Q3 2013 Earnings Call

Company Participants

- Dinos Iordanou, Chairman, President, CEO
- Mark Lyons, EVP, CFO, Treasurer

Other Participants

- Arash Soleimani, Analyst
- Charles Sebaski, Analyst
- Greg Locraft, Analyst
- Ian Gutterman, Analyst
- Jay Gelb, Analyst
- Josh Shanker, Analyst
- Michael Nannizzi, Analyst
- Mike Zaremski, Analyst
- Rob Bottoms, Analyst
- Ryan Byrnes, Analyst
- Vinay Misquith, Analyst

Presentation

Operator

Good day, ladies and gentlemen, thank you for standing by. Welcome to your Q3 2013 Arch Capital Group earnings conference call with Mr. Dinos Iordanou and Mark Lyons. My name is Marie and I will be your operator for today.

At this time, all participants are in a listen-only mode, and later we will conduct a question-and-answer session and instructions will follow at that time. However, before the Company get started with this update, management wants to remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the federal securities laws.

These statements are based upon management's current assessments and assumptions and are subject to a number of risks and uncertainties. Consequently, actual results may differ materially from those expressed or implied. For more information on the risks and other factors that may affect future performance, investors should review periodic reports that are filed by the Company with the SEC from time to time.

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

Management also would make -- 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.

But now, I would like to hand the call over to Mr. Dinos Iordanou. Please proceed.

Dinos Iordanou {BIO 2397727 <GO>}

Thank you, Marie. Good morning, everyone, and thank you for joining us today.

We had a good Third Quarter from just about every perspective. Earnings were solid, driven by excellent underwriting results. On a consolidated basis, our premium revenue grew by approximately 12% on both gross and net basis, although there were noteworthy items that I will get into in a few minutes.

On an operating basis, we earned $1.10 per share for the quarter, which produced an annualized 11% return on equity for the Third Quarter. On a net basis -- on a net income basis, Arch earned $0.80 per share, which corresponds to a 9% annualized return on equity.

Reported net income was adversely affected by foreign exchange losses. These losses rose from the quarterly effects of evaluating our insurance liabilities that are settled in foreign currencies. As you may know, changes in the value of investments used to fund these liabilities are reflected as a direct change in shareholders' equity, and accordingly, foreign-exchange movements did not have a significant effect on book value per share.

Our reported underwriting results in the Second Quarter were solid, as reflected by a combined ratio of 86% that were aided by better-than-average performance on cat underwriting and continued favorable prior-year reserve development.

Net investment income per share on a reported basis declined to $0.49 per share, reflecting the effects of lower yields available in the financial markets and our total return approach to investments.

Our operating cash flow for the quarter was $239 million, a $96 million decrease from the same period last year, substantially due to higher paid losses, including claim payments on prior-year cat events.

The total return of the investment portfolio was 143 basis points, inclusive of fluctuations in foreign exchange rates. Our book value per common share increased by 4.2%, primarily due to our operating performance.

During the Third Quarter, the insurance market continued to attain rate increases, although they moderated somewhat relative to the first half of this year. In our US insurance operations, which gives us a good indication because we have more granular data, we experienced rate increases in the quarter that provided 170 basis points of expected margin improvement. This is as compared to business return of a year ago.

The movement of business from the admitted market back to the E&S market continued. On prior calls, we mentioned our expansion into the binding authority insurance business that caters to small E&S accounts written through the wholesale distribution channel. This group is off to an excellent start. They are producing an increasing level of business and have begun to leverage Arch distribution platform and relationships to access more opportunities.

In our view, on an absolute basis, while most longtail casualty business still require further rate improvements to meet our return requirements, some segments are approaching rate adequacy.

With regard to new versus renewal pricing, based on our monitoring systems, we saw no changes on a relative basis from what we have reported in the last quarter.

On the reinsurance side of the business, in terms and conditions we see pressure in three areas. First, in property cat, alternative capacity is putting pressure on rates. Second, although the profitability of primary insurance has improved, cedents has -- have pressed successfully for additional ceding commissions, generally in the range of 1 to 2 points, so the improved economics remain with the primary insurers. Finally, cedents are moving to excess of loss instead of pro rata coverage, which increases the risk to reinsurance of arbitrage by cedents.

Net written premiums of the reinsurance segment grew by 24%, while the insurance segment increased their net written premiums by 4%. The increase in the reinsurance segment stems primarily from one significant treaty. As was the case in 202 [ph] and 203 [ph], certain cedents, based on their financial conditions, are looking to the reinsurance market to provide capital. The treaty I just mentioned fell into this category, and we recorded approximately $55 million of written premium in the Third Quarter of 2013, including the transfer of approximately $40 million of an earned premium.

In addition, as you may know from press reports, we entered into a transaction with Ethniki, the insurance subsidiary of the National Bank of Greece. Although the reserves reinsure on a nominal basis were in excess of EUR400 million, under US GAAP this transaction will be accounted on a deposit basis. Due to the long-term nature of the liabilities, the expected margin will be earned over several years and is not expected to have a material effect on any individual year.

The insurance segment had a net written premium growth, predominantly emanating from their US operations, which represent approximately 75% of their worldwide volume this quarter. The US operations grew net written premium by nearly 15%, partially offsetting strategic reductions elsewhere in the world. The US growth came predominantly from increases in exposures on existing accounts, new business, including our contract binding business, and, of course, rate increases.

Groupwide, on an expected basis we continue to believe the ROE on the business we underwrote this year will produce an underwriting year ROE in the range of 11% to 13%.

Let me now update you on the status of our previously announced agreement to acquire certain assets of PMI and CMG. We are continuing to work on obtaining the regulatory and other approvals required to complete the transaction. As part of that process, we are continuing our discussions with the GSEs in order to obtain their approval of Arch as an eligible mortgage insurance carrier.

