Q2 2013 Earnings Call

Company Participants

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

Other Participants

- Amit Kumar, Analyst
- Greg Locraft, Analyst
- Jay Cohen, Analyst
- Jay Gelb, Analyst
- John Hall, Analyst
- Michael Nannizzi, Analyst
- Mike Zaremski, Analyst
- Vinay Misquith, Analyst

Presentation

Operator

Good day, ladies and gentlemen. Welcome to the Second Quarter 2013 Arch Capital Group earnings conference call. My name is Glen and I will be your operator for today.

At this time all participants are in listen-only mode. We will conduct a question-and-answer session toward the end of this conference. As a reminder, today's conference is being recorded for replay purposes.

Before the Company get 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 of 1995. The company intends the forward-looking statements in the call to be subject to the safe harbor created thereby.

Management will also make reference to some non-GAAP measures of 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 like to turn the call over to your hosts for today, Mr. Dinos Iordanou and Mr. Mark Lyons. Please proceed, gentlemen.

Dinos Iordanou {BIO 2397727 <GO>}

Thank you, Glen. Good morning, everyone, and thank you for joining us today. We had a good Second Quarter from just about every perspective, with the exception of unrealized losses in our investment portfolio due to the rising investment yields.

Earnings were solid and our cat claim activity was modest relative to the significant level of industry losses experienced this quarter. Across the group our premium revenue was essentially flat in the quarter, although there was a lot of movement in the pieces that will get to in a few minutes.

On an operating basis, we earned $0.99, which produced an annualized return on equity of 10.9% for the quarter. On a net income basis, we earned $1.26 per share which corresponds to a 13.8% annualized return on equity. For reasons that I mentioned on our last call, which I won't repeat again, ROE based on net income was again significantly better than ROE on an operating income basis.

Our reported underwriting results in the Second Quarter were excellent, as reflected by a combined ratio of 87.4. They were aided by better-than-average performance on our cat underwriting along with continued favorable reserve development on the rest of our book of business.

Net investment income was $0.50 per share and essentially was flat on a sequential basis. Our operating cash flow for the quarter was $183 million, a $70 million decrease from the same period last year, due substantially to higher paid losses on prior-year cats including Sandy.

Our investment performance suffered this quarter due to a significant rise in rates and widening of credit spreads. Of course, in the last two weeks credit spreads have come back, but as of the end of the quarter we did suffer a bit. As a result, our book value per common share decreased by 2.3% to $36.80, while it increased by 6.8% relative to the Second Quarter of a year ago.

The insurance market continues on its path of recovery with rates continuing to rise at roughly the same level as in the First Quarter. In our insurance operations, which gives us a good indication because we have more granular data, we experienced rate increases in the quarter that, based on our estimations, provided approximately 150 basis points or expected margin improvement. This is on an underwriting year basis.

Rate changes in the US range from a negative 300 basis points to as high as a positive 1,100 points. But I would like to emphasize that most lines average a positive 500 to 1,100 basis points improvement.

The movement of business from the admitted market back to the E&S market continues. Last quarter we mentioned our expansion into the binding authority insurance business that caters to small, smaller E&S accounts written through the wholesale distribution channels.

The group -- this particular group is off to a great start. They are producing an increasing level of business and have begun to leverage Arch's distribution platform to access more opportunities. We expect them to contribute more meaningfully to our operations going forward.

In our view, on an absolute basis, while most long-tail casual business still requires rate improvement to meet our return requirements, some segments, to our encouragement, are approaching rate adequacy within that block of business.

With regards to new versus renewal pricing, based on our monitoring systems we saw no change on a relative basis from the indications that we shared with you in our last conference call a quarter ago. On the reinsurance side of the business, terms and conditions are generally stable, although as the profitability of the primary insurers and our customers has improved clients have, at times, pressed successfully for additional seating commissions. Generally, 1 to 2 points is the additional seating commission that they gain on coder share [ph] transactions.

On a consolidated basis, in the Second Quarter of 2013 gross written premiums were down 1.1% and net written premiums were down 1.2% year over year. Net written premiums of the reinsurance segment were reduced by 13.1%, while the insurance segment grew their net written premiums by 8%.

The reductions in the reinsurance segment stem from property cat lines, other specialty, and mortgage businesses. The lower level of property cat net premiums written relative to the Second Quarter of 2012 was due to the rate reductions, as well as to a decreasing capacity deployed and an increased use of retrocessions.

