Q2 2017 Earnings Call

Company Participants

- Constantine P. Iordanou, Chairman & Chief Executive Officer
- Marc Grandisson, President & Chief Operating Officer
- Mark D. Lyons, Executive Vice President, Chief Financial Officer and Treasurer

Other Participants

- Brian Meredith, Analyst
- Elyse B. Greenspan, Analyst
- Kai Pan, Analyst
- Meyer Shields, Analyst
- Ryan J. Tunis, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day, ladies and gentlemen, and welcome to the Second Quarter 2017 Arch Capital Group Earnings Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session, and instructions will follow at that time. As a reminder, this conference call 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 the 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 introduce your hosts for today's conference, Mr. Dinos Iordanou, Mr. Marc Grandisson, and Mr. Mark Lyons. Sir, you may begin.

Constantine P. Iordanou {BIO 2397727 <GO>}

Thank you, Liz. Good morning, everyone, and thank you for joining us today for our second quarter earnings call. Our performance for the second quarter was satisfactory, as strong performance in the mortgage segment was partially offset by higher attritional losses in our Property Casualty business. On an operating basis, we produced an annualized return on equity of 8.5% for the second quarter of 2017 and 9.1% on a trailing 12-month basis.

Return on equity, based on net income, was a little higher at 8.7% annualized for the second quarter and 10% on a trailing 12-month basis at June 30, 2017. Our book value per common share at June 30, 2017 grew to $59.60 per share, a 3.3% increase from March 31, 2017 and a 15.2% increase from a year ago.

Now turning to second quarter results, our reported combined ratio on a core basis, Mark Lyons will define in a moment what that means, improved to 7.2 points from the second quarter 2016, led by excellent results in the mortgage segment. Our mortgage segment improved its combined ratio quarter-over-quarter to 30% from 44% in the second quarter of 2016, primarily due to increased scale resulting from the United Guaranty acquisition and consolidation activities at Arch MI U.S.

Integration of the U.S. primary mortgage operations continue to progress very well and is on or slightly ahead of targets that we have set. The combined sales force is fully integrated and is working well with all of our customers. With the exception of a few customers we discussed in our last quarter call, we have not experienced any material changes in our bank or Credit Union relations in the quarter.

There were no significant changes in the property and casualty operating environment from last quarter, as weaker market conditions continued to pressure margins. As we noted on an 8-K last month, our reinsurance segment experienced unusually high loss activity on a small number of contracts in our property facultative unit in the second quarter, which contributed to an 11 point increase to the segment's combined ratio to 94% for the quarter from the same period in 2016. The property facultative unit has produced significant underwriting profits over time and we view these losses on this quarter as an aberration.

Our insurance group combined ratio also rose in the quarter to 100.8%, due to effects of margin compression and an increase in attritional losses. Loss reserve development remained favorable in each of our segments, which in the aggregate reduced our combined ratio by 6.4 points. Marc Grandisson will elaborate on what we see in each of the markets in a few minutes.

Net investment income per share for the second quarter was $0.66 per share, down $0.03 sequentially from the first quarter, due in part to lower returns on one of our alternative asset investments in the quarter. As you know, we manage our investment portfolio on a total return basis, which on a U.S. dollar basis was 163 basis points for the quarter and 129 basis on a local currency basis.

Before I turn the call over to Marc Grandisson, I will like to discuss our PMLs. For many years now we have reported our exposure to a 250-year probable maximum loss from a single catastrophic event, because we believe it is easier to manage exposure by measuring risk and then limiting the amount of risk you're willing to take.

This quarter, we are also reporting to you our exposure to mortgage risk from a systemic stress event, or what we call internally a realistic disaster scenario, or RDS. And in future, we'll be referring to the term RDS, so it'd be good for you to get familiar with it.

Although mortgage risk is different from property catastrophe risk, the mortgage sector is exposed to economic events like the Great Recession, which occurred in 2008 and 2009. Our RDS approach models various assumptions that are outlined on our website, and we encourage you to review. So, please visit our website.

The most current version produces losses that are about one-third more severe than what actually occurred in the Great Recession of 2008. Overall, we believe it produces a reasonable estimate of downside risk. Although as with all of our modeling, we will continue to refine and improve them as we go forward.

As of the end of the second quarter 2017, our RDS generates an indicative exposure that is consistent what we share with you at our Investor Day last month of about $1.1 billion or about 13% of our shareholders' equity at June 30, 2017. This level is well below our maximum risk tolerance of 25% of equity.

Our property cat exposure are substantially the same as last quarter, with our peak zone, the Northeast, representing approximately 6% of equity. We will report the rest of our property cat PMLs in the 10-Q when it's going to be filed shortly. The models for property cat and now mortgage are constantly evolving and we will update you on our assessment of risk as we view changes.

Before I go over to Marc Grandisson, also I want to note that we continue to make progress with the rating agencies. As you know, following the acquisition of United Guaranty, all rating agencies put us on credit watch. Last night, Fitch affirmed our ratings at A-plus with a stable outlook. We're very pleased with that outcome.

And with that, I will turn it over to Marc Grandisson for his comments.