This process takes time. If the required approvals are obtained, it is expected that the transaction will close near the end of 2013 or during very early part of 2014.

Before I turn it over to Mark, discuss our PMLs, it is worth noting that our cat PML aggregates reflect business bound through October 1, while the premium numbers included in our financial statements are through September 30.

As of October 1, 2013, our largest 250-year PMLs for a single event increased slightly to $868 million in the Northeast, or approximately 17% of our common shareholders' equity, while Gulf PMLs increased somewhat to $736 million, where our Florida Tri-County PML now stands at $650 million.

I will now turn it over to Mark to comment further on our financial results, and then after Mark, we will take your questions. Mark?

Mark Lyons {BIO 6494178 <GO>}

Thank you, Dinos. Good morning, all.

The consolidated combined ratio for this quarter was 86% even, with 2.5 points of current accident year cat-related events, which are net of reinsurance and reinstatement premiums, compared to the 2012 Third Quarter combined ratio of 90.2%, which reflected 3.7 points of cat-related events.

Losses in the 2013 Third Quarter from catastrophic events totaled $19.5 million, emanating from a variety of events around the world. The 2013 Third Quarter consolidated combined ratio also reflected 8.2 points of prior-year net favorable development, again net of reinsurance and related acquisition adjustments, compared to 7.1 points of prior-period favorable development on the same basis in the 2012 Third Quarter.

This results in a 91.7% current accident quarter combined ratio, excluding cats, for the Third Quarter of 2013, compared to a 93.6% accident quarter combined ratio in the Third Quarter of 2012. The 2013 accident quarter combined ratio, excluding cats, for the reinsurance segment was 83.7%, compared to 84.3% in the 2012 Third Quarter.

In the insurance segment, 2013 accident quarter combined ratio, excluding cats, improved to 97.0%, compared to an accident quarter combined ratio of 99.6% in the Third Quarter of 2012.

Approximately 80% of the net favorable development in this quarter was from the reinsurance segment, with approximately 60% of that due to net favorable development on short-tailed lines concentrated in the more recent underwriting years. The other 40% of the reinsurance segment's net favorable development was attributable to longer-tailed lines spread evenly over all underwriting years 2010 and prior. The remaining aggregate 20% of net favorable development was attributable to the insurance segment and was primarily driven by short-tailed lines from the more recent accident years.

Similar to prior periods, approximately 69% of our consolidated $7.1 billion of total net reserves for loss and loss adjustment expense are IBNR or additional case reserves, which is a fairly consistent ratio across both the reinsurance and insurance segments. The insurance segment accounts for 63% of total net loss and loss expense reserves, and the reinsurance segment, the balance of 37%.

On a consolidated basis, the Third Quarter of 2013 expense ratio was 32.3%, compared to the prior year's comparative quarter of 30.9%. This 140 basis-point increase is driven by a 150 basis-point rise in the acquisition expense ratio, while the operating expense ratio dropped 10 basis points.

The acquisition expense is a combination of higher ceding commissions on proportional treaties within the reinsurance segment, along with some lift in insurance segment premium taxes and ceded treaty commission adjustments on older years.

The insurance segment expense ratio went up 50 basis points from 32.5% to 33% quarter over comparative quarter, with the acquisition ratio up 120 basis points, while the operating expense ratio dropped 70 basis points. As stated, the rise in the acquisition ratio was driven by increases in contingent commissions on ceded treaties, along with increased premium taxes.

The reinsurance segment expense ratio went up 280 basis points from 28.5% to 31.3% quarter over comparative quarter, with the acquisition ratio up 180 basis points and the operating expense ratio up 100 basis points. The acquisition increase was due to a change in product mix, along with higher ceding commissions on quota share treaties. The operating expense ratio reflects incremental expenses due to certain platform expansions, as commented on last quarter.

Our US insurance operations achieved a 4.7% effective rate increase this quarter, which translates into the margin expansion of 170 basis points that Dinos referenced earlier. This is a 20 basis-point improvement over the 150 basis-point expansion achieved during the Second Quarter of 2013, driven mostly by changes in mix.

These figures represent the excess of written effective rate increases over estimated loss trend and provide continuing evidence of improving market conditions. This average range from having some margin contraction in some units, such as miscellaneous facilities healthcare and some professional liability areas, to large improvements in our private, mostly primary executive assurance growth and middle-market operation.

Other areas of note in margin expansion were E&S casualty and our program businesses. Property lines experienced low single-digit rate increases again this quarter, and therefore, like last quarter, did not experience additional margin expansion.

Specialty casualty, workers' compensation, and national account businesses have now experienced 10 successive quarters of rate increases, whereas our executive assurance, middle market, and alternative asset protection books, along with our retail construction unit, have each experienced nine consecutive quarters of rate increases. Furthermore, our excess workers' compensation and umbrella books have now enjoyed eight consecutive quarters.

As always, we make capital allocation decisions based on our view of the absolute returns and not relative improvements alone. For example, although our insurance property business did not experience margin expansion this quarter, we continue to estimate healthy returns for this line.

The ratio of net written premiums to gross written premiums in the quarter on a consolidated basis was 80.9%, compared to 80.6% a year ago. In the reinsurance segment, the net to gross ratio was 95% in 2013 Third Quarter, driven by an increased use of retro covers, compared to 97.2% a year ago.

The insurance segment was essentially unchanged at a 73.5% ratio as they maintain their ongoing strategy to grow the less volatile, smaller count businesses in the current environment and reduce exposure in higher-severity businesses.

The total return on our investment portfolio was a reported positive 143 bps in the 2013 Third Quarter, primarily driven by equities, high-yield bonds, and alternative investments. Excluding foreign exchange, total return was 84 basis points.