The insurance segment had a net written premium growth predominantly emanating from their US operations, which represented approximately -- which represents approximately 75% of the worldwide volume this quarter. The US operations grew net written premium by nearly 18%, partially offsetting strategic reductions elsewhere in the world. The US growth came predominantly from our program business, national accounts, and our new contract binding business, as well as construction and a continued reduction in casualty lines, even though they are getting closer to meeting our return characteristics.

Construction and national account business had continued rate increases, very strong renewal retentions, strong new business generation, and we experienced ratable exposure growth in those sectors.

Group-wide, on an expected basis, we continue to believe the ROE on the business we wrote this year will produce an underwriting year ROE in the range of 11% to 13%. The underwriting margin improvement that I mentioned earlier will influence expected ROE positively, while the recent improvement in investment yields did not have a significant impact on expected ROEs as of yet.

Before I turn it over to Mark, let me update you on the status of our previously announced agreement to purchase assets of PMI and CMG. On June 20 the Arizona receivership court approved the transaction. We are now working to obtain the necessary 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. If those approvals are obtained, it is estimated that the transaction will close during the end of this year.

It is worth noting that our cat PML aggregates reflect business bound through July 1, while the premium numbers included in our financial statements are through June 30. So when you make the comparison you have to bear that in mind. As of July 1, 2013, our largest 250-year PMLs for a single event declined moderately to $858 million in the Northeast or -- and it represents approximately 17.5% of common shareholders' equity. And $746 million in the Gulf where our Florida Tri-County PML now stands at $606 million.

Now I am going to turn it over to Mark to comment further on our financial results and then we will come back and take your questions. Mark?

Mark Lyons {BIO 6494178 <GO>}

Great. Thank you, Dinos. Good morning all. Consolidated combined ratio for this quarter was 87.4% with 4.8 points of current accident year cat-related events, net of reinsurance and reinstatement premiums compared to the 2012 Second Quarter combined ratio of 87.2%, which reflected only 1 point of cat-related events. Losses from 2013 Second Quarter catastrophic events net of reinsurance, recoverable, and reinstatement premiums totaled $36.3 million, primarily emanating from the Moore, Oklahoma, tornado and flooding events in Europe and Canada.

The 2013 Second Quarter consolidated combined ratio also reflected 9.1 points of prior-year net favorable development, net of reinsurance and related acquisition expenses, compared to 8.6 points of prior period favorable development on the same basis in the 2012 Second Quarter. This results in a 91.7% current accident quarter combined ratio excluding cats for the Second Quarter of 2013 compared to a 94.7% accident quarter combined ratio on a like basis in the Second Quarter of 2012.

2013 accident quarter combined ratio, excluding cats, for the reinsurance segment was 81.2% compared to 81.5% in the 2012 Second Quarter. In the insurance segment, the 2013 accident quarter combined ratio, excluding cats, was 98.6% compared to an accident quarter combined ratio of 103% even a year ago. The corresponding 2012 insurance segment accident quarter combined ratio, however, reflected a higher level of large attritional loss activity of roughly 2.5 combined ratio points. Approximately 80% of the net favorable development in the 2013 Second Quarter was from the reinsurance segment, with approximately 43% of that due to net favorable development on short-tailed lines concentrated in more recent underwriting years.

Furthermore, roughly 6% of the reinsurance segment's net favorable development was attributable to medium-tailed lines spaced throughout many underwriting years and about 51% due to net favorable development on longer-tailed lines, primarily in the 2002 through 2006 underwriting years. The remaining 20% of net favorable development in this quarter was attributable to the insurance segment and was primarily driven by short-tailed lines in the more recent accident years and medium-tailed lines across various accident years.

Similarly to prior periods, approximately 69% of our consolidated $7 billion of total net reserves or losses in LAE are categorized as IBNR or additional case reserves, which is fairly consistent across both reinsurance and insurance segments.

On a consolidated basis, the Second Quarter of 2013 expense ratio was identical to the prior year's comparative quarter with a marginally lower net acquisition ratio offset by a marginally higher operating expense ratio. The marginal increase in the operating expense ratio reflects incremental expense due to certain platform expansions in both our reinsurance and insurance businesses and higher equity expense charges than in the Second Quarter of 2012.

