Q1 2014 Earnings Call

Company Participants

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

Other Participants

- Amit Kumar, Analyst
- Brian Meredith, Analyst
- Ian Gutterman, Analyst
- Jay Cohen, Analyst
- John Hall, Analyst
- Kai Penn, Analyst
- Meyer Hills, Analyst
- Michael Nannizzi, Analyst
- Ryan Byrnes, Analyst
- Unidentified Participant, Analyst
- Vinay Misquith, Analyst

Presentation

Operator

Good day, ladies and gentlemen. Before the Company gets started with its update, management wants to first remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the federal securities laws. These statements are based upon management's current assessments and assumptions. And are subject to a number of risks and uncertainties. Consequently, actual results may differ materially from those expressed or implied.

For more information on the risks and other factors that may affect future performance, investors should review 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 1995. The Company intends the forward-looking statements in the call to be subject to the safe harbor created thereby.

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

I would now like to turn the presentation over to your host for today, Mr. Dinos Iordanou. And Mr. Mark Lyons. Please proceed.

Dinos Iordanou {BIO 2397727 <GO>}

Thanks, Glenn. Good morning, everyone and thank you for joining us today. We had an excellent First Quarter from an underwriting perspective and we were also successful in launching two strategic initiatives this past quarter.

We entered the US direct mortgage insurance marketplace and also became a reinsurance manager for Watford Re. I will comment further on these initiatives shortly. But first let me share a few observations on the quarter.

Earnings were solid and were driven by excellent reported underwriting results aided by low catastrophe activity. On a consolidated basis, our premium revenue grew by approximately 11% on a gross written basis and nearly 12% on a net written basis, although we were a few noteworthy items which I will get to in a minute.

On an operating basis, we earned $1.20 per share for the quarter, which produced an annualized return on equity of 12.1% for the First Quarter 2014 compared to 12.9% for the same quarter in 2013. On a net income basis earned $1.30 per share this quarter, which corresponds to an annualized rate of 13% return on equity.

Our reported underwriting results in the First Quarter were excellent as reflected by a combined ratio of 84.7%. And we are aided by a low level of catastrophe losses and favorable loss reserve development. We also benefited from improved accident year performance in our US reinsurance groups, which was more than offset by an increase in the accident year combined ratio in the reinsurance group.

It is worth noting that there were three components to the increase in the reinsurance group's accident year combined ratio. In the first place, the mix of business changed with the group writing less property cat business, which has a lower expected loss ratio. And secondly, our reinsurance group over the past 12 months found more casualty and professional liability business, both in the US and internationally, which met our return thresholds.

And third, because some of this casualty business we underwrote has a longer duration, which should produce excellent economic returns, we follow our historical practice of reserving very long-held business at a more conservative level. The longer the tail, the more conservative is our loss pick. And historically this approach has worked very well for us. So no need for us to change that methodology and we chose not to.

Net investment income per share on a sequential basis was flat in the quarter at $0.49 per share. Our operating cash flow for the quarter was approximately $200 million, a bit less than the $205 million from the same period last year. The total return on the investment portfolio was 100 basis points for the quarter, inclusive of fluctuations in foreign exchange rates.

Our book value per common share at March 31, 2014 rose to $41.53, increasing by 4.3% sequentially and 10.3% relative to First Quarter of a year ago.

Now, let me return to the strategic initiatives I mentioned earlier. As you know, we, along with Highbridge Principal Strategies, a subsidiary of JP Morgan Chase and Company, launched a newly formed multi-line reinsurer Watford Re in late March with $1.1 billion of initial capital.

Arch invested approximately 11% over the common equity and we will serve as the Watford Re's reinsurance manager. Mark will go into more detail on the accounting for Watford when he gets to his prepared remarks.

Despite the late start in the First Quarter, Watford Re was only formed in the last few days of the quarter. Arch seeded $32.2 million of premiums to Watford Re. We believe that this new venture will benefit shareholders of both Arch and Watford Re.

Our mortgage segment includes primarily mortgage insurance, which is through Arch MI in the US and internationally. The reinsurance treaties covering mortgage risk which is written globally as well as other risk-sharing and structure mortgage business.

Our mortgage insurance business in the US serves two major markets: credit unions. And banks and other mortgage lenders. Arch US MI represents about 40% of the $43.3 million of net written premium in the First Quarter of 2014, most of which is attributed to the credit union sector.

As we discussed on prior calls, in the banking sector we continue to build our client to base. As of last week, we have received over 100 master policy applications from banks, of which 98 have been approved. 13 of these approvals represented national accounts. And the rest are regional or local banks.

The number of master policies is increasing each month with March approvals double February's rate. And April's running at 2.5 times the March rate. Of course, approvals are the first step in this process. It takes time to integrate systems and then getting to the bank's rotation in order to receive new mortgage insurance policies. Our sales force is working hard on this and they are incented to achieve their sales targets all the time.

In the primary markets in which our insurance group participates, we continue to obtain rating rate increases above loss trend, slightly above the levels that we observed last quarter. In our US insurance operations, we achieved rate increases in the quarter that provided the 120 basis points of expected margin improvement which was better than the last quarter.

We continue to see our best opportunities in some sectors of the ENS market and in our binding authority and program businesses. In these areas, we have seen steady improvements in pricing and steady gain in exposure units, which contributed to our solid growth in the First Quarter, although we did observe the large account casualty and professional liability guarantee core segments coming under more pricing pressure in this First Quarter of 2014. We currently remain a minor player in these sectors.

On the reinsurance side of the business, we have seen a continuation of softening in terms and conditions that we noted in our prior quarters' remarks. As you have heard on other calls, the property cat area remains under pressure, primarily due to the alternative capacity that has entered the market. For the First Quarter, we experienced approximately a 15% reduction in property cat rates on a gross basis.

Also, as we reported on the last quarter's call, CDONs are aggressively requesting additional seating commission on code of share contracts of between 2% and 4%. And reinsurance buyers continue to shift business through excess of loss treaties.

Let me remind you again, since we are both an insurance and reinsurance enterprise, should we experience pain in our reinsurance segment, we stand to benefit from the improvement in terms of on our insurance operations as we are significant buyers of reinsurance.

From a production point of view, gross written premium in the reinsurance segment grew by 14.8% over the same period last year, two significant treaties written in 2013 on a risk-attaching basis, as well as some new international casualty treaties.

Net written premium increased just 5% over the same period due to additional retro purchases in our sessions to Watford Re.

The insurance segment grew premium by 6% on a gross basis and 8% on a net basis. Most of our growth is coming from low limit accounts and our loss-sensitive business, which is national accounts and constructions, mostly written on large deductible loss sensitive basis. (inaudible) on an expected basis we continue to believe the ROE in the business we underwrote this quarter will produce an underwriting year ROE in the range of 11% to 13%, with our improvements in the insurance group results offset by deterioration in the reinsurance group, primarily due to lower cat rates.

The higher reserving rates for the casualty business in the current accident year will not affect the underwriting ROE at ultimate in our reinsurance business.