Marc Grandisson {BIO 4369887 <GO>}

Thank you, Dinos, and good morning to you all. The quarterly earnings contribution from mortgage is, again, proving to be an offset to softening conditions we see in the property casualty sector. As Dinos mentioned, integration of the U.S. MI companies are going well, as the expense ratio for the MI segment improved to 22.5% at the end of the second quarter.

Our new insurance written, or NIW, was $17.3 billion for the second quarter, a decrease of 11% over the same quarter in 2016 on a like-for-like basis, largely due to our decreased writings of single premium business. We continue to deemphasize single premium business in the U.S. MI primary sector because we are not satisfied with a current return profile.

For the second quarter of 2017, single premium comprised just 14% of NIW versus 18% last quarter. While market share is important, Arch's focus is on producing the best risk-adjusted returns for our shareholders. Since not all MI companies have reported their writings as of today, so far we estimate that Arch U.S. MI's market share remains in the mid-20s for the second quarter of 2017.

More importantly to Arch, 80% of our NIW came through our risk-based pricing platform, which we believe generates better risk-adjusted returns than a simple rate card. Our expected ROEs for U.S. MI is still above our long-term target of 15%. The overall quality of the risks written remains very strong. A higher level of mortgage rates in Q2 has led to an improved level of persistency which now comes in at 78%. We continued to experience favorable developments in the U.S. MI reserves, consistent with what you have heard from our competitors. The trend of cured delinquencies outpacing new notices of delinquency is continuing.

Arch wrote five new U.S. GSE, the government-sponsored enterprises, credit risk-sharing transactions, or as we call them, the CRT, bringing our total risk in force from them to approximately $2.2 billion at the end of the second quarter of 2017. Average yields in the CRTs remain healthy and ROEs are above our long-term target. We remain very committed to the GSE's ongoing efforts to develop private credit risk transfer solutions.

Finally, our Australian mortgage insurance relationship continues to generate a good flow of business, although it has slowed down as we tightened underwriting standards for new originations. These efforts are contributing to a reduction in written premium of 50% sequentially in the quarter.

Moving now to P&C insurance. Market conditions remain challenging with rate decreases stabilizing somewhat. The rate change differential in the U.S. by size of account is significant. For smaller, or what we call controllable accounts, also those driven by lines with auto exposure, we saw a positive 250 bps rate change in the quarter. However, for our cycle managed businesses we saw a negative rate change of 330 bps.

After factoring in these rates changes and an estimated loss trend of 210 bps, we had margin erosion of roughly 40 basis points for all lines in the second quarter for our U.S.

P&C insurance operations. In addition, we have observed further broadening of terms and conditions.

In this environment, the trend is not our friend. We are prudent, as always, in our underwriting and reserving as we observe the insurance cycle weakening. In general, we believe that in many areas of property casualty insurance, the risks have too much variability around the expected returns to grow our writings.

Turning to reinsurance now, we continue to focus on a few opportunities that have relative rates strength and more favorable returns, while we are deemphasizing the more commoditized segment as rates and loss trends also continue to erode margins. Our net written premium increased, largely due to a specific loss portfolio transfer contract. Excluding the effect of that transaction, our growth was more modest and as a result of our continuing focus on seizing opportunities. Our property cat and property writings are still decreasing due to market conditions, as our reinsurance group focuses on margins and not just the premiums.

Our ability to deploy capital to MI at mid-teens ROE and deemphasizing the traditionally commoditized overcrowded P&C market at single-digit ROEs is a testament to our flexibility.

And with that, I'll hand this over to Mark to cover the detailed financial results.

Mark D. Lyons {BIO 6494178 <GO>}

Great. Thank you, Marc, and good morning to everyone. Given that my colleagues were a little long-winded today, I'm going to try to talk like a New Yorker and blast through what I have to add. So, in so doing, first I'll make some summary comments for the quarter, all on a core basis. And as a refresher, the term core corresponds to Arch's financial results excluding Watford Re, whereas the term consolidated includes Watford Re.

But I'd also like to point out that we've altered the chart on page 1 of the earnings release so that now it provides income statement and combined ratio information for the quarter on both a consolidated basis and excluding Watford Re results, all in one place for convenience purposes. I believe that there is still some confusion about how Watford's financial results really impact Arch given that we consolidate them, and this helps to provide more transparency. For additional clarity, if only the 11% ownership of Watford Re was reflected in our underwriting results, the resultant combined ratio for the quarter would be only 30 basis points higher than our core 82.2% combined ratio.

Okay. So moving forward, claims recorded in the second quarter of 2017 from catastrophic events, net of reinsurance recoverables, related acquisition expenses, was 2.3 loss ratio points compared to 4.1 loss ratio points in the second quarter of last year on the same basis, mostly emanating from within our reinsurance segment. The activity was primarily driven by Australian Cyclone Debbie and our property facultative unit and various other events around the globe.

As for prior period pure net loss reserve favorable development, 6.5 loss ratio points were reported in the quarter, led by the reinsurance segment with approximately $40 million of favorable prior-period development, the mortgage segment providing nearly $30 million of favorable development, and the insurance segment with approximately $2 million of favorable development.