It's worth noting that equities and alternative investments account for 14.9% of our $13.3 billion of investable assets as of September 30 of this year, which is identical to June 30, but higher than the 11.5% allocation a year ago. This allocation on a portfolio basis has the potential to ameliorate future impacts at our investment portfolio from rising interest rates and widening credit spreads.

Our embedded pretax book yield before expenses was 2.41% as of September 30, 2013, compared to 2.43% at June 30, 2013, while the duration of the portfolio shortened slightly to 2.83 years, which continues to reflect our conservative position on duration in the current yield environment.

Reported net investment income in the quarter was $66.1 million, or $0.49 per share, versus $73.2 million, or $0.53 per share, in the 2012 Third Quarter. This difference is attributable to a reduction of interest income from fixed-income securities and an increase in investment expenses relative to Third Quarter of 2012. During 2013, however, fixed-income earnings have been relatively flat each sequential quarter, as have investment expenses.

Our effective tax rate on pretax operating income for the Third Quarter of 2013 was an expense of 5.6%, compared to an expense of 3.1% in the Third Quarter of 2012. Approximately 41% of this Third Quarter tax expense, or $3.8 million, is associated with catch-up of the first two quarters to this higher effective rate. And $2 million of withholdings on equities, tax withholdings on equity securities.

The September 30 year-to-date effective tax rate on operating income, excluding some minor discrete items, is 3.3%. Fluctuations in effective tax rate can result from variability in the relative mix of income or loss reported by jurisdictions.

Our total capital was $5.84 billion at the end of this quarter, up 3.7% relative to June 30 and up 4.9% relative to year-end 2012. We repurchased only 1.3 million of share value during the quarter and 57.8 million year-to-date as of September 30. We have $712 million of authorization remaining for additional share repurchases.

Our debt-to-capital ratio remains low at 6.8% and debt plus hybrids represents only 12.4% of our total capital, which continues to give us significant financial flexibility. We continue to estimate having capital in excess of our targeted capital position.

Book value per share was $38.34 at the end of this quarter, up 4.2% versus June 30 and 5.9% relative to December 30 of 2012. This change in book value per share this quarter is led by the Company's continued strong underwriting results.

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

Questions And Answers

Operator

(Operator Instructions) Michael Nannizzi, Goldman Sachs.

Q - Michael Nannizzi {BIO 15198493 <GO>}

I guess I just had one question on your decision to pull back on property cat. I know you have talked about it in the past. We have seen a lot of other folks increasing property cat exposure this quarter. What do you see as the opportunity set there, and why is it that you're choosing to pull back in that business while maybe others are seeing an opportunity to grow?

A - Dinos Iordanou {BIO 2397727 <GO>}

You know, at the end of the day when we write any line of business, including cat, we look at opportunity by opportunity, contract by contract, and we have an expectation based on the volatility of that business what the proper return should be.

And our cat teams determined that in some areas, the erosion was more than we can stomach, so for that reason, we let some of that business go. But we are still bullish on the cat business. I don't want to give you a misleading conclusion. We still like it, but we are cautious about what our expected return should be and we continue to price it with the expectation that we're going to have very high returns because of the nature of the business and the volatility that brings. Mark, you have anything (multiple speakers)

A - Mark Lyons {BIO 6494178 <GO>}

No, you nailed it. Yes.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Are you seeing pressure from other sources ameliorate now in terms of alternative capital? Are you expecting that to change between now and 1/1, or how should we think about that?

A - Dinos Iordanou {BIO 2397727 <GO>}

I think it is -- I'm not telling you anything that the market doesn't know. The additional capital entering the market has put pressure on rates in the 10% to 15% rate reduction. That by itself has not really changed significantly the prospects of profitability, but in certain segments, like on the low end of the curve, because especially the unrated vehicles that they have to collateralize the limits, they are looking for the high rate on line business, which, of course, is on the front end of the curve.

In that part of the curve, I think, we don't find the returns attractive. Some of those returns, they have moved into the sub two-digit, high single digits. For some investors, high single digits for the cat business might be an acceptable return. I can tell you it's not for Arch, and so if we had business that it was on that low end of the curve and we're not getting the proper return, that's the business that you let go.

And of course, that will magnify, also, because the higher-rate online business also have big premium numbers, so if you don't do one or two of those, in essence you are not using a lot of PML, but you are losing a lot of premium. But the profitability is not there.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Great. Thank you, Dinos. Then, I guess one question for Mark, just on the investment portfolio. It looked like the turnover was pretty elevated again this quarter. I remember there was one sleeve of the portfolio, I think it was the treasury piece, that was turning over multiple times, as opposed to the portfolio itself turning over a significant amount. Can you update us on what might have driven that turnover this quarter and whether that should continue?

A - Mark Lyons {BIO 6494178 <GO>}

It's fairly similar, to your observation, to prior quarters. And I think what you are seeing is taking some realized gains with the expectation of improved yields on those, given where some of those purchases were made throughout the quarter. But the rate of turnover is approximately the same.

Q - Michael Nannizzi {BIO 15198493 <GO>}

And you expect that should continue from here?

A - Mark Lyons {BIO 6494178 <GO>}

It's hard to say, based on what happens in the markets. Just like in the insurance business, we are going to react to what is there, so it depends on what happens with interest rates.

A - Dinos Iordanou {BIO 2397727 <GO>}

And don't forget, our approach to investments is total returns. So if we believe that turning over the portfolio, factoring in friction or cost in doing it, it will be beneficial to us, we'll do it.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it, great. Thank you very much.

Operator

Greg Locraft, Morgan Stanley.