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

As of April 1, 2014, a 250-year PMLs for a single event decreased to $705 million in the Northeast or 11% of common shareholders' equity. This is the lowest level I think I believe in our history, while Gulf PMLs also decreased to $624 million. Our Florida Tri-County PML now stands at $488 million. We know that these reductions reflect a change in catastrophe models from RMS version 11 to version 13, as well as opportunistic retrocession purchases that we chose to buy.

I will now turn it over to Mark to comment further on our financial returns and results. And after his prepared comments, we will entertain your questions. Mark?

Mark Lyons {BIO 6494178 <GO>}

Great. Thank you, Dinos and good morning.

As you have noticed by now, we have made some changes to our reporting format. We added two new segments in addition to our prior insurance and reinsurance segments, as well as modified some line of business definitions.

The new segments our mortgage business and the colorfully-named other segment. The mortgage business segment encompasses both insurance and reinsurance across US and international operations and, additionally, any risk-sharing transactions with the GSEs or banks would be contained here.

Previously, mortgage insurance, reinsurance. And risk-sharing transaction results were reported within the reinsurance segment. But that is no longer the case and we have provided apples-to-apples comparatives so you can properly reference prior periods.

The second new segment, called other, currently reflects the Watford Re results, which is a new Bermuda class 4 reinsurer with an A-minus AM Best rating and, as Dinos said, at $1.13 billion in total capital. Arch acts as Watford's underwriting manager, while Highbridge, a subsidiary of JPMorgan, manages Watford's investments.

Even though Arch only holds an 11% minority interest in the common shares of Watford Re, along with some warrants, we have consolidated 100% of their results in Arch's financial statements with a requisite offset reported as noncontrolling interest. We have consolidated Watford not due to our percentage ownership. But due to the accounting rules at variable interest entities, or VIE. Therefore, Arch's consolidated statements now reflect Watford's assets, liabilities, cash flows, revenues. And other income statement items at a gross 100% level with the corresponding approximate 89% noncontrolling interest removed as a single line offset where appropriate.

Unlike other segments, Watford has its own operations and, accordingly, has its own assets, investment strategy. And management. We will present Watford results inclusive of its investment performance.

The other change we made within our financial presentation is our definitional grouping of products within the insurance segment. Some lines are broken out more finely than before, whereas others are combined with previously provided lines. In both cases, groupings were made with an eye towards our line of management accountability in conjunction with materiality levels.

Now I will proceed to report on our financial results for the quarter. At this point, the financial results of ACGL with or without Watford Re are not materially different from each other, since Watford only had $2.2 million of neat earned premium. Over time, however, as Watford Re grows, they will become more significant. And I will make some comments that include or exclude their results as appropriate in those future quarters.

The only comment of significance this quarter is to point out that ACGL's cash increased approximately $1.1 billion. This is predominantly due to the capital raise for Watford Re in late March and that Arch is consolidating Watford.

For this quarter, I will make financial comments that include Watford since they don't move the needle at this time.

The consolidated combined ratio for this quarter was 84.7% with 6/10 of a point of current exit year cat events, net of reinsurance and reinstatement premiums, compared to the 2013 First Quarter combined ratio of 84.6%, which reflected 1.5% of cat-related events.

Cat losses occurring in the 2014 First Quarter represented $5.5 million, net of reinsurance, our recoverable and reinstatement premiums, emanating from various events. The 2014 First Quarter consolidated combined ratio also reflected 9.5 points of prior year net favorable development compared to 7.1 points of prior-period favorable development in the 2013 First Quarter. 86% of this net favorable development was from the reinsurance segment, with nearly 75% of that due to net favorable development on short-tail lines, primarily associated with the more recent underwriting years.

Approximately 20% of the reinsurance segment's favorable development was attributable to longer-tailed lines, mostly emanating from the older 2003 to 2005 underwriting years. The remaining 5% of the reinsurance segment's net favorable development was attributable to medium-tailed lines throughout many underwriting years.

The insurance group accounted for 14% of the aggregate net favorable development, which was almost entirely driven by short-tailed lines in recent accident years. Similar to prior periods, approximately 68% of our total net reserves for loss and loss-adjusted expenses of $7.2 billion are IB&R, or additional case reserves, which is a fairly consistent ratio across both the reinsurance and insurance segments over time.

Therefore, the current accident quarter consolidated combined ratio excluding cats for the First Quarter was 93.6% compared to 90.2% accident quarter combined ratio in the First Quarter of 2003.

In the reinsurance segment, as Dinos has already commented on, the 2014 accident quarter combined ratio, excluding cats, was 92.6% compared to 79.7% in the corresponding quarter of 2013. And 85% in the 2013 Fourth Quarter serially.

The reinsurance segment's results this quarter effect reflect the reduction of property cat writings on a gross basis with additional retrocessional support as well, along with an increase of casualty business driven by a large US professional liability treaty and some European excess of loss contracts.

In the insurance segment, the 2014 accident quarter combined ratio excluding cats improved to 94.8% compared to 97.9% a year ago, showing continued improvement in margin expansion that has been aided by the lesser volatile smaller account strategy implemented over the last half-dozen years.

Also on a consolidated basis, the ratio of net premium to gross premium in the quarter was 82.2% versus 81.9% a year ago. In the reinsurance segment, the net to gross ratio was 85.9% in this quarter compared to 93.8% a year ago, primarily due to the changing mix of business on a written basis and the increased uses of retrocessional covers as previously mentioned.

The insurance segment had a 74.7% net to gross ratio compared to 73.2% a year ago as a function of the lesser volatility businesses that they continue to expand upon.

The consolidated expense ratio of 34.0% this quarter is 2.5 points higher than the 31.5% expense ratio reported in the First Quarter of 2013. This is largely driven by increased acquisition expenses in the reinsurance segment, along with operating expenses related to our US primary mortgage insurance operation. The insurance segment's expense ratio was flat with the First Quarter 2013.

As respects pricing levels, the US insurance operation, as Dinos mentioned, achieved a net 120 basis point margin expansion in the quarter over the corresponding quarter of 2013. Margin expansion, as a reminder, as we reported, represents the excess of written effective rate increases over estimated loss trends.

Margin expansion continued in our program, casualty and construction and national account businesses, while contracting slightly in healthcare and property. We are continuing to see a lower level of loss cost inflation. But are approaching these trends cautiously.

Our new mortgage business segment posted an 81.3% calendar combined ratio for the quarter. The expense ratio of 59.4% is largely driven by front-ended operating expenses assumed during the CMG PMI acquisition, such as staff and infrastructure to support the acquisition of premium for the bank channel of our new US primary mortgage operations. The increase in net written premiums of $17.5 million this quarter is driven by premium gain from our new US primary operation, mostly the credit union channel as Dinos mentioned. And by assumed premium emanating from about the 100% quota share of PMI's 2009 to 2011 underwriting years as part of the aggregate acquisition of those platforms.

Other reinsurance business added nearly $5 million of net written premium, offset by approximately $11 million of reduction from one reinsurance treaty.

At March 31, 2014, we held $5.3 billion of risk in force from our primary US operations. And additional $5.5 billion through our mortgage reinsurance and risk-sharing operations. Risk in force is a standard measure of exposure in the mortgage insurance industry that generally represents approximately 25% of the total aggregate loan values. It is this risk in force figure that forms the basis for capital ratios used by the GSE's regulators and rating agencies.

