure of it, it really comes down to mix. So I would not read in anything to an incremental change quarter-over-quarter.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Are you discussing the dollar amount or the percentage?

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

Well, effectively both...

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

But mostly the ratio.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Thanks, that helps. And then on the insurance segment, I guess, you've talked a lot about a shift towards smaller account and low volatility. Is that going to have an observable impact on either the acquisition expense ratio or the loss ratio, that mix shift?

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

Well, I don't - I mean this shift has been happening now for five years, six years. We didn't pivot to that. The largest initiative we have which is about $160 million worth of business is our binding authority business, and that has a little higher expense component. It comes from the binding authority wholesale agents, and in essence, they do a lot of the work. It's all electronic, they use our systems, they price, pricing algorithms, et cetera, but they do all the input and they issue the policies. Our system is so good that you can bind and issue a policy within 24 hours in the agent's office. So it has a little bit of a higher expense.

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

Yeah. I would also say, yes, we actually have seen some marginal improvements, just in the past quarter, it's 30 bps down on the net acquisition ratio. Just remember, premium taxes are in there too. And when you go from a harder to a softer market, it tends to become more admitted than not admitted, so you get a little bump there, everything else being constant. But the biggest thing is that you should keep in your mind is as we move to lower and have moved to lower volatility businesses, they come with a higher acquisition cost and a lower loss ratio.

So the fact that we have a higher proportion of higher commission oriented businesses, yet the net acq is continuing to go down shows you that leverage power of our reinsurance sessions with increased ceding commissions. It's offsetting and sometimes more than offsetting that shift, mix shift towards higher acq businesses. Does that make sense?

Q - Meyer Shields {BIO 4281064 <GO>}

It does. Only I'm not contesting it, it was just interesting, a lot of competitors have talked about lower volatility business having higher loss ratio.

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

Well, remember we're after volatility containment. You can cede a lot, what's left is still - essentially if it's quota share, it's still highly volatile on its own, you're getting ceding commission overwrites, and you're putting gain into your income statement right away, but what you still have left is volatile. We've moved more towards, as Dinos said, smaller accounts and small policy limits associated with those...

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

...but we keep 100% net.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. No, that helps. Are the ceding commissions that you're seeing in reinsurance the same as you're benefiting from on the insurance side?

A - Marc Grandisson {BIO 4369887 <GO>}

Yes. The answer is yes.

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

It's pain on one side, and there is gain on the other side.

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. It's a market phenomenon.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay, perfect. Thanks so much.

A - Marc Grandisson {BIO 4369887 <GO>}

Thank you.

Operator

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

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

Hi. Thank you. I guess first, Marc, you talked earlier about growth in UK motor, and I think a number of others have talked. But can you just talk a little bit more about sort of what exactly that business is and what's appealing about it? I guess I have ancient bad memories of that causing trouble from time to time?

A - Marc Grandisson {BIO 4369887 <GO>}

Oh, yes. And you're quite right. It is an very interesting and very volatile, if you're not careful, but we have a good relationship with one big originator in the UK, and they've been a partner of ours for a little while and we've been able to maneuver through this cycle with them, alongside with them, and we are seeing rate increases over the last three quarters or four quarters, I would say. And we were able to seize on the opportunity and give them what we think are appropriate reinsurance terms to be partners with them on a going forward basis.

In addition to this, the excess of loss in the UK has also gone through a tough time in terms of a lot of changes in the rate level, and we were also able to take advantage of that. So this really is a reaction to echo what you just mentioned to the fact that rates have been increasing and improving. And as I said in my comments, and they've increased enough so that we believe that returns are there for now for us to take advantage of it.

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

Got it. And so you're doing XOL then?

A - Marc Grandisson {BIO 4369887 <GO>}

As well -

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

We're doing both share (01:13:17).

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

Doing both (01:13:18).

A - Marc Grandisson {BIO 4369887 <GO>}

Yes.

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

Yep.

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

Got it. And are there loss caps on those to protect you or is it just, you can -

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

There is terms that we like.

A - Marc Grandisson {BIO 4369887 <GO>}

Because of the trade (01:13:28) that you're asking me, and I'm not sure I'm comfortable sharing that with you.

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

That's fair, that's fair. Okay. I guess maybe what I was getting at is – I was thinking that being a long-tail business and just are there ways – if you see it deteriorating is it just you won't renew it the next year – are there other things that you can do to protect yourself with five years down the road, it goes bad?

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

Are you talking about the share (01:13:55) business or the XOL loss?

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

I guess that's probably more on the quota, right, but I mean, I guess it could be either?

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

Well, I mean, no. The quota share, you can adjust very quickly by based on your underwriting audits and how you're monitoring rates, don't forget. We do a lot of underwriting audits, and we continue to watch the pricing on a quarterly basis.

Now, the biggest bet is the excess of loss bet, because you get that wrong and it's not as easy to correct, you can get out later on, but sometimes it might take you a couple of years, or three years before you recognize that you didn't get the pricing right, that's more. But that's not from a premium revenue point of view, it's not as big as the quota share. So we watch both, believe me.