Approximately 80% of the mortgage segment favorable development emanated from the U.S. primary first lien portfolio and a meaningful portion for $6.8 million, stemmed from net favorable development resulting from subrogation recoveries as discussed on last quarter's call, and ULAE led by the second lien portfolio that came over as part of the UGC acquisition, and that is in fact a runoff operation.

The reinsurance segment net favorable development was across most underwriting years for short and medium-tailed lines, and predominantly from the 2002 to 2004 and 2008 to 2012 underwriting years for a longer-tailed line. The overall calendar quarter combined ratio on a core non-Watford basis was 82.2%, and when adjusting for cats and prior period development, the core accident quarter combined ratio was 86.3% compared to 94.2% in the second quarter of 2016.

The reinsurance segment accident quarter combined ratio, excluding cats, of 101.1% compares to second quarter of 2016's 98.3%, while the insurance segment's accident quarter combined ratio excluding cats was 99.4% compared to 96.1% in the second quarter of 2016. Both results reflect higher loss picks due to increasingly difficult market conditions. However, the reinsurance segment was impacted by abnormally high claim frequency, as Dinos mentioned, reported during the quarter, emanating from the property facultative unit, as previously disclosed in an 8-K released in June.

The property facultative unit has historically been one of the most profitable within Arch and only in one other quarter over the last 10 years has the quarterly combined ratio been over 100%, giving more support and stock to Dinos' comments of it being an outlier. The reinsurance segment also booked a retroactive reinsurance transaction for an existing client that contains sufficient risk transfer for insurance accounting treatment.

Although the reinsurance segment calendar quarter combined ratio does not vary materially, when looking at results inclusive or exclusive of this transaction, the components of the combined ratio do vary. Accordingly, the calendar quarter loss ratio, excluding this transaction, would be 6.5 points lower, whereas the expense ratio would be 5.6 points higher, excluding this transaction. This should be considered when examining the components of the quarter combined ratio.

Lastly, for the reinsurance segment, the second quarter of 2016 contained an unusually large gain in the other underwriting income line of $19 million, stemming from the commutation of a large deposit accounted contract with no corresponding impact this quarter.

The reported insurance group accident quarter, excluding cat loss ratio, increased approximately 230 basis points quarter-over-quarter and after controlling for large attritional losses and mix changes, increased approximately 160 basis points. As a result of the ongoing competitive conditions in the P&C markets, we continue our approach of prudent current accident year loss picks.

However, these difficult conditions in the insurance and reinsurance markets were more than offset by the continued improving profitability of the mortgage segment, also amplified with their net earned premium being a larger proportion of total. The mortgage segment's accident quarter combined ratio improved to 42% even from 60.6% in the second quarter of last year, and their net earned premium represented, similar to the fourth quarter of 2017, nearly 25% of the total core net earned premium, compared to only 7.5% in the corresponding quarter of 2016.

Now, although I said this last quarter, I think it's still worth repeating that in the mortgage segment accident quarter has a different connotation than in the PC world and is more similar in concept to claims made businesses in the PC space since the notice of default defines the assignment to the appropriate quarter.

Similar to last quarter, there were some nonrecurring costs in the second quarter resulting from the UGC acquisition. This quarter, such nonrecurring costs totaled $2.7 million in contrast to the first quarter of 2017's $15.6 million. So, they're trailing off, as you might expect. The sources of costs emanated from severance, outplacement, and trailing-related UGC transaction costs.

Now, there were additional reduction in force actions taken in the quarter, but the implementation was slightly different than in the first quarter of 2017. The first quarter had two actions, one effective on January 31 and another effective on March 31. Therefore, the first quarter saw some salary expense reflected for employees who were terminated by that quarter-end. This quarter, however, the effective date of a reduction in force was actually effective on July 1. However, the 63 affected employees were noticed in May, so related severance costs were accrued, totaling $2.6 million.

The salary compensation recognized in the second quarter associated with employees involved in the July 1 reduction in force was $1.4 million, which also equals the quarterly run rate salary savings because the action was effective July 1. When combined with the actions taken in the first quarter of 2017, the cumulative quarterly run rate salary savings are $7.1 million, and this would be $28.4 million on the annualized basis. We will continue to comment in future quarters about any other actions taken and their financial impact. We'll report them as they occur.

Given the nature of these expenses and consistent with last quarter, we have excluded this $2.7 million of cost from operating income, as they are not indicative to our true underlying performance. Through six months, 265 employees and 85 contractors have been subject to reduction in force actions. It is also worth noting that operating earnings per share this quarter included a $1.7 million equity accounting charge due to our proportional ownership interest in Premia Re due to their startup nature.

As most of you are aware, we worked with AIG in June to alter the common equivalent stock lockup provisions contained within our UGC acquisition purchase agreement and completed a secondary offering in which approximately 56% of such shares were sold, thereby increasing our stock's float. Irrespective of that sale, however, the earnings per share calculation continues to employ the full – approximate 130 million shares that reflects the full issuance of such stock that were part of the UGC acquisition purchase price.