This segment also experienced $1.2 million of net favorable development this quarter, which represents approximately 3 combined ratio points. This net favorable development mostly emanated from older report years that had better-than-expected emergence.

The other segment currently contains the results of Watford Re. As I discussed previously, Watford Re was consolidated into Arch's financial statements at 100% level. Therefore, the $32.2 million of net written premium written by Watford this quarter represents 100% of all the business they assumed. And not just Arch's 11% comment shares interests. Adjustments for the noncontrolling interest are made in the single adjustment lines in net income, rather than each line on the income statement balance sheet or cash flow statement.

Watford Re reported a 151.8% calendar combined ratio on a small net earned premium base of $2.2 million. Certain startup expenses associated with the formation of Watford were also reflected and these should be viewed as non-recurrent.

Reported net investment income in the quarter was $0.49 per share, substantially unchanged from the 2013 First Quarter of $0.48 a share. Our embedded pretax book yield before expenses was 2.27% as of March 31, compared to 2.38% at prior year end.

The duration of the portfolio increased this quarter to 3.24 years from 2.62 years as of year-end. The total return on the portfolio was 100 basis points in the quarter with noninvestment grade fixed income, equities. And alternatives augmenting returns on our core investment grade income portfolio. Excluding foreign exchange, total return was marginally different at 102 basis points in the quarter.

The effective tax rate on pretax operating income for the First Quarter of 2014 was an expense of 1.7% versus an identical expense of 1.7% in the First Quarter of 2013. As always, fluctuation in the effective tax rate could result from variability in the relative mix of income or loss reported by jurisdiction.

Arch's total capital was $6.8 billion at the end of this quarter, compared to $5.7 billion at the end of 2013's First Quarter and $6.5 billion at year-end 2013. The $1.1 billion increase in total capital from a year ago is primarily driven by the $500 million debt raised in December 2013, plus approximately $600 million of retained earnings over the last four quarters.

Our capital structure now at March 31, is comprised of 13.2% debt, 4.8% preferred. And 82% even of common equity. At the end of this quarter, we continue to estimate having capital in excess of our targeted capital position.

And as Dinos has just mentioned, book value per share as a reminder increased 4.3% in the First Quarter up to $41.53, which is also 10.3% higher than a year ago. The growth in book value this quarter is driven by the Company's continued strong underwriting results.

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

Questions And Answers

Operator

(Operator Instructions) Amit Kumar, Macquarie.

Q - Amit Kumar {BIO 15025799 <GO>}

Congrats on another strong quarter.

A - Dinos Iordanou {BIO 2397727 <GO>}

Thanks, Amit. And good morning to you and everybody else, by the way.

Q - Amit Kumar {BIO 15025799 <GO>}

Just two quick questions. The first question is -- goes back to your comment on capital and I guess declining PMLs and your two new initiatives.

I was just wondering, how should we -- maybe can you update your views on potential acquisition opportunities in the marketplace versus what you are building out right now. Does your view change if something presents itself? Or are you more focused on MI and Watford Re right now?

A - Dinos Iordanou {BIO 2397727 <GO>}

Multiple questions. Let me start with, we are always focused intensely on everything that we run. I don't care if it is insurance, reinsurance, the MI or Watford. So that focus is always going to be there. But it doesn't preclude us from also looking forward on other opportunities.

Your question about M&A activity, yes, we are willing to look at opportunities presented in the marketplace. But still our preferred way is to build versus buy. We find that from a lot of different perspectives to be more attractive. Culturally, we -- better selection, or at least the selection of people that we believe culturally fit with us, et cetera.

So -- and there are some of those opportunities we are pursuing now globally that will fit into the category. And of course we will not say no to potential acquisition if it fits our characteristics. Is it specialty business? Does it fit with our DNA? Is the underwriting pasture past and going forward a good fit with us? Because I am very -- and maybe I am very biased to culture within a company. And one thing I am extremely careful is not to change the culture that we have within Arch.

I am not saying it is better or worse than anybody else. But it is what it is. And it seems we have had very good performance over 12 years following that philosophy. I am kind of the guardian of it. So we are more of a difficult Company to come to an agreement on an M&A opportunity because of all these issues.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. That is actually very helpful. The only other question I have is on your MI platform.

First of all, maybe this is a numbers question. But some other MI players -- and, again, I am new to this -- give sales metrics in terms of new insurance written, et cetera. Would that be in the Q, or how should we think about the sales metrics?

A - Dinos Iordanou {BIO 2397727 <GO>}

Well we are going to be reporting that in our Q. And eventually, don't forget, this is of course (inaudible) the MI disclosure. And as I said in last quarter, we are looking also from input as to what it is going to help you as analysts viewing our business. So any suggestions you have with what kind of information it would be helpful to you to see -- get with Don Watson, which is the head of our investor relations. And then if we find it appropriate, we will improve disclosure in our press releases and supplemental data.

A - Mark Lyons {BIO 6494178 <GO>}

But the overall approach is we will provide at least as much as what is standard in the industry.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. That's very helpful. And I guess, related to that. And this is my final question, any update on your reviews on that the MI market? I guess my understanding is there have been some players who have attributed a slowdown I guess to the cold weather in Q1. And there is some discussion in that marketplace regarding the housing recovery. Any of this would be helpful on the marketplace. Thanks.

A - Dinos Iordanou {BIO 2397727 <GO>}

Well I -- first, a little bit of a shameful plug on our people. If you go on our website, Arch Mortgage Insurance publishes a quarterly newsletter which gets into a lot of these macro issues. And I will encourage you, instead of taking everybody's time, to get on the website, go to Arch MI and look at the quarterly views that we have on the macro issues within the mortgage insurance space.

It is clear that in the First Quarter, re-files have been reduced significantly, on the basis that interest rates -- mortgage interest rates have gone up. And I believe if you look at it from inside mortgage finance, I think that the reduction in re-files was like 63% in the First Quarter.

Having said that, your persistency, there is no re-files, goes up on the existing business. So because a mortgage that gets refiled, you are losing the premium if it was already a covered mortgage to a new one that you are going to get under the refile.

We are not projecting, at least in the data that we have, a significant change in volume on our credit union business, which is -- but we expect some slowdown over the year because new originations are down and re-files that are way down.

Now, the more difficult question for us to answer, that is why it is going to take three full quarters for you guys to get a flavor, it is a penetration in the bank channel. Because we are early on in the process, we are signing these master agreements, we are starting to receive business. But it is a lengthy process. You have got to go through the process of filing and getting approvals on the master agreement. Then the systems linkage has to be there and then you are starting to get on the rotation to start receiving that business. Mark, anything else?

A - Mark Lyons {BIO 6494178 <GO>}

Yes. I would just add -- Dino really just outlined a staggered approval process. And I think what supplements that is the fact that the industry is dominated by monthly, not single premiums. So even when you get to the approvals, the business flow takes a while to build because of the monthly nature of the premium renders.

Operator

John Hall, Wells Fargo.

Q - John Hall {BIO 1497612 <GO>}

Good morning, Dinos, Mark and the rest of the Arch team. I have got a question related to the shifting business mix and the combined ratio in the reinsurance segment. Have we sort of reached a steady state whereby the mix shift has occurred and the migration up in the combined ratio is -- variable loss experience aside, we sort of hit where we are going to be on a go forward basis?