Our US insurance operations achieved a positive 4.2% effective rate increase this quarter, which translates, as Dinos denoted, to a margin expansion of 150 basis points over the Second Quarter of 2012. This average range is from having margin contraction in some units, such as healthcare and professional liability, up to a positive 890 basis point improvement in our energy casualty operation.

Other areas of note in margin expansion were the executive assurance middle market, E&S casualty, and program businesses. These figures represent the excess of written effective rate increases over estimated loss trend and provide continuing evidence of improving market conditions. Property lines experienced a low single-digit rate increase this quarter and, therefore, did not experience additional margin expansion.

It is also important to understand that many insurance segment lines of business have experienced effective rate increases over an impressive amount of serial quarters. For example, although it is likely no surprise that wholesale and retail insurance property lines have seen eight to nine consecutive quarters of rate increases, it may not be apparent that other lines of business have experience comparable results.

Our specialty casualty, national accounts, workers' compensation businesses have experienced nine successive quarters of rate increases, whereas our executive assurance middle market and alternative asset protection books, along with our retail construction unit, have experienced eight consecutive quarters of rate increases. Lastly, our excess workers' compensation and umbrella books have enjoyed seven consecutive quarters of increases.

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

The ratio of net premium to gross premium in the quarter on a consolidated basis was 77.9% versus 78% even a year ago. In the reinsurance segment the net-to-gross ratio was 91.5% in 2013's Second Quarter compared to 94.3% a year ago, reflecting more retro purchases protecting their property book. The insurance segment had a 71.3% net-to-gross ratio compared to 68.7% a year ago as a result of their ongoing strategy to grow the less volatile smaller account businesses and reduce exposure in higher severity businesses.

The total return on our investment portfolio was a reported negative 159 bps in the 2013 Second Quarter, primarily reflecting mark-to-market adjustments on fixed income securities. Excluding foreign exchange, total return was a negative 156 bps in this quarter.

This quarter's unrealized losses of approximately $260 million overshadowed realized gains of $12.7 million, so the following commentary will focus on the unrealized. This quarter's unrealized loss of approximately $260 million is almost entirely due to changes in fixed income security valuations driven by the rising interest rate environment and widening credit spreads, particularly in corporates and mortgages.

This unrealized loss for the quarter represents 2.5% of the March 31, 2013, fixed income asset fair value. This percentage reduction ranged from a low of minus 1.3% for asset-backed securities to minus 3.4% for corporate bonds, although much of the portfolio clustered near minus 2.5%.

It is worth noting that equities and alternative investments now account for 14.9% of investable assets as of June 30, 2013, versus 12.9% a quarter ago and 9.6% a year ago as of June 30, 2012. This allocation on a portfolio basis has the potential to ameliorate future impacts on fixed income securities from rising interest rates and widening credit spreads.

Our embedded pretax book yield before expenses was 2.43% as of June 30 compared to 2.45% at March 31, 2013, while the duration of the portfolio lengthened slightly to 3.04 years, which continues to reflect our conservative position on duration in the current yield environment. Our exposure to Eurozone countries as listed in the supplement with continued minimal exposure to countries undergoing severe economic hardship.

Reported net investment income in the quarter was $68.4 million, or $0.50 per share, versus $65.7 million in the 2013 First Quarter, or $0.48 per share, and $73.6 million, or $0.53 a share, in the comparable quarter a year ago.

Our effective tax rate on pretax operating income for the Second Quarter of 2013 was an expense of 3.3% compared to a benefit of 0.3% in the Second Quarter of last year. Approximately 90 basis points, or $1.3 million, of the Second Quarter tax expense is associated with catch up of the First Quarter to this higher effective rate. Fluctuations in the effective tax rate can result from variability in the relative mix of income or loss reported by jurisdiction, along with forecast variances for the last six months of the 2013 year.

Our total capital was $5.63 billion at the end of this quarter, down 1.8% relative to March 31 and up 1.1% relative to year-end 2012. During this quarter we repurchased $15.5 million of our common stock at an average 1.33x multiple to March 31, 2013, book value, which had a $0.03 impact on book value per share.

Our debt-to-capital ratio remains low at 7.1% as debt plus hybrids represent only 12.9% of our total capital structure, which continues to give us significant financial flexibility. We also continue to estimate having excess capital in excess of our targeted capital position.