Moving on to tax, as respect to the effective tax rate, with our changing portfolio and geographic mix, the second quarter of 2017 tax rate on pre-operating income of 14.4% represents an updated 15.3% effective annual tax rate, along with 190 basis point reduction stemming from a change in GAAP accounting, affecting stock compensation as mentioned last quarter, and 100 basis point addition, or roughly $2 million, reflecting a year-to-date catch-up for the now higher effective annual tax rate just mentioned. As always, the tax rate is affected by varying mixes of income by geographical distribution and any associated changes in local tax rates.

Turning now to the mortgage segment, I want to point out the difference between the U.S. primary mortgage division's gross versus net risk in force. At the end of the second quarter, the gross risk in force was $62.4 billion, whereas the net of external reinsurance risk in force was 27% lower at $45.8 billion.

As we have consistently implemented in all of our segments, our ongoing mortgage strategy is to maximize profitability, while simultaneously protecting the balance sheet. The existing quota shares that are in place, along with existing and ongoing excess of loss reinsurance and capital market protections, provide the aggregate and tail risk balance protection that we seek. I'll also point out that the U.S. primary MI gross risk in force as of June 30 contained only 8.4% emanating from 2007 and prior.

As for after-tax operating income earnings per share accretion realized in the second quarter of 2017 from the UGC acquisition, we examined our results with and without the impact of the UGC acquisition giving due consideration to associated debt financing, interest costs, preferred stock dividend charges, associated transaction costs, and intangible amortization. The accretion from the transaction for the quarter was approximately 29% on an adjusted reported basis.

Now, I used the term adjusted because the heretofore mentioned property facultative losses abnormally depressed the reinsurance segments underwriting income, making the apparent operating earnings per share accretion for the quarter artificially high. Instead, substituting the property facultative unit's long-term quarterly financial results provide the more realistic 29% earnings per share accretion just referenced earlier.

In a similar vein, I'd also like to clarify some aspects of the profitability contributions from our three underwriting segments: insurance, reinsurance, and mortgage business. As stated earlier, when discussing the earnings per share accretion, stemming from the UGC transaction, the relative underwriting income contribution is also distorted by the property facultative unit's abnormal loss activity in the quarter.

Adjusting for this, along with making allocations of intangible assets, incremental interest and dividend costs from acquisition financing, as well as allocating net investment income to the three segments, which has not been historically done within our earnings releases or financial supplements, yields the following pre-tax operating income contribution mix for 2017 on a six-month year-to-date basis. The mortgage segment contributed 55% with that definition; reinsurance segment, 25%; and the insurance segment, 20%.

Management continues to evaluate performance for the operating segments primarily by underwriting income and manages the investment income on a total return basis across all segments. This alternative view, though, may provide additional insight into our sources of profitability.

On a GAAP basis at June 30 versus year-end 2016, our total debt-to-capital ratio was 20.1% and total debt plus preferred-to-total capital ratio was 27% even, down 170 basis points from year-end 2016. This leverage reduction was due to our growth in common equity, as our debt and preferred levels were unchanged from year-end.

Arch core operating cash flows were $274 million, up $121 million relative to the second quarter of 2016, and this increase was primarily driven by premiums collected net of reinsurance sessions and related acquisition expenses.

As Dinos mentioned, book value per share increased 3.3% sequentially this quarter, but tangible book value increased 4.2% sequentially, driven primarily by intangible asset amortization along with a small refinement to goodwill emanating from the UGC transaction. Once again, we did not repurchase any shares and do not anticipate repurchasing any during the balance of 2017.

With these introductory comments, we're now prepared to take your questions.

Q&A

Operator

Thank you. Our first question comes from Kai Pan of Morgan Stanley.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you, and good morning. Well done, Mark. And I timed you that you cut prepared remarks by five minutes.

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

All right. Thank you. I (28:52) as I could for you.

Q - Kai Pan {BIO 18669701 <GO>}

First question is on the mortgage expense ratio. Is that 22% a good run rate going forward, or is there more to come given that some of these expense saving was still to come?

A - Marc Grandisson {BIO 4369887 <GO>}

It's still early in the game. We've been at it for six months. We're – at least, like Dino said, we're running on or slightly ahead of target. It's hard to see where it's going to end up in the long run. I think we'll be able to have a clear view of where we are probably by middle of next year. But if you look at a comparison in the industry, I think that anywhere from 18%, 19% to 24% seems to be where everybody is landing. We certainly are ongoing, as you know us, focusing on extracting as much scale as we can out of the operation. So, we'll have a much better, good sense of the run rate by middle of next year.

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

And Kai, I would just add, this is a mortgage segment combined ratio. So, it'd also depend on the relative mix of the GSE transactions which attract just very low marginal cost to it.

Q - Kai Pan {BIO 18669701 <GO>}

Is that – the $32 million of other operating expense in the quarter, is that the good run rate going forward, or there's going to be sort of like a further improvement or reduction there?

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

Well, if you look – are you talking MI, specifically?

A - Marc Grandisson {BIO 4369887 <GO>}

MI?

Q - Kai Pan {BIO 18669701 <GO>}

Yes.

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

Well, that's a little tougher. You wind up – remember, it's a ratio, so you've got – you're asking a numerator question. I think Marc answered the denominator answer with growing scale. Given some of the activities that are in place, I think it's likely to creep lower, but I don't have a – I don't think it's appropriate to have a forecast moving forward.