A - Dinos Iordanou {BIO 2397727 <GO>}

That is a tough question because I've got to understand the mix that we are going to have going forward. I would say probably because of a bit of a conservatism we took on some of the business we wrote that had very long duration. And I am not talking about four -- or five-year duration. This is business that it will have maybe seven, ten. And some of it even beyond that duration.

We are always very cautious when we price that business and also when we reserve that business, because you can fool yourself early on and we try not to. If you saw where our reserve releases came from casualty in the reinsurance sector, they came from the 2003, 2004, 2005 years. So that tells you it was the same philosophy we had then that, hey, let's not celebrate early on very long term duration business.

So not knowing only what kind of contracts I'm going to see in the future, I would tell you that we have reached that -- if the mix is exactly the same next quarter, in all probability that will be probably down 5 or 6 gross ratio points, if we go back to more of our normal mix that we had in prior quarters. So it is a very difficult question to answer, unless you have a scenario as to what we are going to write and what type of business going forward.

But Mark, do you want to add a few points on that and spend more time on that analyzing and --

A - Mark Lyons {BIO 6494178 <GO>}

Yes. I would be happy to, Dinos. I think, first thing, I have two points to make. I think the first one is that you really have to look not as much quarter to quarter. But perhaps what year-to-year would be like.

I mean, the First Quarter being at 79.7% last year, that was really an 82% for the year and Fourth Quarter ended at like 84%-ish or something. So it is a little bit of an artificial movement. But I think what is more important. And I think it is telling that since I changed jobs from the insurance group over. And had a chance to really dig into the reinsurance group in position, when you look backwards, either business emanating out of the US or out of Bermuda reinsurance operation, not only was it an outstanding job of underwriting. It was an outstanding job of reserving.

And when you look now versus then, it is the same chief actuaries. It is the same management of the segment. It is virtually the same as the holding company, which is what we are talking about here.

So it is one thing for a company to say, we haven't changed anything on the reserve methodology. It is different to say compoundly so with the same individuals involved with regard to consistency. And I think that is an important point.

A - Dinos Iordanou {BIO 2397727 <GO>}

And John, accident year in one quarter, especially the most recent quarter, it is a self-grading exam. Self grading exams do something that it has more than, let's say, a five-year duration. In fool's paradise, at the end of the day, look at me five years from today and you see how well we have done in that business.

Now, it makes it difficult for you guys to estimate and I understand that. But I think the historical performance, which is where Mark is pointing you, might give you an indication of the culture and also the methodologies that we go through in making these long-term reserve decisions that we have to make.

Q - John Hall {BIO 1497612 <GO>}

I appreciate that. Thank you, Dinos. And I guess the profit characteristics when you talk about the target ROE. And the ROE you are achieving here, there is a greater portion of the most recent quarter's business attributable to investment earnings.

A - Dinos Iordanou {BIO 2397727 <GO>}

That is correct. When you write a very long-tail line of business, there is a few of these -- we have treaties that we have booked at 110 combined. We have treaties that we booked at 115 combined, depending on very long duration of liability. And you are going to earn the adequate return because the investment income is going to come over many years.

So when you take those cash flows, net present value then back. And then you look at it from that perspective. And that is why I made that comment that the 11% to 13% on an underwriting year basis -- because that is the step that usually will make all of our decisions.

When we bring all the cash flows, we wrote something that is going to be revenues and expenses going out. And claims going out over a long period of time. We bring it all back to that underwriting year and then we make that determination. What is the expected return? And that is what guides us.

I mean, that is the methodology, not only from a pricing point of view. But also from a reserving point of view. And usually, we will start reflecting some of that, depending on the longevity of the business. Maybe four or five years out, we take another look at it. We are not going to touch it for four or five years because it is too early. You have got to allow the data to come in.

You get more confident and you say, hey, maybe my reserves are little higher than they should be. The beauty of our reserves, nobody sticks their hands in your pocket and takes some money out. It's in our bank accounts, they're earning interest and dividends on our behalf.

And at the end of the day when you recognize them in your financial statements, it becomes data-driven. But data-driven from our perspective needs to have some conservatism in there.

A - Mark Lyons {BIO 6494178 <GO>}

And John, one of the key principles in any part of the market cycle that we operated on is that we are driven by the economics of a deal or transaction, not the accounting of it. And I think the best example of that would be excess workers' compensation, which is more -- the green light decision on that is more a function of the interest rates more than the underlying pricing in some cases, because it is a 16 -- to 18-year duration business. So it is supersensitive to changes in interest rate that is dominated by the investment return.

And that will book poorly. That might be looking at a 1.20 or 1.30 even in the good market. But it will be a killer on a return basis.

Q - John Hall {BIO 1497612 <GO>}

I appreciate that. And I just have one point of clarification. In your prepared comments, Dinos, you mentioned that rate in the primary market was above loss trend. But you didn't mention what that number was. I was wondering if you could share that.

A - Dinos Iordanou {BIO 2397727 <GO>}

Well we said 120 bps improvement. In the last quarter, we said it was 80 bps. I think the rate increase on average, I think, in the last quarter was 3.8%. This quarter I think it was 4.0%. So 20 bps came just from that. And there is a little bit of a trend improvement.

But when it comes to trend improvements, we are a very, very, very hard bunch of guys to convince. We look at it, we look at the improvement. But we don't factor it a lot on our published numbers until -- we are from -- what's that town? (multiple speakers) We are from Missouri. It has got to prove itself.

And -- but, I can tell you, I look -- a lot of these indications, I think the actuaries see -- they see a lot of me and I don't know if they like it or hate it. But I am the only actuary in the room usually and they are all around me.

But a lot of our indications -- the positive, the trend indications are better than expected. And more importantly, we do an analysis on actual versus expected. We got these curves and then we try to see what expected losses we expect from all the underwriting years for the quarter and how much has come in and those have been extremely good, especially this quarter.

But one quarter can always fool you. But we have consistency in looking at actual versus expected and being very, very positive.

Operator

Michael Nannizzi, Goldman Sachs.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Let me just ask, if I can, on the reinsurance book. Was there anything unusual in this quarter about the profitability of that book? Or -- I realize that year-over-years are different because of mix. But just standalone this quarter, anything unusual about where the profitability came in?

A - Dinos Iordanou {BIO 2397727 <GO>}

Yes. The only thing unusual is that we expect less from the property cat, from two points of view. One is less volume because -- and second, probably a little less ROE because of the rate reduction. We are not happy about it. But, listen, even the best management teams can't fight Mr. Market and Mr. Market is going against us in that particular segment.

So that is the only thing unusual. Everything else is as normal as anything. We look at transactions. We look at the potential profitability long-term. We don't care if it is short tail, medium tail, very long tail -- as long as it makes the return characteristics, we do it. And as Mark said, we really don't pay too much attention on the accounting.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it.

A - Mark Lyons {BIO 6494178 <GO>}

Add one thing there, I think one of the intents to your question, no, there was no underlying influx of paid claims, reported incurred claims, frequency or severity that would have caused this and caused movements. No. There was nothing of that kind.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Great. Thanks. And I guess if we were to isolate the cat reinsurance book, what impact would the pricing that we have seen have on the attrition loss ratio? And all else equal, would you expect that the attritional loss ratio in that book, given pricing is now higher?