Book value per share was $36.80 at June 30, as Dinos denoted, which still represents a 6.8% increase relative to one year ago at June 30, 2012. This change in book value this quarter primarily reflects the Company's continued strong underwriting results offset by the negative impact of rising interest rates and widening credit spreads on fixed income securities.

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>}

Thanks and good morning. Two brief questions. First of all, just going back to the data points on pricing and new business on the insurance side, those were very helpful. I was wondering if you could also broadly talk about the impact of exposure on those lines, maybe just on some of your larger lines. If you were seeing any meaningful impact on that side too.

A - Dinos Iordanou {BIO 2397727 <GO>}

Exposure is customer by customer. Some customers their business starting to show some growth and we have seen some improvements, but it is not across the board. There is still a lot of customers that from an exposure point of view where the economy is suffering. We are not seeing increase payrolls or increase sales, etc.

But when we do our rate calculations, they are all exposure-based rate calculations and comparisons. But if your question is where the economy is going and if there is a lot more buying of our products, the answer is no. It is incrementally better than a year ago, but this economy is not moving at a high degree of new exposures.

And the customers, we haven't -- sometimes you can get them to purchase either additional layers or additional limits and we don't see that either. They are pretty conservative in that purchase.

Q - Amit Kumar {BIO 15025799 <GO>}

I didn't phrase that question properly. I guess what I was trying to ask is that if rates are, as you said, are approaching adequacy do you feel that exposure growth will still result in a positive sequential trend line? I guess that is what I was trying to ask and I think in some ways you did answer the question.

A - Dinos Iordanou {BIO 2397727 <GO>}

Well from a rate point of view, the more business that you get close to adequacy to maintain the same ROE performance. Then from that point on you don't need extraordinary rate increases, you need rate increases that will cover loss cause escalations. So as long as we are covering trend or we are ahead of trend, then we are very happy to write the business and continue to renew it.

In prior calls we talk about we have green lights, yellow lights, and red lights depending on the products that we put in the marketplace. We are seeing very few reds and more getting into yellow, that means writing with caution, and more getting into green, which will allow our divisions to grow that business.

Mark, you want anything to add to it?

A - Mark Lyons {BIO 6494178 <GO>}

Yes. Thank you, Dinos. Just a potential clarification, in the insurance group -- in the US it is 75% of the insurance group where we have all the detail. You kind of think of the aggregate rate versus premium growth this way in the US.

Rate was roughly 4.5%. It might be, to Dinos' point, a marginal increase in exposure on same-store accounts. Maybe 4% to 5% of that growth is new business, which is new aggregate exposure but not growth in exposure within the existing accounts. Then the balance, because you are looking at net written premium, you have to take into account the change in the net to gross, which bumps up the increase in the change in net written.

A - Dinos Iordanou {BIO 2397727 <GO>}

Then you got to deduct the business that you have lost to get to your aggregate exposure.

Q - Amit Kumar {BIO 15025799 <GO>}

So you did answer my question. Sorry, I did not phrase it properly.

The only other question I had was your discussion on excess capital. On another call earlier today we were talking about third-party capital, new capital, whatever you want to call it. Perhaps looking at other avenues including cash realty reinsurance risk versus traditional prop cat, I am curious A) what is your view on that and B) would Arch be interested in something like that potentially down the road? Thanks.

A - Dinos Iordanou {BIO 2397727 <GO>}

First, my views are that capital formation will take different kinds of forms. It is more difficult from a buyer's perspective, a customer perspective to create those structures on the casualty line, because in casualty lines, due to the long nature of the tail, it requires more of a permanent capital. It is not capital that you can put in towards a period of time that is in need and then withdraw it when there is other ample capacity.

So my view is eventually some of these structures, even in casualty, they will be created but it will have more permanency to the capital. And don't forget, in the casualty area you need to have significant underwriting capability for the model to work.

So as a company we are interested in those structures. We had over the years many different discussions with different parties, and if we find the right structure that it benefits our shareholders we will do it. But that is basically what we are.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. Thanks so much for the answers.

Operator

Mike Zaremski, Credit Suisse.

Q - Mike Zaremski {BIO 20606248 <GO>}

Thanks. Maybe a follow-up on Amit's question and I may be nitpicking here. Dinos, in the prepared remarks I believe you cited primary insurance pricing trending in excess of loss costs by 150 basis points.