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

Yeah. Kai, we try to manage the company as well as we can, lean and mean. We didn't do the transaction because some investment banker put on a spreadsheet some synergies that we have to achieve, et cetera. We believe that the activity so far is being better than expected, and there will continue to be some additional savings. Now, not knowing how much volume of business we're going to have, you don't know the ratio. But I think you will see, on just pure dollars, a little bit of improvement as we go forward.

A - Marc Grandisson {BIO 4369887 <GO>}

The one thing I would add, finally, to this is there is a lot of things going on at GSE, as you guys know, in Washington. A lot of things could be changing which would mean having to beef up or increasing the amount of resources we have to allocate there, or it could be a lot less. So, there's a lot of moving parts as we speak. That's why we're trying to be as careful in answering that question to you.

Q - Kai Pan {BIO 18669701 <GO>}

Great. My second question on the reinsurance reserve releases is that this quarter has been meaningfully lower than a year ago quarter. I just wonder, is there anything or any trend that we should read into that?

A - Marc Grandisson {BIO 4369887 <GO>}

In my comments, I mentioned about comments on the ongoing trends and conditions. We have seen, and I think you've heard it from other calls as well, that the loss trend is picking up in general in the marketplace. So, we have seen some changes in the development, but not that significant. We're just trying to be more prudent in the way we're recognizing history and the actual experience. It also has helped us inform our current accident year picks. So, we're trying to be more prudent because there's a lot of things that – in addition to the loss trend, I did mention terms and conditions. So, we're trying to do – be appropriately prudent and careful in the way we're going about this.

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

I'm sorry. And Kai, I would also add that the relative mix of the reinsurance reserves these days, because of our reduction in the PML, purposeful reduction, we just don't have as much short-tailed release. It's longer-tailed lines, and longer-tailed lines have more complexity to it, and emergence. So, we're a data-driven company as Marc alluded to, and we'll release it when it shows, but you've got to be more prudent when you're dealing with longer-term lines.

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

Yeah. And we talked last quarter – Kai, to remind you that also there was the Ogden 75-negative bps change and that has to be included in the data, which it affects a lot of our long-tailed reserves.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. Great. Last one, if I may, your PML as well as RDS, when you consider your 25% shareholders' equity limit, do you simply add them up, or you just consider them separately given that they're uncorrelated?

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

Well, they're uncorrelated and we – don't forget, we don't add them up because you've got to – there is a probability that they might happen the same year. But they're different. The property cat is usually an annual event. It happens immediately. The mortgage is not going to happen in one year. It's going to – it will drift, it will be three, four years, it will be a recessional period that is going to affect us. So, we don't quite add them up, but we're cognizant of where we are in either segment and we do an aggregate probability estimation. And if we feel comfortable, we continue to add exposure; if we don't, we reduce exposure. Where we are today is not an issue. Even if you add them up together, it is well within our tolerance. So, we're not spending a lot of time thinking about that right now.

A - Marc Grandisson {BIO 4369887 <GO>}

Correct.

Q - Kai Pan {BIO 18669701 <GO>}

Great. Thank you so much.

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. Welcome.

Operator

Our next question comes from Elyse Greenspan, Wells Fargo.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Good morning. My first question, we've heard some companies kind of point to maybe a bit of a stabilization in the market. Just from some of your introductory comments, it doesn't seem like you guys are seeing that. When you kind of look out toward the end of this year and even into next year, do you expect that we'll see any kind of change in the property casualty market, whether in insurance or reinsurance, with the caveat, obviously, we are still in the middle of wind season?

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

Yeah. Well, when you look at it in the aggregate and if you look at it purely by rate, so to speak, it's fine as long as you ignore some sort of trend, right? I mean, there's always. If you think trend is zero negative, that comment holds water, our competitor's comment. We don't believe in that. We believe that between the slight rate increases we get in a few segments and the rate decreases we get in other segments, when you look at trend, we're losing ground. Clearly, we're losing ground. And you saw it in the way we choose to publish our accident year numbers. We try to factor all that in. And we booked our insurance group at over 100%, I think, on the accident year for the first time in quite a few quarters. And it's our anticipation that the market is not giving us enough rate to overcome loss trend and improve margins. So, the margins, I think they're slightly deteriorating.

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. I think the market behavior, Elyse, if you look at it in broad terms, it is still very, very competitive. There's a lot of appetite to grow books of business and new ventures and new approaches and new teams being moving around. So as we speak, we're are not seeing that competition going away. We are also, as you are well aware, in an environment of excess capital globally and, specifically, in the P&C marketplace. So where we are right now, it's hard to see the future. But from where we sit, we are expecting a continuation of this for the foreseeable future.

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

And Elyse, a follow-up to Dinos' comments there, as a quip, you could equate that to Midas mufflers; pay me now, pay me later. So, specialty business has a range, it depends where you are in that range. If you're on the upper end of it, there's less chance of adverse development down the road. If you are on the lower end of it, you have an increased chance of adverse development down the road, and different managers have different views on how they report.