Q - Greg Locraft {BIO 4221265 <GO>}

Thanks and nice quarter. Wanted to just ask about capital deployment. I think you guys are pretty explicit on when you like to buy back stock, and at 1.5 book, it doesn't seem that it fits the grid that well, given prospective ROEs. How should we be thinking about excess capital as it continues to build, within the context of your corporation and the future periods?

A - Dinos Iordanou {BIO 2397727 <GO>}

The first thing you ought to think is our ability to put that capital to work in the marketplace, because that's what we have been hired to do as managers. And hopefully, by year-end we close the MI deal.

In addition to that, I don't know if you have been following that space, not only there is opportunities for us that they're going to come with PMI and CMG, but also there is transactions in the market that both Fannie and Freddie, they are testing in putting more of the credit business to the private sector, and we intend to be a participant of that.

So the prospects of us actually deploying more capital and utilizing in our business, including the mortgage insurance space, it's very high.

Also, as you have seen with the two transactions that we have done in the Third Quarter, the Ethniki transaction, which is significant, EUR400 million of reserves, and the Tower Group transaction, we are seeing other transactions of similar nature and similar size. I'm not predicting anything, these things are lumpy. Sometimes you are successful in landing them and sometimes you are not, but I am optimistic in utilize more of our capital in the business going forward.

Absent of that, we will refer back to share repurchases and we will not rule out an extraordinary dividend, if that's appropriate to return capital to shareholders. We will be good stewards of capital. We don't try to hoard it, but I can tell you when I look into the future, I see opportunities, so I'm not going to be too anxious to let that capital go right now.

Q - Greg Locraft {BIO 4221265 <GO>}

Okay, okay, very thorough answer. Just one follow-up on that. So it sounds like the core business is where you want to deploy it and you are seeing good opportunities, so in a way, we should be growing the core faster, prospectively, (multiple speakers)

A - Dinos Iordanou {BIO 2397727 <GO>}

Given the market opportunities -- don't forget, the mortgage insurance space is going to eat up some of our capital. We've got to fund those, and like I said, the opportunity is not only with what we are going to write direct through PMI and CMG, it's also these transactions, the bulk transactions, that the GSEs are putting into the marketplace.

Q - Greg Locraft {BIO 4221265 <GO>}

Yes, yes, okay, good. Then, you actually had mentioned buybacks ahead of a special dividend. Would you reverse that at this particular price? Again, I think you guys are somewhat valuation sensitive on the buyback front?

A - Dinos Iordanou {BIO 2397727 <GO>}

Yes. We are. We are looking at kind of a light post, a guiding post, that says we will recover it within three years is the right mix. But we still believe there is a lot of intrinsic value in the Company, so it will not stop us driven by our stock at 150 [ph] multiple.

Q - Greg Locraft {BIO 4221265 <GO>}

Okay. Okay. Then last, just on the special dividend, it sounds -- you brought it up. You guys don't like a regular dividend. How do you compare and contrast a special versus a regular, and what caused you to do a special?

A - Dinos Iordanou {BIO 2397727 <GO>}

A regular dividend is not a way to manage capital, right? This is a capital-intensive business. In the soft cycle, you have a lot of excess and you've got to return it to shareholders. And when things get into a very good cycle, you probably -- you can utilize as much capital as you can get your hands on.

So by introducing an ordinary dividend of 1% or 2%, it is not really going to manage your capital. It might expand your shareholder basis, because some funds might not invest unless you're paying a dividend. But we don't think in those terms. We don't try to make actions because they're going to be a reaction by investors.

Our focus is what is the proper way to run the Company. How the capital structure needs to behave, depending if we're in a soft or in a hard cycle. How much leverage we have in the capital structure. All those thoughts go into it, and how much excess capital we need to keep, because we got our high ratings and also we want to have the financial flexibility, because when the markets turn, they turn very quickly.

This gradual improvement in the market is not what I will call a hard turn to a hard market. But if you have continuation of pressures as we have seen with some small companies because of either reserve deficiencies or other issues they have, if that for some reason accelerates, you're going to see a hard market. We don't see it in the next year or two, but we always -- our responsibility is to be prepared for it. And we take that all into consideration before we make these decisions.

So we never believe on an ordinary dividend. Now, if you have excess capital and let's say you believe that the marketplace is not giving you the right multiple, you might consider the extraordinary dividend because it's a quick way to return capital to shareholders and let them decide what to do with it.

A - Mark Lyons {BIO 6494178 <GO>}

Greg, I would just add to Dinos. You get a high-level look at it, but any special dividend would be the excess over all contemplated uses.

When Dinos says he is more optimistic, it is because marketplace opportunities, we have higher odds in our minds that these things might close. So a special dividend would just be any potential uses outside of that, plus the guardian of our high ratings, if there is any left over, only that would be considered discussion worthy.

Q - Greg Locraft {BIO 4221265 <GO>}

Yes, great. Yes, it's very clear that you will be really busy building out the core, as you have stated -- the core underwriting operations, so that's great. Thanks for the thorough answers, guys, and great quarter.

Operator

Arash Soleimani, KBW.

Q - Arash Soleimani {BIO 18869554 <GO>}

Just a couple quick ones here. First, you had mentioned earlier on the call that you are seeing better economics on the primary side, so just one question there is to what extent are you benefiting from the primary economics there and to what extent are those economics then pressuring your reinsurance side? I am just qualitatively trying to assess the net impact on the overall business.

A - Dinos Iordanou {BIO 2397727 <GO>}

The way I will answer is 60% of our business is primary, 40% is reinsurance. We don't have any target. It can switch, it depends on market conditions.

What we see today, and it's fair to say I think we had phenomenally good results in the reinsurance market, and that is not deteriorating. What I am saying is basically we're not getting incremental improvement on the reinsurance sector because when we talk to cedents, they have seen the improvement on the insurance side, they want to keep it. It is sticking to their ribs, not ours.