A - Dinos Iordanou {BIO 2397727 <GO>}

Well listen, putting volume aside, putting volume aside, because there is a reduction in volume because it forces us to buy more retro, we felt it was advantageous for us to buy retro, the cost of capital of some of our retro providers is lower than ours. So in essence, they allowed us to buy that in what we think on an expected basis, a good price.

So putting aside volume, we also believe that, based on our own calculations, the ROE projections, expectations, on our cat book has gone down by 2 to 3 points. So if we draw it on a net basis, we have, let's say, 15% to 16% ROE last year, this year it will be more like 12% to 13% ROE.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. So just overall, your book aside, it is probably why you are shrinking and then the expectation would be if pricing continues to recede in property cat business. But margins should fall, attritional loss ratios should rise. That would be the logical outcome.

A - Dinos Iordanou {BIO 2397727 <GO>}

Well in the cat business, it is feast or famine. You don't have the events, it is not going to show up.

Let me remind you guys, we had very little exposure in Japan. We saw Japanese rates that were ridiculously low. We didn't participate. Our PML in Japan before the quake was $75 million. And it was from international programs that we couldn't even avoid. We didn't have much of Japanese only quake.

But that served us extremely well when that event happened because, at the end of the day, even though we look foolish for 10 years, if there was no quake, there were no losses. So any premium you wrote it became profit --

Q - Michael Nannizzi {BIO 15198493 <GO>}

Right.

A - Dinos Iordanou {BIO 2397727 <GO>}

-- We were proven right 10 years later. So I have a lot of confidence in our cat teams. I think we have great analytical team there from -- and great underwriting team. And one area that I don't put my two cents in. And I usually like to in a lot of areas, is in the cat area because I think those guys are better than me. I wish I can get as good as they are.

Q - Michael Nannizzi {BIO 15198493 <GO>}

That is great. Thanks. Then metrics on the MI book, risk to cap, maybe different from other carriers just given the way you run that business, a breakout of primary to risk-sharing and reinsurance that -- and then some demographic data on the profile of the book. Vintage, for example, would be helpful.

Then, just last one on -- a numbers question. What were the startup costs in the quarter, just so we can try to think about what the business should run at, excluding those costs that hit the First Quarter? Thanks.

A - Mark Lyons {BIO 6494178 <GO>}

Yes. It was roughly $2.6 million, plus there was some unusual ones. You can see in our presentation we have a line called other expense.

Q - Unidentified Participant

(multiple speakers)

A - Mark Lyons {BIO 6494178 <GO>}

Oh, I'm sorry. MI startup costs.

Q - Michael Nannizzi {BIO 15198493 <GO>}

The MI, yes, sorry about that.

A - Dinos Iordanou {BIO 2397727 <GO>}

Well we have -- the MI startup costs, we have a sales force that came on board ahead of the transaction. And we have been expensing that. So we have a lot of expenses in the First Quarter from the sales force, which has no corresponding revenue attributed to it.

Because, don't forget, we got two sales forces. One, which is the existing business, which is (inaudible) mutual employees working on our behalf that they distribute to the credit union channel. Then, our own sales force, who is trying to penetrate the bank channel. And other mortgage originators. And so all that.

And we can get you a number. I haven't added it all up. But I will get Mark Lyons and then we will try to figure that number out. We haven't --

A - Mark Lyons {BIO 6494178 <GO>}

But one thing you need to understand about the totality of how this works is that there is a shared services agreement that goes on that varies by quarter on what services were performed. So we have everybody on the old PMI onto our payroll system now. But there is offsets associated with various classes of work -- accounting work, IT work, claims handling work. And so forth, that is measured and there is metrics that determines what that percentage allocation is.

So over time, there will be a shift where it is going to be more resident in Arch. Right now, a lot of that is still pushed off as a credit against it. But it really varies by quarter. So understandably, it is going to be a little hard for you to see through that -- that is a little opaque. But that is the dominant driver of the OpEx from quarter to quarter.

A - Dinos Iordanou {BIO 2397727 <GO>}

The one area you can forecast eventually it's -- I think we have got about 40 people in the sales force. All that is going to be our cost. I mean, we are not going to share that because we are building, right? We are building.

We have the sales force. The sales force is our expense. We are expensing it as we go. It is salaries and benefits, et cetera. And revenue is going to come down the line.

There is literally insignificant amount of revenue coming from the bank channel in the First Quarter. It will be starting to show up in the second, third, Fourth Quarter. I don't know to what magnitude. It depends on how effective we are. But we are in a build out stage.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. Maybe a better way to ask it is, once you reach scale and once you kind of reach critical mass, where do you think the acquisition and/or operating expenses should run into?

-- run to?

A - Mark Lyons {BIO 6494178 <GO>}

Again, it is hard to ask -- or hard to answer. But if it is three years or more out -- now, for the entire segment now -- it should be in the 20 area. That doesn't mean every unit within the mortgage business runs at that.

Q - Michael Nannizzi {BIO 15198493 <GO>}

I understand. Okay. Thank you.

Operator

Vinay Misquith, Evercore.

Q - Vinay Misquith {BIO 6989856 <GO>}

Well the first question, just wanted to clarify on the reinsurance operations. So about a 93 accident year ex-cat, that is the normalized -- I mean, that is the new norm, correct? Is that the way that we should think about that?

A - Dinos Iordanou {BIO 2397727 <GO>}

No, no. That is not the new norm. I said you might be five or six points off.

Q - Vinay Misquith {BIO 6989856 <GO>}

Oh. So this quarter was five or six points higher than the normal, you were saying?

A - Dinos Iordanou {BIO 2397727 <GO>}

Assuming no change, like I said, you heard my comments, right? Assuming no change in the mix, the mix -- if I write a lot of very long-tailed business, because I continue to find opportunities there and bind those contracts, it might still be another quarter at 92, 93. But if I go back to more of a traditional mix, it will probably be at least five or six points lower than that.

And Mark just went through the evolution of this. It didn't come overnight. In the past, we were below 80. There has been some deterioration to that, which we will always reflect because of additional cost and ceding commissions.

Then there is some deterioration to that because of a change of mix, less short tail as a percentage of the total that has low accident year loss ratio on an expected basis. So I would say mid-80s is more of a number. But let me caution everybody, it will depend on our mix.

Q - Vinay Misquith {BIO 6989856 <GO>}

Sure. Okay. That's helpful. The second question was on the MI business.

I thought that -- I mean, you said that it would take about maybe two or three years to really gather steam and contribute to the bottom line. It seems that, even the new acquisition, that is actually having a small positive impact on the bottom line this quarter. Just curious as to whether you think that impact is going to increase even in the near term.

A - Dinos Iordanou {BIO 2397727 <GO>}

Again, it will depend as we start getting more business, how do we do with these books, target transactions. So it is hard to predict, right?

But don't forget, even though it is positive and it is good news, I think it is positive faster than we thought, right? We didn't expect to have a positive earnings, especially with frontloaded expenses on this First Quarter. The ROE associated with it is not yet acceptable to us.