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

Yeah. The accident year numbers are self-grading exams. So, you write the paper, you grade it, and the professor comes three, four years down the line, which is going to give you the real grade. So bear that in mind.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay. That's helpful color. On the property facultative reinsurance loss, how much of that went through the underlying number and how much hit your catastrophe losses?

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

There was one claim that it was from the cat. The rest of it was individual fire losses. And like I said, it was a very unusual quarter for us, and we view that as an aberration. It's not - anything we looked either from an underwriting point of view, selection of risk, et cetera, or what has happened in the 10 year that we have been running that group, this was a surprise to us and an aberration. But no need for us to make any changes either on underwriting guidelines and/or any concern that we have with the existing book of business.

A - Marc Grandisson {BIO 4369887 <GO>}

And Elyse, it's an excess of loss portfolio, so bear that in mind. I mean, it actually has given us the way below longer term expected losses for so many quarters. So once in a while you'll have that volatile result. So, that's something that we should expect. I think they've been unusually favorable for such a long time, it happens once in a while. So, it's volatile excess of loss portfolio, so.

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

On average, we take around $10 million lines and three, four losses can get you $40 million quickly. Having said that, it's highly unusual in a single quarter to have four or five losses. We usually get one, we get two. Sometimes we get none. And...

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

And the other color on that, Elyse, just little less than half is cat related.

A - Marc Grandisson {BIO 4369887 <GO>}

That's right.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay. I was just thinking about the underlying margin. And one last question. You guys called out international motor growth in the quarter. Was that in response to some rate increases following on Ogden? Was that just a material number? Just a little bit more color there. Thank you.

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. A little bit of it is Ogden, Elyse, absolutely. So you can – I think we can geographically sort of circle into where we are, focusing some of the efforts. But there are also other countries, mainly in Europe, that have had rate increases or rate and terms and conditions changes that are, we believe, favorable at this time. So, we are partnering up with companies out there and supporting them and providing them expertise and capacity to seize on the opportunity. So, it's not only isolated to one area, but certainly the areas you mentioned about sort of the Ogden rate, is certainly a catalyst and one of the larger participation increase that we've seen in the last quarter.

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

But to your point, Elyse, the quota share, quota shares are unbounded, but there's internal – there's protective XOL, so it keeps that bounded. So, quota shares are less impacted by Ogden. And therefore, until we get clarity around what Ogden does, there's more of a slant towards the quota share business.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay. That's great color. Thank you very much.

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

Welcome.

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

You're welcome.

Operator

Our next question comes from Meyer Shields with KBW.

Q - Meyer Shields {BIO 4281064 <GO>}

Thanks. Good morning. I wanted to get in a little bit on the loss portfolio transfer that you mentioned. First of all, is there any sort of limitation on how conservatively you can set initial reserves for that relative to your typical practice?

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

Well, it's - I'm sure everybody will kick in here. But it depends on the - somewhat to the accounting, and the accounting is driven by what kind of risk transfer there is. There's underwriting risk and timing risk, that is effectively, internally, a decision tree on the accounting treatment depending upon those characteristics. So the extent that there's not material underwriting risk, we don't put that through insurance accounting. It gets deposit accounting treatment. To the extent that it does get sufficient risk transfer and it does get insurance accounting treatment, we generally will - depending upon the deal, but as a broad statement, we'll book it very close to a breakeven, and any margin associated with it gets accreted over the exposure period.

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah, Meyer, typically, on LPT, to add to this, you'll have to have mirror accounting between all the parties. Typically, whatever was transferred will be assumed by the other party and it will have to be recognized by both parties. There's not really any difference in booking the reserves, if you will. Over time, it might change, it might evolve, which might raise other questions. But certainly, at the beginning of it, there has to be a commonality of agreement as to where we think the loss reserves ought to be. And whatever - if you are seeding more premium than you're seeding loss reserve, the addition will be described as an expense for the over-the-top and you'll have to take it as a seeding company. So, it's a very, very straightforward way to look at things. There used to be, all the way in the past, 30 years ago, things you could do, but those days are over and it's very, very transparent.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. That's very helpful. Thanks. Second question, I guess, I think, Marc, you talked about the spread of rate changes being pretty dramatic. Is there a similar spread in trend, or is it just where those various product lines are performing now that's dictating the various rate changes?

A - Marc Grandisson {BIO 4369887 <GO>}

There is a spread in trend, absolutely, just by virtue and 330 bps that I mentioned about the rate decreases, it's actually focused on the excess portfolio, which, by definition, if you have a ground up 2% trend, we'll have a leverage inflation ratio into it. So, there is definitely - which is counterintuitive, Meyer, because you would expect rates to not go down as much when a trend has that much impact, but that's the nature of our business. We tend to have, unfortunately sometimes, doubling up on the negative impact against the loss ratio. So, this is what we've seen so far.

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

And let me add to what Marc said. At least in our shop, sometimes when there is negative trend, less losses being filed, whatever, we tend to ignore it. We kind of - I guess, we have difficult time accepting negative interest rates, I think we have a difficult time accepting negative trend. Some others, they – and believe me, smart people can argue this point and they might be right. They say, well, listen, look at the data, there's certain segments that indicate that we have a negative trend. And it's a philosophical...