A - Dinos Iordanou {BIO 2397727 <GO>}

Yes.

Q - Mike Zaremski {BIO 20606248 <GO>}

I wrote down last quarter that you said it was trending in excess of loss costs by 300 basis points.

A - Dinos Iordanou {BIO 2397727 <GO>}

That is also correct.

Q - Mike Zaremski {BIO 20606248 <GO>}

Okay. So is the climate being driven by new entrants into the E&S marketplace? Or maybe you can comment on why that has changed.

A - Dinos Iordanou {BIO 2397727 <GO>}

No. I think -- as Mark said, and I will turn it over to him, you are not going to get consecutive -- you are not going to get rate increases escalating by 8%, 10% forever. So at some point in time you will see that -- the market works in peculiar ways.

When certain lines of business they get to rate adequacy, to us rate adequacy is to produce 15% ROE. Once you get there, as I said, the only thing you need is you try to make sure that you are getting enough rate to cover the loss trend because loss trend will escalate. And as long as you are above it you have an improved environment.

So there is, I think, in the aggregate -- and, Mark, you know the numbers better than I do -- we probably lost on average about 1 point. If we aggregate all of our businesses, the rate increases we got in the First Quarter versus the rate increases we got in the Second Quarter, there might have been 1 percentage point less in the Second Quarter. But it is still an improvement because it is on top of what we got a year ago and two years ago.

When you look at it from that perspective the ROE on an underwriting year basis on that business we write today will be a little bit better. And that is what we try to estimate, that 150 basis points. Mark?

A - Mark Lyons {BIO 6494178 <GO>}

That is a great point. One of the reasons I talked about the serial changes for like eight or nine quarters is you are at the right quarter, you are now approaching your third increase which is why you are going to start to get to some of this adequacy. But a lot of this still comes down to mix from one quarter to a different quarter.

We would have had more insurance property which flattened out a little bit more this quarter, but, for example, we felt that more of the E&S casualty business had gone over the goal line to 15%. That unit experienced 9.5% rate increases in the last quarter. Didn't open that floodgate yet, but as Dinos said, it is starting to approach that.

We start contributing some of that business as it goes over the goal line you are going to see the effect of rate changes increase because of the weighting impact of that unit.

Q - Mike Zaremski {BIO 20606248 <GO>}

Okay, that helps. Are you saying then, Dinos and Mark, that a lot of these lines have reached the rate adequacy, meaning a 15% projected ROE?

A - Dinos Iordanou {BIO 2397727 <GO>}

We didn't say all. As I said, we still have product lines in the yellow, which just means you got to be selective and do it with caution.

To us a green light is a product line or a division that we believe the marketplace is allowing them to underwrite to 15%. Still quite a bit of what we do is in that. As I said, I gave that 11% to 13% ROE depending. And the reason we give a range is because we don't know how the mix is going to come in, but that means there is still a lot of business that is in there, high single-digit ROE and low double digits, in order to average 11% to 13%.

We have lines of business that are in the green, but we do have some in the red still and we still have more and more in the yellow.

Q - Mike Zaremski {BIO 20606248 <GO>}

Got it. Lastly, on investment income, you guys have done a good job on the book yield and on just overall investment levels. Do you expect the recent rise in new money yields to be a material benefit on a perspective basis? Thanks.

A - Dinos Iordanou {BIO 2397727 <GO>}

Mark, do you want to --?

A - Mark Lyons {BIO 6494178 <GO>}

Yes, I think to kick that off we view that the new money rates in this quarter compared prior was about a 50 basis point move up. And that is beneficial. But the range Dinos quoted, 11% to 13%, all it really does is change the placement within that range more than anything else. So it depends on how sustained it turns out to be.

A - Dinos Iordanou {BIO 2397727 <GO>}

We have been guarding against rising interest rates for a long time with keeping the portfolio short in duration and also high credit quality. So in essence, we might take the unrealized hit, but it will unwind itself within the duration of the portfolio pretty quickly.

So if rates move up it will be beneficial to us and I guess most of our competitors. It depends what happens to the underwriting side of the business. Will the underwriting then get adjusted because we are getting more yield, or people they say, no, let's keep the same underwriting margin because -- and yield will be a margin improvement?