Long-term, it is going to be much better. But a lot of the other indicators we are very, very pleased with, especially on the existing book that we have for credit union business. First quarter numbers was the delinquency rates are coming down and they are coming down significantly. And on new delinquency rates in the quarter, they were down by 24.7%. That is a significant number.

The average cost per claim in one quarter was down by almost 20% from an average of 48,000 at year-end to 38,000 at March end. So there was a lot of positive on the existing -- and this is -- I am only talking about the US MI -- and I'm only talking about what we do with a credit union business.

So there is a lot of positive indications because that is an existing book. We have it. We own the old. We own the current. And we are going to own the future. Those indications (inaudible) that this is a good segment to be and it is with very acceptable profitability.

A - Mark Lyons {BIO 6494178 <GO>}

And I would suggest simply, just think of it like this. The US MI operation versus, I'll say, everything else -- reinsurance operations, everything else -- has comparably outstanding loss ratios. The primary business has the drag of expense that we just talked about because of the front ended load nature, where the reinsurance transactions do not.

Q - Vinay Misquith {BIO 6989856 <GO>}

Right. Right. Okay. That's helpful. And the $6.7 million from the 100% quota share from the MI -- so does that recur every quarter or is that a one-time deal?

A - Dinos Iordanou {BIO 2397727 <GO>}

No. It is quarter over quarter. That is the business that is already on the books and usually this business takes, I don't know, six, seven years to run off, right? So this is business that you wrote right before they went into receivership -- that would be 2009 to 2011.

So there is declining revenue coming over time because some of the more -- the mortgages that they get off of that is -- those that they achieve more than 78% loan to value and the mortgagee decides to interrupt the insurance, re-files that they drop off, otherwise -- or a sale when the mortgage gets set aside. But usually the tail on these is about six, seven years. So it will go out until 2016, 2017, taking 10 as the midpoint of this.

Operator

Kai Penn, Morgan Stanley.

Q - Kai Penn

So first off, the investment side, the duration extended for the 2.6 to 3.2. Is that related to now the sort of you have longer duration liability on the (inaudible), particularly on the reinsurance side?

A - Dinos Iordanou {BIO 2397727 <GO>}

Well it is a -- yes, a little bit of that -- a combination, also where we believe with -- at least our investment people believe where interest rates are where the new Fed Chairman might or might not go. Duration, for us, usually gets conservative. We think that there is imminent rise of interest rates. We don't see that yet, at least for the next year or so based on statements they made. So we make that adjustment and also we always match duration of reserve liabilities with assets, covered notes.

Q - Kai Penn

So would we expect that at least a higher duration than at the higher, like you mentioned, yields?

A - Mark Lyons {BIO 6494178 <GO>}

Could you ask that again?

Q - Kai Penn

(multiple speakers) where you said your longer duration of your investment book -- is that the average yield?

A - Dinos Iordanou {BIO 2397727 <GO>}

I don't think it is going to move the needle. We got $14 billion-plus of investable assets. A few hundred million wouldn't move the needle that much.

A - Mark Lyons {BIO 6494178 <GO>}

And it is also, what is the steepness of the yield curve, because quarter after quarter, it flattened out in the quarter just passed that made you a little more indifferent to where you were.

Q - Kai Penn

Okay. Second question for me, besides your minority interest in the operation. And what other economic benefits for Arch in terms of the ceding commission or the others?

A - Dinos Iordanou {BIO 2397727 <GO>}

I mean, it is what we put in -- we get paid for that activity upfront as managers of reinsurance. Then we have a performance fee that we get at the end on underwriting performance -- total return performance. So that is the benefits that we get as an organization for that business that goes there.

Q - Kai Penn

In terms of accounting, where are those booked in your income statement?

A - Mark Lyons {BIO 6494178 <GO>}

Acquisition.

Q - Kai Penn

Okay. Lastly, is on the capital management. Now you have the MI and Watford Re behind you. And the stock trading at 1.4 times book, probably a little bit above your threshold, at the same time you still have excess capital. So what is your preferred way to deploy that excess capital and have you considered a dividend?

A - Dinos Iordanou {BIO 2397727 <GO>}

Our preferred way is to deploy in our business and there is a few opportunities that we still are looking at. So that hasn't changed. I haven't given it a lot of thought if we are going to do a dividend or share repurchases because, right now, we are focused on the opportunities rather than how to return capital to investors.

And let's face it, they are paying us to find the opportunities. And I am spending a lot of time and all of our people are looking at new opportunities. And there is quite a few out there in the market.

Operator

Ryan Byrnes, Janney Capital.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Quickly, on the Watford segment, how long should that take to get to scale? Because, again, thinking from a reinsurance standpoint, you would think it should be able to get to an underwriting premium dollars in a fairly quick manner.

A - Dinos Iordanou {BIO 2397727 <GO>}

I would think maybe three years or so. It is going to take at least two, maybe three, years to get to scale. It depends on a lot of things -- market conditions, et cetera, other opportunities.

But we don't force things. We are going to go -- our obligation to them is to be prudent underwriting managers. That is what we got hired to be, use the techniques that we have been using for Arch and look for the opportunities for them.

And if it takes two years, fine. If it takes three years, it's fine. I don't -- and as Highbridge is going to focus on the investment returns, I think they have the same approach. They have a long-term approach there.

A - Mark Lyons {BIO 6494178 <GO>}

And remember, this year is already just a nine-month year.

Q - Ryan Byrnes {BIO 16902592 <GO>}

I'm sorry. Because it was closed (multiple speakers)?

A - Mark Lyons {BIO 6494178 <GO>}

(multiple speakers) (inaudible)

Q - Ryan Byrnes {BIO 16902592 <GO>}

Yes. Sure. Certainly. Then, just my last question on the increased retro purchases for the prop cat book, it clearly looked like it had an impact on your one and 250 PMLs. But I just wanted to see where of the risk curve you are trying to -- you're seeing this efficiency. It certainly seems like it is at the one and 250 level. But wanted to see how far lower that goes.

A - Dinos Iordanou {BIO 2397727 <GO>}

Well I will give you the 40,000-foot view of this because it is a little more complicated than that. But we try to maintain the customer relationship that we have. There is more tendency because capacity is plentiful and available for a lot of the buyers to what you want you to play across the placement. So they don't want you to pick and choose layers, et cetera.

As usually we do not like to be down on the frequency area. We believe that is -- this is a high rate on line areas that also have a lot more exposure from a frequency expectation. So that is where we buy most of our retro. So on the front end of the curve, we buy more retro.

We don't like to be at the tail end of the curve because -- so even on a direct basis, we do not bring in that business. We are not there to put a lot of PML's or a lot of capacity on 2% or 3% rate on line business. We try to avoid that.

So that is the general principle for our thought process. And with that, that is where our cat teams go and buy the retrocessions.

Operator

Meyer Hills, KBW.

Q - Meyer Hills

Two quick points if I can. One, when we look at the other segments, I would have expected the income available to Arch to be about 11% of total. But it is coming in a little bit less. I am wondering what I am missing there.

A - Mark Lyons {BIO 6494178 <GO>}

Well it is not exactly 11%. It is within spitting distance of 11%. So I am not sure exactly what you are looking at, because it is there.