But having said that, it doesn't mean that transactions that do the worst than they were a year ago. They just don't have the improvement. All the improvement stays with the primary.

On our insurance group, as you have seen from the numbers that Mark mentioned, we have seen their margin and their combined ratio on an accident-year basis coming down, and as the market improves, we expect that to continue.

So on the 6% of our business, we are getting the benefit of it. On the reinsurance, I think we are remaining steady. The reason that we haven't changed the 11% to 13% ROE, when you put everything in the hopper, we see improvement on the insurance side, we see steadiness on the reinsurance, but we are losing a bit on the cat business from a margin point of view, plus we are losing a bit on the investment income side. So when you put it all together, I didn't see a reason for us to go beyond the 11% to 13%, because that's what the numbers indicate.

Q - Arash Soleimani {BIO 18869554 <GO>}

Thanks, that's helpful. And just my next question, how should we think about risk-based capital for mortgage insurance?

A - Dinos Iordanou {BIO 2397727 <GO>}

I'll give you the short answer. The FHA is in the process of coming up with new capital requirements. We know that the capital requirements are going to be somewhere between 15 times to 20 times value at risk. So we don't know exactly where they are going to come, but basically we believe the business is still very attractive from the low end of that range to the high end of that range.

And I don't know how long the transition period is going to be, especially for some of the existing mortgage insurers who right now, they are not meeting those thresholds from a capital point of view. So there might be a transition period, a year or two for people to come within those ranges, but we don't know that yet. We are waiting for the regulator to come with the requirements.

Q - Arash Soleimani {BIO 18869554 <GO>}

Okay. Great. Thanks so much for the answers.

Operator

Vinay Misquith, Evercore.

Q - Vinay Misquith {BIO 6989856 <GO>}

The first question is on the primary insurance operations. That's grown at a healthy pace of 14% for the US. Just curious as to what is happening there, and also wanted to know -- you mentioned that more lines are reaching adequate profitability. Do you think that you could open the spigot next year and write more business?

A - Dinos Iordanou {BIO 2397727 <GO>}

Growing at double digits in the US, that's pretty good growth. And like I said, it's not only coming from -- first of all, some of our customers, they are seeing a slight improvement in their business, so the exposure bit goes up, so you get a little more premium. On top of it, you have the rate increases. That helps.

And of course, we are gaining a bit of a market share. And the market share we are gaining predominantly is coming in the small E&S market through our binding authority business and, I think, in our program business. A lot of our program administrators, they have seen both growth in exposure units and very good rate increases. So the combination of those gives you that.

Now, we expect that to continue, but you never know. The insurance business has always been very, very competitive, so I don't know what the competition is going to do. If there is no changes and the trajectory continues to go, we expect to continue to grow, especially in the US.

That's not the same story in other parts of the world. As a matter of fact, you saw that we decided to shrink in some other parts of the world, the UK and Australia and continental Europe in some lines, professional liability lines and D&O lines, et cetera.

So we will look at it. We will look at the profitability, and then, growth is not what drives us. I think bottom-line results is what drives us. But we are not bashful. If we see opportunity, we will seek it and we will go out and write the business. Go ahead, Mark.

A - Mark Lyons {BIO 6494178 <GO>}

Just as a follow-up to Dinos' comments, I would note that there are some similarities in the two major areas in the US where there was growth, one, programs, and the second, contract binding, as Dinos pointed out.

First off, they are all -- both smaller accounts. They get a good overall spread. It's more stable. It's less volatile. As a result, we keep a massive amount of that net, so compared to other lines of business that might be getting similar rate increases, this will stick to the ribs more, a lot more, than they would.

Q - Vinay Misquith {BIO 6989856 <GO>}

Sure, that's helpful. Dinos, you sounded more bullish about reinvesting the money into business. And yet, it seems on the P&C side, there are not as many opportunities. So am I reading this correctly that you're looking more at the mortgage insurance and these Fannie/Freddie transactions and one-off transactions that we can't really see where you propose to deploy the capital?

A - Dinos Iordanou {BIO 2397727 <GO>}

Yes, you got it absolutely right. You continue to do your homework, what can I tell you.

Q - Vinay Misquith {BIO 6989856 <GO>}

. All right, great. And one, I think, for Mark. Actually, Mark, the margins are quarter over quarter in the reinsurance segment. I mean, the loss ratio went up a tad. Just curious whether that was because of the new quota share reinsurance transaction.

A - Mark Lyons {BIO 6494178 <GO>}

Good question. It had a marginal impact. I'd prefer to look at the combined ratio impact more than each piece, but happy to address that.

On the acquisition side, as we commented, the acquisition quarter over quarter was up 180 basis points, but if you control for that large transaction, it would be 130 basis points. It was a 50 basis-point impact on the net acquisition ratio, but you really can't stop there because you got to look because of the different premium base and what it does on your operating expense ratio, and that really takes it back to another 60 basis points the other way.

And there is a point difference because of just pure premium size and where the loss ratio is on that, as well.

So on a combined ratio point of view, it's hardly noticeable. On a component point of view, it had 50 basis points on acquisition. So depending on where you're looking, that is the answer.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay, that's helpful. Thank you.

Operator

Mike Zaremski, Credit Suisse.

Q - Mike Zaremski {BIO 20606248 <GO>}

A couple of numbers questions, probably for Mark. Other expenses were well below previous-quarter levels, and also, any equity-method investment returns were also -- I think the absolute return levels were healthy, but also well below prior quarters. Any guidance on how to think about those going forward?

A - Dinos Iordanou {BIO 2397727 <GO>}

Mike, I will let Mark answer it, but I know numbers, too. I don't

A - Mark Lyons {BIO 6494178 <GO>}

Dinos wants to jump in on numbers questions and I want to jump in on underwriting questions. .