So I don't know. I can't predict the future and I can't predict behavior, but I can tell you a rising interest rate environment, even though it is negative early on, it gets very positive for us.

Q - Mike Zaremski {BIO 20606248 <GO>}

Maybe I could just in more simpler terms then? So if current interest rates stay where they are and you talk about a 50 basis points increase in new money yields, do you expect the portfolio yield to increase by 50 basis points?

A - Mark Lyons {BIO 6494178 <GO>}

Well again, it depends on what mix of business that we wind up with. But you really have to layer on the duration of that on top of it.

A - Dinos Iordanou {BIO 2397727 <GO>}

Also, the portfolio turns over -- what is coming off from the prior years, what is maturing, and what gets reinvested. But I can tell you there is also a shift in our allocations to alternative investments and assets. That is the reason I went through that whole explanation why our net income is different than our operating income, because as we are increasing allocations into alternative investments, including equities, etc., some of it is not going to come as investment income. It is going to come to us over time as realized capital gains.

So it is not easy to answer your question with a simple answer and say, yes, it is going to improve by 50 bps. But looking at the fixed income portion of what we do and not taking into consideration how much is rolling off and coming and gets reinvested, anything that is new and we are putting in fixed income has a 50 bps improvement. I don't know if that is a quarter of the portfolio or -- I haven't done those calculations.

Q - Mike Zaremski {BIO 20606248 <GO>}

Thank you.

Operator

Michael Nannizzi, Goldman Sachs.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Thank you. I guess one question is within the reinsurance book, all else equal, would you expect to continue to reduce capacity that you are gearing towards property cat as the year progresses? And would you expect to be moving at into either areas of reinsurance or just taking the opportunity to write more insurance at the same time?

A - Dinos Iordanou {BIO 2397727 <GO>}

Listen, there is nothing that we do because we move from one to the other because we are in an excess capital position. So basically all of our units can have all the capital they want as long as they can deploy profitably. So let's start with that, because I am not stressed out that I have to take from Peter to pay Paul. If Peter and Paul can give me very good returns, they get all the capital they want.

Now having said that, our market conditions will influence as to how much we do on the reinsurance sector and depending if it is US cat or international cat or whatever. We will look at transaction after transaction and we see what we believe the profitability is and do we like it. Then we write that business.

As you can see, we are at 17.5% of common equity as our highest 250-year big zone, so we got plenty of room. We are authorized by the Board to go all the way up to 25%. So from a capital point of view, from a capacity point of view we have more. It's only the market will allow us to do more or less.

Now you are asking me to predict how the market is going to behave. I don't know. It depends on that behavior, and we will tell you that if rates continue to go down we will adjust accordingly. And if rates go up, we will adjust.

Also, sometimes we are sellers and sometimes we are buyers. We did buy more this quarter. It gives us more protection. It smoothes out the volatility within our book of business.

We felt we were getting good deals. I'm sure the people who sold it to us they also think they are good deals, but people can have difference of opinion on that.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. One question I had is I saw recently the New York MTA floated an insurance bond which it had sold to the capital markets. It seems to me, and I could be wrong, but I think it is one of the first either insurance market transactions or just specifically outside of property cat reinsurance.

Is that important as a development? Again, I realize it is very small. Or is that something that you think will happen from time to time?

A - Dinos Iordanou {BIO 2397727 <GO>}

They will happen from time to time. It is not significant. Even in the cat market today, which the benefit seems after Katrina, which is seven, eight years, it is not a significant part of the capital formation. Still, traditional capital and those type of transactions they are preferred by most customers.

The sum of the specialized companies they are unrated, fully collateralized vehicles. They are reissuing similar covers as the rest of us and that is capacity that you have to worry about. The cat bonds, they had been around for a long time, but they are not a significant part of the business.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. Great, thank you.

Operator

Jay Gelb, Barclays Capital.

Q - Jay Gelb {BIO 21247396 <GO>}

I had a couple in terms of business volume trends. The first with the pull back in reinsurance premiums. I understand that reflects, to some extent, market conditions, but I'm trying to get a sense of whether you think that you will still see growth in premium volume for the year. So that is first for reinsurance.

Then, second, can you talk a little bit more about within the insurance segment the growth in the program business? And I will have a follow-up.

A - Dinos Iordanou {BIO 2397727 <GO>}

Let me start with reinsurance. Reinsurance, it is a lumpy business and it is hard to predict what is going to happen. Let me start.