Q - Meyer Hills

I guess what I am thinking -- and maybe this is the accounting of it, that since you have got the 11% stake and you are collecting fees, the net impact should translate into a higher percentage.

A - Mark Lyons {BIO 6494178 <GO>}

Right. And part of it is geography, because this is -- Watford Re -- the fees that we earn don't go to Watford Re. They go to Arch.

Q - Meyer Hills

Okay. Got it. That makes sense.

A - Dinos Iordanou {BIO 2397727 <GO>}

So it is going to be in our numbers, right?

Q - Meyer Hills

Right. But is it in the other segments showing up elsewhere.

A - Dinos Iordanou {BIO 2397727 <GO>}

Well the other segment is only going to be the investment. And that will be pari passu with any other investor in Watford Re. Fees and/or profit commission because of performance as underwriting managers or Highbridge's investor managers and all that, is not going to be on this line.

Q - Meyer Hills

Okay. That is in the acquisition -- (multiple speakers)

A - Mark Lyons {BIO 6494178 <GO>}

But we do sympathize because you are looking at the 100% numbers. And you got them on each line of account at 100%. Then there is one line that is an amalgamation of all the impact that is the 89% subtraction. So we don't make the rules. We have got to follow them.

A - Dinos Iordanou {BIO 2397727 <GO>}

Right.

Q - Meyer Hills

Absolutely understood. Just a follow-up on a question before, I understand that the flatter yield curve limits the benefits of the increasing duration. But then why increased duration in the quarter?

A - Dinos Iordanou {BIO 2397727 <GO>}

For our belief, it is to where the yield curve is and where it is going. We didn't -- we elongate it by almost half a year in duration.

Our approach to duration is that we match liabilities on the reserves. This way we don't take any risk there. When we borrow funds, right, we try to have the cost of those funds on the spread. So in essence, by us borrowing $500 million that pushes us to increased duration a bit.

Then, we use the shareholders' capital to vary duration up and down depending on how we view where the prospects and where the yield curve is going to go. So that is the combination of all three principals in one. And like I said before, that is what pushed us -- our investment in people to move duration to the level that we have.

Operator

Jay Cohen, Bank of America Merrill Lynch.

Q - Jay Cohen {BIO 1498813 <GO>}

A question on Watford. The premiums that you ceded to Watford, is that basically a mirror image of your whole book? Or were there only particular lines that were ceded?

A - Dinos Iordanou {BIO 2397727 <GO>}

No. To oversimplify, it was a few transactions. Some of it mirrors what we have, some of it doesn't. But don't forget, Watford wasn't in business and some of it -- think of it as a miss for the First Quarter. We would have something that they might have written direct themselves. Then we ceded it back to them.

We are the underwriting managers. So we said, hey, this will fit Watford. We didn't want to lose time and wait for them until they were in business. So we might have bound a piece of business, put it on at Arch and then we ceded to them when they were up and running.

Q - Jay Cohen {BIO 1498813 <GO>}

That is helpful. Then (multiple speakers)

A - Dinos Iordanou {BIO 2397727 <GO>}

You are not going to see 100% cessions from Arch to Watford in future quarters. What you're going to see is going to be some cessions from us because we still -- we're ceding to a lot of reinsurance, Watford being one of them. And also you want to see a lot of deals that Watford would write direct.

A - Mark Lyons {BIO 6494178 <GO>}

And also back to the whole underlying theory of it, although there is property cat that may be there as a piece of our portfolio, in all likelihood it is only going to be a lesser percentage than what Arch would have. And therefore, a longer duration on the liability stream of Watford versus the average of Arch.

Q - Jay Cohen {BIO 1498813 <GO>}

And in the casualty business, you will see -- or I should say, they will write at the end of the day, do you think that will be a lot different than the casualty business that you have or -- they seem to have some similarities to it.

A - Dinos Iordanou {BIO 2397727 <GO>}

Well they are going to have -- listen, it is the same underwriting standards, right? We view their advantage is that I think we can assume a bit higher investment yield. And so that always -- and I don't know transaction by transaction. But it might push you to maybe a little longer duration in liabilities type of business, because that is where their advantage becomes greater.

But only time will tell. As we see the transactions either for us and/or Watford come in. And then our underwriting people apply our standards to come up to expected ROE and see where it fits.

Q - Jay Cohen {BIO 1498813 <GO>}

Yes. That makes sense.

Operator

Brian Meredith, UBS.

Q - Brian Meredith {BIO 3108204 <GO>}

Two questions here for you. First, in the mortgage insurance operations, where do you guys stand in getting on the platforms of large national banks?

A - Dinos Iordanou {BIO 2397727 <GO>}

We've got 13 already out of the top 40.

Q - Brian Meredith {BIO 3108204 <GO>}

But what about the big three (multiple speakers) comes from?

A - Dinos Iordanou {BIO 2397727 <GO>}

Well we are still in the process. I don't know exactly where we are. I don't know who the top three in your mind are. But we are not going to comment on specific relationships that we have. But believe me, our goal is to be in all top 40 over time. And we are working hard to get approval from all of them.

Q - Brian Meredith {BIO 3108204 <GO>}

Okay. Great. And I guess my second question for you, Dinos, is I am just curious -- so increasing in casualty reinsurance business, although you listed the people in the market and they are talking about higher ceding commissions and a lot of capacity there, I am just trying to understand why is all of a sudden the casualty reinsurance business that much more attractive? Is it because interest rates are up, call it, 100 basis points year-over-year? Is there something else happening?

A - Dinos Iordanou {BIO 2397727 <GO>}

No. Listen, you have got to look at it transaction by transaction. There is always this displacement in places. Four years ago, five years ago, it was the mortar XoL in France because everybody was withdrawing, et cetera. So we look at these opportunities.

We don't like to talk a much about it. But -- as to where, because if I found a little vein with a little goal and it and I am digging into it, I don't want every competitor to know what it is and then they go and they mess up the market.

So either you guys trust that we got the underwriting skills to do that or you don't. And I trust our people and when they find the opportunities. And we look at the economics, if it fits, we do it.

And we don't -- as Mark said, we don't really care that much about the calendar year accounting issues, because you can't make a decision on, to buy your reinsurance underwriter on calendar year numbers. You have got to understand policy here and you have got to understand the underwriting year performance. And do you trust that they will do a good job in making those determinations.

A - Mark Lyons {BIO 6494178 <GO>}

I think you should think of it as a collection of well thought out transactions rather than sector bets.

Q - Brian Meredith {BIO 3108204 <GO>}

Right.

A - Dinos Iordanou {BIO 2397727 <GO>}

Well said, Mark. You see, you're much smarter than I am.

Operator

Ian Gutterman, BAM.

Q - Ian Gutterman {BIO 3106649 <GO>}

Good afternoon.

A - Dinos Iordanou {BIO 2397727 <GO>}

Ian, you are between me and my souvlaki sandwich, baby.

Q - Ian Gutterman {BIO 3106649 <GO>}

I know it is getting cold. So I am not as smart as Mark either. So I am still confused on the reinsurance. I guess I don't understand why it should be so variable quarter to quarter. If we are looking at written ratios, I can get that. But the earned should be a reflection of what you have written over the last year or so. And I would think that is reasonably baked in for the next couple of quarters of what this mix change is, given casualties have been growing a lot the past few quarters and cat has been shrinking. I would think we've kind of know for the next couple of quarters what it should be. So why might it switch a lot Q2 versus Q1?