A - Dinos Iordanou {BIO 2397727 <GO>}

Go ahead, Mark.

A - Mark Lyons {BIO 6494178 <GO>}

So first, just a clarification of your question. When you said expenses, are you talking investment expenses or operating expense?

Q - Mike Zaremski {BIO 20606248 <GO>}

The operating expenses, the other expense line item. I think it was $7.8 million?

A - Mark Lyons {BIO 6494178 <GO>}

Okay. Well you will -- I think the insurance group, it was -- I mean, it was an improvement in the operating ratio, but that was really driven by the denominator more than anything else. There wasn't big movement in it.

Where you saw some movement was in the reinsurance group because of some platform expansions, and as we have said in some other quarters, there is always some differences in quarter to quarter because of equity and how equity is recognized. Especially with retirement-eligible people, it creates some differences.

And there is a little bit, of course, of some front-ended mortgage-related acquisition expenses that hit prior to receiving the premium would be in this quarter.

A - Dinos Iordanou {BIO 2397727 <GO>}

We have no revenue yet from that, but we're building a sales force. We're building -- so we are a little bit ahead on the MI because when that transaction closed, we want to be able to hit the road running, not putting our shorts in the locker room.

Q - Mike Zaremski {BIO 20606248 <GO>}

Got it. And on the equity method investment income?

A - Mark Lyons {BIO 6494178 <GO>}

When it comes to that, there is not a ton that really jumps into my mind. That stuff from quarter to quarter can be all over the place. So we do various analysis, of course, on it, like you might think, but it's really -- there is no underlying causative trends that would be predictive if you are thinking in a forward sense.

Q - Mike Zaremski {BIO 20606248 <GO>}

So we should just think of it as alternative investments?

A - Mark Lyons {BIO 6494178 <GO>}

You should look at it as pretty lumpy. You should expect it -- it is like D&O business. It is going to be very, very lumpy. On a long-term basis, it's predictable. Quarter by quarter, it's not.

Q - Mike Zaremski {BIO 20606248 <GO>}

Okay. And last question. Could you clarify the ultimate size and duration of the Tower Group arrangements, and is there any elements of first-mover advantage if that business doesn't renew with the same party next year?

A - Dinos Iordanou {BIO 2397727 <GO>}

The business is July on to year-end. So we don't know how much -- because of the downgrade, we don't know how much they're going to write in the Fourth Quarter.

But in essence, it was the unearned premium reserve coming in, plus what they wrote in the Third Quarter and then what they're going to write in the Fourth Quarter.

After that, it depends what they want to buy, if there is any opportunities to come into an agreement on a going-forward basis, all that is up to future negotiations, et cetera. But this transaction has that finality to it. It's July 1 to December 31 of this year, including the unearned premium reserve coming for certain parts of their business. We didn't cover everything that they have.

Q - Mike Zaremski {BIO 20606248 <GO>}

Got it. Thank you.

Operator

Josh Shanker, Deutsche Bank.

Q - Josh Shanker {BIO 5292022 <GO>}

I just wanted to talk about taxes a little bit. I listened to Mark's disclosure. I am trying to understand what the true-up is, and is tax rate a little higher than it used to be, based on where you are writing business, or am I just imagining things?

A - Mark Lyons {BIO 6494178 <GO>}

The interesting thing that I found out, once I took over this job, is how tax rates can move really as a function of either where cats or where prior-period development winds up being, by jurisdiction.

Now when you -- here is the big picture. The operations in the US on both the reinsurance side and the insurance side are improving. We have been talking about that because of the margin expansion, so that's naturally going to gravitate to US-based enterprises on what remains on shore as being subject to tax.

In the quarter by itself, because of prior-period development, you got to -- you have to look at more of the skin underneath the onions as to where the prior-period development was coming from. When we look at -- it is always annualized. We never forecast prior-period development on a go-forward basis. So when it actually emerges in the quarter and we have to react to it, be cognizant of where it emanated from by jurisdiction and give it the appropriate tax rate.

Q - Josh Shanker {BIO 5292022 <GO>}

Okay. And so (multiple speakers)

A - Dinos Iordanou {BIO 2397727 <GO>}

Let me give you an example. This way, you can focus on the example. If euro cat business a year ago or two years ago, and for whatever reason, the reserves, they were higher than needed, and now you're dropping those reserves in this quarter, that business will show a lot of underwriting profit, and for that reason, you're going to pay the appropriate tax because it is emanating from the US.

So just an example just to see as to how improvement in results and increased profitability will increase the tax by depending where you are writing the business.

Q - Josh Shanker {BIO 5292022 <GO>}

And so, as a proportion over time, would we expect if you guys are writing less reinsurance next year that the tax rate is probably going to go up a little bit more?

A - Mark Lyons {BIO 6494178 <GO>}

Quite frankly, I can't really predict that. But let's follow on to Dinos' example, for a minute.

First off, we like to use the cat example, but cat is only a piece of the pie here. It is all lines of business and what prior years the prior-period development is coming from.

So for example, next quarter, until the analyses are done I can't tell you what jurisdictions, what lines of business, and what accident years are going to show pluses or minuses. I'm not being coy. I'm just simply saying until the analysis is done, I can't tell you.

A - Dinos Iordanou {BIO 2397727 <GO>}

But directionally, Josh, you are in the right queue because if a US operations, they're improving in profitability, the tax pie is going to be higher.

Q - Josh Shanker {BIO 5292022 <GO>}

Okay. And when I think about mortgage insurance, the taxing arrangements, how is that going to look on your tax rate going forward?

A - Dinos Iordanou {BIO 2397727 <GO>}

No different than anything else we do in the US. We generate a lot of the business in the US. We got to pay the US tax.