We had reductions in three sectors. One, it was mortgage, but that is kind of comparing apples to oranges. If you go back to when we reported a quarter ago, a year ago for the Second Quarter, you will note that we had kind of an incoming portfolio because on the mortgage reinsurance we had premiums from November, December, and First Quarter, and Second Quarter that we booked.

Now the second part was the UK motor that we said. As long as we believe the business is profitable, we stick with it. If it is not, we will let others do it.

As you can see, there is more competition in that line so we have switched to write more excess of loss, not as much quota share. So that affects the premium production.

But I don't know if that is a predictor as to what is going to happen into the future. By its nature you can write one or two new contracts and you can change the trajectory. The reason we don't give guidance and all that is because I can't predict the future. I mean our whole principle is we are going to underwrite and we have a big appetite, but it has got to have profitability before we do it.

Not trying to avoid your question there, but I'm just telling you, Jay, how we operate.

The second part was the insurance group. We believe we have a great program division. You heard from some of our major competitors who write package business, and these are very good companies like the (inaudible) or the Travelers, etc., and they are getting good rate increases.

And that is the sector that our programs administrators compete with because they write, even though the specialized covers for certain kind of customers that are in that market. We have been experiencing very good rate increases, which in essence give us more revenue, but also new exposures. Winning additional customers. And that business has been behaving extremely well for us for all the last 10, 11 years, so we are glad that it is growing.

Our binding authority business, which is the level below that, these are average $5,000 per policy premiums. They are small E&S accounts. And that business is going through market improvement from a rate point of view and through the teams that we have and also the very broad distribution capability that we have for either relationships that Arch has with wholesalers is really going very well. That unit, I think, is up to about $1 million a quarter -- a week in production which is ahead of our projections.

A - Mark Lyons {BIO 6494178 <GO>}

One thing I could add, Jay, is that on the program business, as Dinos denoted, and the contract binding business and why I always bring mix up, growth in that if that is above average growth it's going to really impact the growth in the net written, because that is virtually 100% net business. So it's not like we are growing in a line where we are feeding reinsurers heavily. Those kinds of things alter the net pretty dramatically.

A - Dinos Iordanou {BIO 2397727 <GO>}

It is small limits. We keep it 100% net and it all sticks to the ribs.

Q - Jay Gelb {BIO 21247396 <GO>}

Then switching gears to capital management. The pace of buybacks has been pretty modest so far this year. Should we expect anything before 4Q?

A - Dinos Iordanou {BIO 2397727 <GO>}

No, Third Quarter we don't like to buy because of the cat exposure that we have. That would be an issue in Fourth Quarter.

Q - Jay Gelb {BIO 21247396 <GO>}

Understood, thank you.

Operator

Vinay Misquith, Evercore.

Q - Vinay Misquith {BIO 6989856 <GO>}

A few questions here. First is just a numbers question on the mortgage reinsurance and the UK motor. So I presume those lower premiums are also negatively impacted during the Fourth Quarter. Do you have a sense for how much is it going to negatively impact the third and Fourth Quarter for those two?

A - Dinos Iordanou {BIO 2397727 <GO>}

The mortgage is a comparison issue. You are comparing a fat quarter a year ago to on a written, not on an earned basis. So basically, I don't think that has an effect as we move to the third, fourth, First Quarter from a year-to-year comparison.

The motor will be coming down proportionally on the same basis for the third and Fourth Quarter, because we have cut back our capacity in that line.

Q - Vinay Misquith {BIO 6989856 <GO>}

So do you have a number on that by any chance?

A - Dinos Iordanou {BIO 2397727 <GO>}

I don't have all the treaties [ph] in front of me calculating numbers.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. Thanks. The second thing is actually more of a philosophical question. I think your company, I think you do notice, has taken the stance that we will wait for the market to turn. And only when it is sufficiently turned, we will also go after growth.

And (inaudible) to the fact that more is green now versus red, and that is interesting. But there's some discussion out there that maybe we are reaching the end of tier rate increases. So just a philosophical question, do you think that you can actually now grow or take advantage of the opportunities, or do you think that now that pricing is reaching sort of adequacy that there will be more competition?

A - Dinos Iordanou {BIO 2397727 <GO>}

Like you are asking me, first, a philosophical question. Let me answer that first and then get to the predictions, which I don't like to make predictions.