A - Dinos Iordanou {BIO 2397727 <GO>}

Well don't forget, you had Q1 versus Q1 of a year ago. As Mark said, that thing was inching up along as we wrote those transactions. And some of these transactions we wrote in the third and Fourth Quarter. So they're inching up as the earnings are coming through.

So your statement is actually correct. But also you have got to go back and see the sequential movement that we have done. The only change to that is what we have done in the First Quarter. And mostly it was European kind of business, which was not part of what was coming from the third and Fourth Quarter last year.

And don't forget, if you go and look at our statements and what we have reported, we talked about some of these transactions, that they had a higher combined ratio on an expected basis. But very good return characteristics over time.

Q - Ian Gutterman {BIO 3106649 <GO>}

Okay. So if the written patterns stay consistent with the last few quarters, then, if I am understanding right, we will see the accident years increase year-over-year. But not as much as the First Quarter. But sequentially be reasonably similar to this quarter. And if the rest of it comes through from higher investment, because you have gone longer tail. Is that fair?

A - Dinos Iordanou {BIO 2397727 <GO>}

That is correct and it might reverse itself and go the other way, depending if those transactions get renewed or not as when you get to the expiration.

Q - Ian Gutterman {BIO 3106649 <GO>}

Sure. Okay.

A - Mark Lyons {BIO 6494178 <GO>}

Ian, I think one thing we prudently do. And that is we take -- try to take maximum advantage of what the market gives us. And it changes from quarter to quarter, what it allows and what it gives us.

Q - Ian Gutterman {BIO 3106649 <GO>}

No I agree. I get that on that underwritten. I just wanted to make sure I wasn't misunderstanding the earned.

A - Dinos Iordanou {BIO 2397727 <GO>}

No, no, no. You are absolutely -- you are right onto it. But that is why the comparison year-over-year sometimes has got to be supplemented by also the sequential change quarter over quarter.

Q - Ian Gutterman {BIO 3106649 <GO>}

Exactly. Got it.

A - Dinos Iordanou {BIO 2397727 <GO>}

Quarter after quarter.

A - Mark Lyons {BIO 6494178 <GO>}

Right. Yes.

Q - Ian Gutterman {BIO 3106649 <GO>}

Got it. Then on the mortgage insurance business, two questions there. One, from just the publicly available rate filings everybody has, it looks like you guys are priced lower than the market. A, is that accurate? And B, what is the thought behind that? Is that just an easy way to get established or something else?

A - Dinos Iordanou {BIO 2397727 <GO>}

The statement you made is incorrect. I have the table with our competitors and we are right on. There is not even a -- out of the table that is -- it has one, two, three, four, five, six, seven, eight, sixteen sales, right? We are slightly lower in only one and not with all, right? And in everything else, I think, we are right in line with everybody else.

Q - Ian Gutterman {BIO 3106649 <GO>}

Got it. Okay. I'll take another look at that. I am still learning this stuff (multiple speakers).

A - Dinos Iordanou {BIO 2397727 <GO>}

I have Arch compared to Magic, Radian, General, SM and NMI and we have the grid and -- I mean, the grid I was referring to is the --

A - Mark Lyons {BIO 6494178 <GO>}

Rate card.

A - Dinos Iordanou {BIO 2397727 <GO>}

The rate card. And when you look at the rate card, there is one -- only one sale that we slightly achieved. Every other sale is exactly the same as everybody else.

Q - Ian Gutterman {BIO 3106649 <GO>}

Got it. Okay.

A - Mark Lyons {BIO 6494178 <GO>}

The buyer paid sale as opposed to the lender paid.

A - Dinos Iordanou {BIO 2397727 <GO>}

Right.

Q - Ian Gutterman {BIO 3106649 <GO>}

Okay. Got it. Then just my last one, where the stackers that you have written -- how does that show up? It wasn't in the commentary of the premium. Was that in the premium this quarter or does that show up somewhere else because it is derivative form? Or how does that work?

A - Mark Lyons {BIO 6494178 <GO>}

Yes, Ian, we have deemed it because of the way the loss side works. The loss severity is referential to a table. It has nothing to do with individual characteristics of the claim itself.

So we viewed it as a derivative. So you are not going to see it anywhere in premium. Instead, it is closer to a mark-to-market impact each quarter. And it finds itself into -- okay, yes. It is an acquisition expense.

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Q - Ian Gutterman {BIO 3106649 <GO>}

Okay. So where do we see that? So does that end up in operating income? I'm just trying to figure out how to think about where that -- will show up in my model basically. Is it an operating (multiple speakers) is it?

A - Mark Lyons {BIO 6494178 <GO>}

Yes. It is acquisition expense. So it is in underwriting.

A - Dinos Iordanou {BIO 2397727 <GO>}

But it will affect the underwriting combined ratio. But it is in the acquisition expense.

Q - Ian Gutterman {BIO 3106649 <GO>}

Oh. Okay. Okay. But it is in that mortgage insurance segment.

A - Dinos Iordanou {BIO 2397727 <GO>}

It's a derivative. So at the end of the day it is going to be income.

A - Mark Lyons {BIO 6494178 <GO>}

Right.

Q - Ian Gutterman {BIO 3106649 <GO>}

Got it. And is that because it is a derivative, it might be volatile given based on what is going on with interest rate and such or is it reasonably (multiple speakers)?

A - Dinos Iordanou {BIO 2397727 <GO>}

No. No. It is a derivative because, if you look at these transactions, a portion of the (inaudible) transactions is done in the cash market that sold us bonds, right? And those trade on a daily basis. Then, you are bottom market to that. So it depends when that happens, right, how those bonds will trade.

It will tell you if you -- you can write a stack of transactions that over a long period of time will give you positive returns. But it may be in the first or second or Third Quarter, depending when we have the cash transaction trades, you might take a loss in the (multiple speakers).

Q - Ian Gutterman {BIO 3106649 <GO>}

(multiple speakers) okay. Got it. So as that becomes material, I'm guessing you will call that out if we have any of (multiple speakers)?

A - Dinos Iordanou {BIO 2397727 <GO>}

Right. You know. But it is -- we expect that to be positive. We expect it to be -- but -- and don't forget it is going to come over six or seven years, right? So we are spreading it out.

Q - Ian Gutterman {BIO 3106649 <GO>}

Got it. Thank you. Enjoy your lunch.

A - Dinos Iordanou {BIO 2397727 <GO>}

Do you want to pay for it?

Q - Ian Gutterman {BIO 3106649 <GO>}

We will see. Maybe next time.

Operator

At this time, we have no further questions. I will now turn the call over to Mr. Iordanou and Mr. Lyons for closing remarks.

A - Dinos Iordanou {BIO 2397727 <GO>}

All right. Thanks, Glenn. Thank you, everybody, for attending. We are looking forward to speaking to you next quarter. Have a wonderful day.

Operator

Ladies and gentlemen, that concludes today's conference. Thank you for your participation. You may now disconnect and have a great weekend.