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

Okay, understood. I was just curious because, I've seen a lot of people adding to it. On the MI, I guess a couple of things on rates, one is now that everyone has lowered their rate cards for your non-RateStar business or is this from rate card I think in certain sales looks off market, do you feel you need to adjust your rate card to match everybody or for those customers who want to keep that business?

A - Marc Grandisson {BIO 4369887 <GO>}

We actually just – Ian, we just issued our new rate card in April 7, but we wish -

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

Okay.

A - Marc Grandisson {BIO 4369887 <GO>}

– so we're – we're not matching everyone, so there's no plan right now to do anything else.

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

Got it, okay. I missed that. Okay. And then on the RateStar business, my sense is and again, I obviously, don't know exactly what your rates are, but it feels like conceptually a lot of what the competitors did to change your rate cards felt like it was trying to get closer to where you and UGC are. Is that fair that maybe the advantage of RateStar is a little diminished?

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

I don't know what drove the actions because you're mixing apples and oranges, right. At the end of the day, if you have a pool of risks that on average gives you a good return ROE, and now through a selection process, maybe one or two competitors, they might be taking out of the pool certain mortgages for a slightly less price, but a much better risk characteristics. That means the remaining part of the pool needs to be priced a little higher than the past, not a little lower. So adjusting the rate cards and not going to look at exactly what adjustments they make, you might be getting into adverse selection, so to speak.

At the end of the day - the problem with the rate card is a simplistic way to price. Just credit score and LTV alone is not the only thing that is going to tell you as to how that mortgage is going to behave, there is other parameters around, and I think that's where our advantage is. Our advantage is we introduce other factors to allow us to more appropriately price that business.

A - Marc Grandisson {BIO 4369887 <GO>}

But clearly, Ian to your questions bit more directly, I believe that - so it's going to a more refined rate card is sort of one step for most of them to get to that direction. There's recognition to Dinos' point that the rate card has been historically too generic in nature.

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

Yeah, okay - (01:17:33)

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

And it might die within a year or two and it might get into more as to what we do in all of our other business, on the P&C, I don't care if it's auto or homeowners or lawyers and accountants, et cetera. We don't have one or two rating parameters, we have multiples and then you look at it from many different perspectives to put a price. So I think the mortgage insurance business is moving in the right direction in our view.

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

For sure. And then just last one on that topic is if you were to look at a sizeable acquisition in that space that would take you over the one-third mix, can you just talk about sort of how you evaluate metrics, meaning obviously, we can all look at EPS accretion, but what are the different things you look at in addition to just EPS and is it ROE, is it your PE, I mean, I think one of the concerns some people might have is those companies trade at lower multiples, so if it becomes too big a part of your mix, it might hurt your evaluation. Just how do you think about sort of the combination of accretion versus valuation versus risk returns?

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

You know that old saying, in the short-term, the equity market is a beauty contest and in the long-term is a weighing machine. That's Buffett's analogy. As long as I'm producing good profits and I'm adding - I don't worry about what the Street valuations might be because how do you explain - one competitor we have who is trading at 1.7 times book, right, in the MI space, versus another competitor we have, who is trading at 1.1. Well, maybe one has legacy business and the other one doesn't, et cetera.

So I'm not worried about that because the mortgage insurance business produces very good ROEs to demand a higher multiple than the P&C world right now. And we only have one marker out of the seven who has the purity in only having post crisis business and the market is rewarding them with 1.7 multiple. So I don't know, our actions is not as to - about the market multiples, our actions is, are we producing a good return for the capital that we're committing to a particular sector and is the ROE acceptable, that's what drives us, that's the key driver in what we do.

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

Okay, the reason I ask – yeah.

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

Ian, for an insightful guy like you and the others, it would wind up being that ACGL would bring up the mortgage multiple rather than the mortgage bring down ACGL.

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

The reason I asked because if it's something big, I assume we'd have to use some stock, so that was sort of the context I was thinking about. Maybe a better way to say this is what things do you – historically you haven't done anything that's required an issuance of stock, so sort of what are the things you evaluate in deciding whether stock makes sense in a merger?

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

Well, let me just start on that one, is I mean, we've talked about this before on tangible book value hit, that's not new as to how – when we've repurchased our shares, there's that hit, what's the recovery period, that is still an in-force principle that we will look at. And that's one of the criteria, not the only criteria, but that's certainly one of them. But don't lose sight of the prior discussion, which is on the risk management side. So EPS is a no-brainer really and that's so so tactical (01:21:45). We don't want to impair the balance sheet, number one. So what's the recovery of it and the risk management aspect, we wouldn't go into it if there weren't higher ROEs to begin with, but defensively we don't want to put any dents in the balance sheet.

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

Got to make sense. What's for lunch today, Dinos?

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

That's your best question.

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

Today we have kept Keftedes.