A - Marc Grandisson {BIO 4369887 <GO>}

Pretty much.

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

...point of view. I think our entire management team here, including our Chief Actuary, our Senior Profit Center Managers, we don't allow negative trend to get into our price, or reserving, or anything of that sort. We don't like that. We don't like that concept.

A - Marc Grandisson {BIO 4369887 <GO>}

And one of our tenets, Meyer, that it's very important, is as a trend changes and we think it is somewhat changing in the underlying business, the uncertainty as to what impact it will have in the excess layer is magnified going forward. So, we tend to be, as you know, a lot more careful and we will tend to migrate towards more primary, where there's a bit more clarity into where the claim trend is going. And this is, I think, one of those situations in the market where trend is picking up a little bit somewhat, terms and conditions are also weakening. So, we try to be a bit more careful in where we write a business.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. That was very helpful. Thank you so much.

A - Marc Grandisson {BIO 4369887 <GO>}

Welcome.

Operator

Our next question comes from Brian Meredith, UBS.

Q - Brian Meredith {BIO 3108204 <GO>}

Yeah, thanks. A couple of questions here for you. First one, just back in the reinsurance and kind of a follow on to, I think, Elyse's question about the underlying combined ratios there. It looks like if you strip out the facultative release, the additional facultative losses, your actual underlying combined ratio's improved on a year-over-year basis.

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

That's correct.

Q - Brian Meredith {BIO 3108204 <GO>}

Is that true?

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

That's correct. Yeah.

Q - Brian Meredith {BIO 3108204 <GO>}

(46:44) you think is better. Okay. Good.

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

Well, that's right. On the underlying basis, given the mixes, because you've got the facultative unit, you've got the U.S. reinsurance unit, and you've got the Bermuda-based reinsurance unit. So, a lot of that is a mixture.

Q - Brian Meredith {BIO 3108204 <GO>}

Got you. Okay. Just wanted to clarify that. And then, second question was on the kind of deterioration you're seeing in your higher loss picks that you've got in your insurance segment, wondering is it possible to quantify how much of that is related to terms and conditions loosening up? And I think that's something that's just kind of hard to quantify.

A - Marc Grandisson {BIO 4369887 <GO>}

It's hard to quantify at this point.

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

Well, I mean, there is a portion of it that is terms and conditions. There is more - a portion of it that is actually the rate. I mean, how - what the indication is, what our actuaries believe the rate increase we need to get to maintain a certain loss ratio. And if we're not getting that, you've got to factor it with a higher accident year loss ratio. So, I think it's a combination of both. But the terms and conditions is subjective. Very, very, very hard, I mean, for both underwriters and actuaries. Even when I ask these questions to our claims people, they throw their hands up, because they say, well, we're going to tell you when we see it. Well, the time they see it is when there is a lawsuit and they say, if you didn't have that clause, you wouldn't be able - we would have been able to defend ourselves, and with that clause, we can't. So there is a loss that we've got to pay because of language on the contract.

So, how do you factor this mathematically is very difficult. But we take it into consideration. If you ask me, it's a wild guess, what it is, but we factor some of it, when the conditions go down, and you have to. If you're not looking for adverse development in future years, you better try to get your accident year as close to what you believe it is today.

A - Marc Grandisson {BIO 4369887 <GO>}

My experience on the contribution from terms and conditions is that as we get in a weakening and softening market, the terms and conditions overwhelm the pure loss trend that you would have seen. So, it's still not, we believe - I believe, the majority of the rate decrease as we see it, as we speak. But again, to Dinos' comment, it's a judgment call at the end of the day. It's very difficult to quantify most of it.

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

And, Brian, before you move on, I'd like to backtrack to your first question.

Q - Brian Meredith {BIO 3108204 <GO>}

Yeah.

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

When you talked about the reinsurance mix and what the underlying is. From what you said, it sounded like you were leaning towards excluding all of the property facultative large attritionals, when in fact there is always a piece of that that would be in there at all times. We tend to think of it, not only in a load basis - remember, they're not a cat load-driven unit. But it's always going to be something so that subtracting it all is too much.

A - Marc Grandisson {BIO 4369887 <GO>}

Right.

Q - Brian Meredith {BIO 3108204 <GO>}

No, no, no. I was actually just looking year-over-year. I was assuming the 2.7 points that you referred to in the second quarter of 2016 is what you had. So, like the delta, that's all I was doing.

A - Marc Grandisson {BIO 4369887 <GO>}

Okay.

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

Yeah.

Q - Brian Meredith {BIO 3108204 <GO>}

Okay. Great. And my last one, Mark, I'm just curious, going back to Kai's question in the mortgage insurance unit, the decline in other underwriting expenses you saw from the first quarter, is that inclusive of the $7.1 million of quarterly kind of salaries and benefits reduction? And what other kind of stuff went into that reduction in other underwriting expenses?

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

Yeah. You have to be careful there, because the $7.1 million is a run rate as if we took UGC into our operation and did nothing. Right? Brought them in and kept everyone and kept all the systems in place. You've got to have a baseline, it's relative to that, it's forward looking. So, we will reap those $7.1 million on an ongoing basis if we hadn't - versus having done nothing. So, it's only a partial - so in the quarter, on salaries, it was $1.4 million of impact. I'm trying to - with that statement, Brian, I'm trying to give you a little bit of a run rate because you guys are always interested in that in your modeling.