Q - Josh Shanker {BIO 5292022 <GO>}

But I think it will be reinsuring, trying to reinsure part of that back to Arch Reinsurance in Bermuda?

A - Dinos Iordanou {BIO 2397727 <GO>}

Yes, there is some arrangements with Arch Re and other reinsurance. I mean, we don't have the entire reinsurance structure in front of us. We got to close a transaction, and then we will see as to how we are going to reinsure the business.

A - Mark Lyons {BIO 6494178 <GO>}

But I will remind you, though, since you are asking a tax question, we don't expect it to be accretive until year three, maybe later into year three. So just keep that in mind.

Q - Josh Shanker {BIO 5292022 <GO>}

Understood.

A - Dinos Iordanou {BIO 2397727 <GO>}

The earnings are not going to be on day one. It might be very profitable business, but by the time it starts dropping to the bottom line, it will take a couple years.

Q - Josh Shanker {BIO 5292022 <GO>}

Good luck landing that ship, I guess, if you (multiple speakers)

A - Dinos Iordanou {BIO 2397727 <GO>}

Thanks, thank you.

Q - Josh Shanker {BIO 5292022 <GO>}

Take care, thank you.

Operator

Charles Sebaski, BMO Capital Markets.

Q - Charles Sebaski {BIO 17349221 <GO>}

Just one more follow-up on the mortgage insurer, and how you view that business, where it could be comparatively to the rest of the business? Do you have lines on -- you would cap it at certain size? What could it grow to as a percentage of the overall book that you're doing now?

A - Dinos Iordanou {BIO 2397727 <GO>}

Listen, our expectations will be somewhere between 15% and 20% of what we do. It can be as high as one-third. We won't let it go beyond that because, like I said, we're in three businesses. We are in the reinsurance business, we're in the insurance business, and with the mortgage insurance business, both insurance and reinsurance. So that's the three legs of the stool.

It balances a little better. I used to balance on two legs, now I got three. But at the end of the day, we like to be diversified. We don't like to overload -- I don't care if it's the cat business or anything else -- and put a lot of our eggs in one basket.

And the way we structure that, if the opportunity is bigger, we have abilities to bring additional investors into the mix and not own 100% of the mortgage insurance enterprise. We can own 80% or 70% with other investors that showed interest to come and partner with us.

So we got a lot of flexibility there. But my projections over the next three to five years, think of it as 15% or 20% of our business. If things happen the way I envision them to happen, that's what's going to be.

Q - Charles Sebaski {BIO 17349221 <GO>}

And would that be both on top line and operating income?

A - Dinos Iordanou {BIO 2397727 <GO>}

The top line is different than the P&C world. But the operating income, once it gets into steady state, it's going to be there and might be a little north of that.

A - Mark Lyons {BIO 6494178 <GO>}

Yes, I think on that range of the 15% to 20%, there are so many unknowns, but to the extent that the core business gets harder quicker, of course there is going to be more growth there relative to mortgage insurance that might be on the lower end of that 15% range.

As the business stabilizes, though, which is the whole reason we went into it, it should become a higher proportion of the net income.

Q - Charles Sebaski {BIO 17349221 <GO>}

Okay. Just a little different side, in the insurance business, in the professional lines, and you may have said this earlier and I missed it, two out of the last three quarters, you are seeing some pullback. Is this on the basis of pricing not being adequate where you guys want? Is there some sort of change or anything different going on in why we are seeing the contraction there?

A - Mark Lyons {BIO 6494178 <GO>}

It's exactly -- it's really what you said and what we said the last couple of quarters. This was a purposeful pull back out of the UK, continental Europe, and Australia, mostly because we, through repeated attempts, could not get the rate that we were seeking. And with that inability to do it, it doesn't make sense. So we purposely decided to pull back, and you should expect to see that next quarter as well.

Q - Charles Sebaski {BIO 17349221 <GO>}

Great. Well thank you very much.

Operator

Ryan Byrnes, Janney Capital Markets.

Q - Ryan Byrnes {BIO 16902592 <GO>}

I guess in your press release here, you noted that the underlying loss ratio in the reinsurance segment was helped by the mix of more mortgage insurance business. Is that something you're going to look to do -- to continue doing next year? I just want to see if you guys have the appetite -- risk appetite to do it on both the insurance and reinsurance side going forward?

A - Dinos Iordanou {BIO 2397727 <GO>}

I don't totally understand your question. The mortgage insurance will be a low loss ratio business, so as we write more of that, that will have the effect on the loss ratio on the reinsurance business because that is where we book it.

But loss ratios for us, it depends always on our mix, and since we are a company who changes mix more often than most, the loss ratios, that's why we focus more on profitability and combined ratios, because the components of loss ratio, expense ratio, they're going to be moving around, depending on what we do.

What's coming in for the reinsurance business is the transactions we did with one major mortgage insurer that we wrote a big quota share for them for two years in a row. And that, it will continue to have that effect of lowering the loss ratio on the reinsurance sector.

Now, the second part of your question was?

Q - Ryan Byrnes {BIO 16902592 <GO>}

I am just trying to figure out if you're writing on the reinsurance side, it sounds -- I guess I don't know the expense ratio, but it sounds profitable. Is it just the ramp why it will take three years on the insurance side? Just trying to figure out why (multiple speakers)

A - Dinos Iordanou {BIO 2397727 <GO>}

Because you got to build a portfolio, and as you are building the portfolio, it's how you are earning the premium.

Don't forget, the mortgage insurance duration is about seven years, six, seven years, it depends. Because these are loans that mandated to buy mortgage insurance that they have less than 20% down payment, and some of these loans, once the amortization schedule comes down and they have more than 20% equity in the house, they drop their insurance because they are not required to have it. And for that reason -- but you're getting a piece of the premium with every mortgage payment. So it will take you quite a bit of time to ramp it up.