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

Okay.

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

That's the Greek meatballs.

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

Okay, I remember the -

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

You know, I can give you the recipe when I see you. It's – they're phenomenal.

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

I remember those from last summer and thank you.

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

Yes, you're welcome.

Operator

Thank you. Our next question comes from Mark Dwelle with RBC Capital Markets. Your line is open.

Q - Mark Dwelle {BIO 4211726 <GO>}

Yeah. Hello, thanks. Just one follow-up question, something that was discussed on the Australian mortgage transaction, kind of what you said kind of confused me, is this a recurring revenue transaction which is to say, we'll see another one of $40 million or whatever the number will be next quarter and then continuing thereafter? Or was this a one-off one shot deal?

A - Marc Grandisson {BIO 4369887 <GO>}

No. Like I said it's – and we're sorry for the mix (01:22:54) – I just want to make sure it's clear to everyone. This is really like business that was produced in that quarter, that relationship is still existing, it's been around since last year. So yes, I would expect depending on the level of production that our partner will do in Australia, we could be around that same level, if they continue producing at same level.

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

If they originate the same level of mortgages -

A - Marc Grandisson {BIO 4369887 <GO>}

They will flow through.

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

They will flow through with us and it continues and it will continue as such until -

A - Marc Grandisson {BIO 4369887 <GO>}

We terminate -

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

They cancel us or -

A - Marc Grandisson {BIO 4369887 <GO>}

We terminate the relationship.

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

There is a termination by either party on the relationship.

A - Marc Grandisson {BIO 4369887 <GO>}

Correct.

Q - Mark Dwelle {BIO 4211726 <GO>}

So this puts in place really a fairly, I'm going to use the word permanent or at least hopefully long-term kind of fore-flow of premiums that should last for at least on an earned basis for quite a long time?

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

Yes. That is correct.

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah.

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

Yes.

Q - Mark Dwelle {BIO 4211726 <GO>}

Okay. That's what I thought and that's – that was my only question, thank you.

A - Marc Grandisson {BIO 4369887 <GO>}

Thanks, Mark.

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

Thanks, Mark.

Operator

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

Q - Michael Nannizzi {BIO 15198493 <GO>}

Sorry for the follow up. Just one last one here, back to the MI and Mark maybe your comments on the expenses, I mean I'm looking at premiums doubled year-over-year, acquisition ratio is in half dollars or down notionally, other operating expense, the ratio is flat. And I understand there was a reinsurance transaction that may be obscuring some of that trend, but I would generally think that the ratio of dollars, it would seem to be more of fixed in nature, the operating expenses, that ratio would improve and that the acquisition ratio would remain relatively flat, again absent, some adjustments.

I'm just trying to get some understanding of what that should look be – and I understand they're like three different businesses, they all operate differently, the stackers, expenses are low and things like that, but I mean would the line that's growing this quickly, I feel like I'm just missing the mark on how to think about. Should we be looking at expense dollars relative to written premium dollars as opposed to earned during this growth phase, just any guidance or help, not guidance, but any help in how to think about would be great?

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

Well, I think written is a better way. It's more of a statutory view, but it's – it still makes more sense. We talked about hitting critical mass in steady state at some point, but also Michael think about how market share is measured, it's measured on NIW, which is effective new premium. But that's new exposure, the premium is – comes in at a slow build up rate over time. So if we get to a reasonably larger market share in two, three years, that doesn't mean that overnight, the whole in-force book is where it needs to be. That means the marginal amount in 2017 that we hit market share of X is additive to the portfolio.

In PC world, we have new business and renewal business. Here, you -

Q - Michael Nannizzi {BIO 15198493 <GO>}

Sure.

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

– don't renewal business, you have new business and in-force. So all you're doing is adding on to the heap with a new NIWs that you're getting. So this is a long-winded answer to say, you've got to be patient, the OpEx dollars are really not going to grow as much. You've got to wait for the revenue to catch up with that and it will.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay. So OpEx doesn't grow as much. And the acquisition expense, I am guessing that was impacted somewhat by this Australia transaction and the lack of the reinsurance transaction you mentioned that you have in the prior year, but it is sort of teens level of acquisition expense, I mean is that given the mix of business you have, is there anything in there that we need to peel out in order to think about the forward.

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

No. I think it is the mix. The mix will change by quarter. It, by the way, changes in the reinsurance segment, it changes in the insurance segment. By mix, the change is, the reported acquisition expense. OpEx is – the questions you asked are applicable to any of our business segments, but acquisition can fluctuate as a function of the business we write. So I'd say, no, it's a mixed thing quarter by quarter.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it, okay. Thank you so much.

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

Thanks, Mike.

Operator

Thank you. I'm showing no further questions. I'd like to turn the call back to Mr. Dinos Iordanou for closing remarks.

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

Well, thank you all. A little late lunch today but I'm going to enjoy the Keftedes along with the team. We are looking forward to seeing you next quarter.

Operator

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