Q - Brian Meredith {BIO 3108204 <GO>}

Right. Right. So, it's $1.4 million. So, to that, I guess, I'd go back to what was the difference between the $42 million or $41.9 million in the first quarter and the $32.2 million in the second quarter, a big drop?

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

Okay. Hang on a second. Let me yank out, make sure I know where you're talking from.

Q - Brian Meredith {BIO 3108204 <GO>}

Because you exclude the re-severance and stuff in those numbers, right?

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

Well, severance, yes, for our – well, be careful. It's in the OpEx, so it's there. We excluded only in our definition of after-tax operating income per share. But it's reflected in the OpEx line, in what you're referring to.

Q - Brian Meredith {BIO 3108204 <GO>}

So, it is in there. Okay. Excellent. That's what I needed to understand.

A - Marc Grandisson {BIO 4369887 <GO>}

Okay.

Q - Brian Meredith {BIO 3108204 <GO>}

Thanks.

A - Marc Grandisson {BIO 4369887 <GO>}

No problem.

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

Thanks, Brian.

Operator

Our next question comes from Ryan Tunis with Credit Suisse.

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

Hey. Thanks. Just following up on some of the increase in loss trend in insurance. I guess, what I'm trying to figure out is, in some lines, we've clearly recognized the trend is a little bit elevated and that's being reflected in loss fix. Are you leaving room for – like if trend gets a little bit worse from here, is that in the loss pick? Or are we at a point where to the extent that it deteriorates further from what you've already seen, we'll see further increases?

A - Marc Grandisson {BIO 4369887 <GO>}

So, I think currently, the answer to your question is, yes, we would reflect a little bit more cushion, a margin of safety, if you will, in loss ratio pick. And in addition to this, it will make us be a lot more careful in writing more, and actually will make us de-emphasize and walk away from deals that we think are no longer providing us with that margin of safety. And that will be – this is an ongoing process, Ryan, right. It's back and forth as you go through the quarters.

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

Ryan, I mean, this is – the point that Marc makes is very, very critical to our underwriting DNA here. If you're not willing to truthfully reflect, based on all the information you have, what the current profitability is on a particular line of business or a particular product line, you're bound to continue making mistakes going forward by not being truthful to yourself, if there is positive margin, negative margin, how big the margin is, et cetera, because at the end of the day, these profit centers, they're going to determine if they're going to defend the book, if they're going to write more, if they're going to shrink the book. And all those determinations are done in our profitability review meetings that we do with every one of our profit centers. And we're very, very religious in doing those and you can do that and have one opinion, and when it comes to reserving have a different opinion.

So, it's all intertwined and we speak from the same set of numbers and the same page, and it's all integrated between our pricing actuaries, our reserving actuaries, the profit center managers and our underwriters to make sure that we know where we're going. Do we always get it right? No, nobody is perfect, but we try to be as truthful to ourselves as possible because that determines what is going to happen to us in 2017 and 2018 and 2019.

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

Understood. And then, I guess, a follow up for Dinos. I guess in insurance, I mean, you booked above 100% combined. In terms of what you're seeing from a trend standpoint, I mean, that feels like that could be a reality where things are going forward. I'm just curious, I mean, is that something you're willing to accept writing over a longer term basis at worse than 100% combined in the insurance segment?

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

It's not a question of accepting it. At the end of the day, it's – listen, you can't shrink the company to zero. You're going to look for opportunities. Not every one of our product lines is at 100%. Don't forget we're not shooting for that number. We're recognizing that that's the outcome of the market. We're not happy about it. I'm not saying we're satisfied with that result and we've taken actions to try to improve it.

But go back to the comments that Marc Grandisson, is very, very difficult in the market environment we have to go and get a 4, 5, 6 loss ratio points improvement. I mean, if you have underwriters who can do that, just send me names, because I'd like to hire them. It's very, very, very difficult. You can't ignore.

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Now, given a market change and I think if pain continues to push people to be more realistic about the extra results that they're available in the marketplace today, you might see improvements. Between us, I don't think we're many years away from that. I think you're starting to see people to start recognizing that we're at the bottom, but at the bottom doesn't mean you need to grow at the bottom. You've got to see improvement and it has to go the other way before you can start opportunities to grow. That's the way we see the market. It's a difficult market. You've got to manage it. We're managing personnel, expectations, expenses, customer relationships, broker relationships. It's not as simple as, well, let's cut the book in half, because 100% is not an acceptable number.

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

All right. That's helpful. Thanks so much.

A - Marc Grandisson {BIO 4369887 <GO>}

Welcome.

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

You're welcome.

Operator

I'm not showing any further questions at this time. I would now like to turn the conference over to Mr. Dinos Iordanou for closing remarks.

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

Well, thank you, Liz. It's exactly 12:00, so it's lunch time. So, on the menu today is dolmades. So, thank you all for listening. I'll see you next quarter.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes the program. You may all disconnect.