Now, when you do a reinsurance transaction, you are already reinsuring an existing book that is already in steady state. That's the difference between the two.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Got you, great.

A - Mark Lyons {BIO 6494178 <GO>}

But if your question was, do you anticipate us continuing to write on both sides of the house, insurance and reinsurance, the answer is yes.

A - Dinos Iordanou {BIO 2397727 <GO>}

Yes.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Great. Sure, go ahead. Okay, I guess, then just separately, just one numbers item. With the -- I guess it looks like it's about -- just under $40 million of unearned premium left in the Tower transaction, just want to figure out how we should think about how that will earn over the next couple of quarters. Is it mainly for 4Q, 1Q, 2Q, and then a little bit in 3Q/4Q? Is that the right way to think about it?

A - Dinos Iordanou {BIO 2397727 <GO>}

Yes, the unearned premium depends when they wrote the business. They might have wrote it in the First Quarter, Second Quarter, maybe even a bit in the Fourth Quarter of 2012.

So the Fourth Quarter in 2012 already earned fully, right? Because by the end of that Third Quarter this year, it earned, so it earned in our Third Quarter this year. But what they wrote in the first and Second Quarter will continue to earn until it cycles over to next year. All the policies that they wrote, they are annual policies. So the earning pattern is 12 months.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Got you. Thank you.

Operator

Ian Gutterman, BAM.

Q - Ian Gutterman {BIO 3106649 <GO>}

Hi. Good morning.

A - Dinos Iordanou {BIO 2397727 <GO>}

Hi, Ian, you are getting into lunch hour. My souvlaki sandwich is getting --

Q - Ian Gutterman {BIO 3106649 <GO>}

I will be quick. I only have two. First, on the Tower transaction, obviously you have that downgrade clause. They have been downgraded. Why are you still committed to this deal? Have you had any change of -- what would make you decide to back out, given they have been downgraded?

A - Dinos Iordanou {BIO 2397727 <GO>}

The business we underwrote, they were already wrote before they were downgraded, the bulk of it, right? It is the unearned premium, plus what they did in the Third Quarter.

We don't know how much they're going to write in the Fourth Quarter.

But from an underwriting point of view, we don't expect them to deteriorate. They might have less volume because some people might not, but they are not prepared as a company to go and just start slashing rates. In the condition they are, they are going to try to retain as much business as they have and they try to maintain the rating structures they have.

So that's our expectation, that's part of our discussions we have with them. But the Fourth Quarter business, highly unpredictable as to how much is it going to be. We were originally estimating about $17 million, $18 million for the Fourth Quarter. It might be less than that, significantly less, we don't know. Only time will tell. But overall, we are pleased with the entire transaction.

Q - Ian Gutterman {BIO 3106649 <GO>}

Got it. Then, the other one on the investment portfolio, Mark's comment about the equities and the alternatives giving you protection from fixed income if interest rates go up. I guess I'm wondering, is that really the right way to think about it? It would seem -- it's probably a reasonably consensus view that if interest rates go up, equity markets sell off, credit spreads gap out. It would seem they would be all fairly highly correlated. So is it really going to protect you?

A - Dinos Iordanou {BIO 2397727 <GO>}

But don't forget, you are assuming our alternative investments is in the equity world only. We have a lot of high-yield fixed-income stuff that it will be uncorrelated with that. We have special funds that they invest in special situations.

One that I can mention to you is we do the development and managing of parking spaces in China. So I don't think that correlates with anything.

So we have some investors -- investments that they are in sectors that we have floating rates. So the investments will go and follow floating rates. So think about it as more how much of our asset allocation should be in alternatives before you decide as to what type of alternatives we're going to do and what the expectation.

Now, a lot of what we do in alternative investments, we have an expectation of double-digit returns. So we are looking for 10% returns or better when we make these investments. That, of course, there is -- you can't be a fool. If you are investing on something with expectation of 10%, you are taking a lot more risk, and we understand that. But it will supplement the less risky stuff we do that we are getting 2% return.

A - Mark Lyons {BIO 6494178 <GO>}

And there has already been a couple of quarters of exactly what Dinos just said, about the performance and the extent of the performance of some of these alternatives as an ameliorating factor.

Q - Ian Gutterman {BIO 3106649 <GO>}

Got it. Thanks so much. Enjoy your lunch.

Operator

Rob Bottoms [ph], Capital Returns [ph].

Q - Rob Bottoms {BIO 18003156 <GO>}

Ian Gutterman asked my question. Thank you.

A - Dinos Iordanou {BIO 2397727 <GO>}

. Rob, it's all right. I got an extra sandwich for you.

Operator

Jay Gelb, Barclays.

Q - Jay Gelb {BIO 21247396 <GO>}

It will be a quick one. The mortgage insurance opportunity, when you look three years out, when that can be accretive, what type of combined ratio assumption do you think is reasonable?

A - Dinos Iordanou {BIO 2397727 <GO>}

Don't think about combined ratios. Think about ROE. I think the business will produce mid double-digit ROEs.

Q - Jay Gelb {BIO 21247396 <GO>}

So does that mean mid-teens?

A - Dinos Iordanou {BIO 2397727 <GO>}

Yes.

Q - Jay Gelb {BIO 21247396 <GO>}

Okay. Thank you.

Operator

Thank you. There are no further questions.

A - Dinos Iordanou {BIO 2397727 <GO>}

Thanks, everybody. Enjoy your lunch, and looking forward to speaking with you next quarter. Have a good afternoon.

Operator

Thank you, ladies and gentlemen. That concludes your conference call for today. Thank you for joining us and you now may disconnect. Thank you.