On a philosophical point of view, this is the same playbook we have been running Arch for the last 12 years. Business is in the red, you had better justify everything that you do. If it is in the yellow, you be very careful. If it is in the green, write as much as you can get to.

Now as I said, there is more in the yellow and there is some moving into the green, and that is where you see growth especially. And that is more of a phenomenon in the United States. I don't think the European markets have moved yet. So the price corrections they are mostly in North America -- the US and a bit in Canada.

Having said that, once you get to rate adequacy, in our view, and you are getting enough rate increases, maybe smaller than before but it is ahead of trend, you would be stupid if you are not trying to write as much as you can. So we are going to have that approach. We are going to try to write as much as we can.

Having said that, I don't know how the competitors are going to react. They might -- because rates go up and down depending on what I do versus somebody looking at the same account from a competitor's point of view. So if rates start going down, then you are going to see us pulling back again. Because our whole mentality is let's look at treaty by treaty on the reinsurance side, account by account on the insurance side, does it meet our return characteristics.

Then -- we are not governed by volume. We are not a volume-driven company. I have no production goals for any one of my divisions. They don't get compensated on production. They only get compensated on return on equity.

It is my problem to make sure that our capital gets utilized properly. So if they can write a lot, I give them the capital. If they can't write as much, then I have to deal with the capital and excess capital issue at the holding company.

A - Mark Lyons {BIO 6494178 <GO>}

Vinay, one other little insight would be, I made the comment that the E&S casualty book was up 9.5% in the quarter. And there have been prior quarters where it has been similar. We just have chosen not to play in there yet because it hasn't gone into the green, but it is approaching it. So there has been no evidence, strong evidence, of that abating.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay, that is helpful. Just as a follow-up to that, your primary insurance operation you only keep about 70% net. Do you think you are going to raise your retention on primary business now that it is improving?

A - Mark Lyons {BIO 6494178 <GO>}

Don't mislead yourself, that is a premium comparison, not a limit or exposure comparison. Remember, we chose to grow contract binding business, program businesses, lenders businesses -- things that don't put out a lot of capacity and, therefore, we take as frequency-based. And we are more comfortable taking that risk assumption in-house.

The fact that D&O businesses and hospital professional businesses have capacity out to $25 million in the US simply means we haven't deployed it as much, but they may still be reinsured to the same level until we are comfortable of where the returns are.

A - Dinos Iordanou {BIO 2397727 <GO>}

Right. But if you have seen the trend for the last few quarters, our net-to-gross is increasing. So we are getting more net, because what we are actually selling is more low limits, primary small accounts business. And that we keep 100% net. There is no reinsurance behind that.

A - Mark Lyons {BIO 6494178 <GO>}

And to emphasize, Dinos has made the point before that this is US-centric. Technically, the Bermuda insurance market has a lot of global and a lot of US companies that are very complex and they buy a lot of capacity. The businesses we are growing in in the US don't make it to Bermuda because they are very low limit. So you are not seeing those kind of increases yet out of the Bermuda facility.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay, that is helpful. Just one last question, if I may. On the ROE of 11% to 13%, what amount of that can we see hit the bottom line as an operating return? Because you have excess capital and you have also the returns on the equity portfolio. So how should we translate that into really the bottom-line operating ROE?

A - Dinos Iordanou {BIO 2397727 <GO>}

Well if you don't know how much excess I have you can't make that calculation because we take the S&P AA level capital and that is what we allocate to the operating unit. Everything else -- of course, we allocate some capital to the investment department. We expect alpha from the investment department for the capital that we allocate.

Don't forget, we do the ROE on the operating units on the reinsured rate of return when I allocate capital, so it is the combination of that. Our excess capital is not significant. It is not 20% of the book. It fluctuates, but it has been around 10% of our total capital.

So you can do the calculation. It might affect it -- because the underwriting ROEs we do on allocated capital to the operating units. And that is when -- and the underwriters there get compensated on that ROE because I don't want to give them excess capital, bring down the ROE specifically to one division, and affect their compensation negatively. Because I'm going to go out and try to find business to write and then that is business that I don't want on the books if they don't have the proper return.

So we try to align their interest by giving them the right amount of capital, AA capital, let them operate, and we hold them responsible to their performance to that. So it is old formula, it works. It is like doing cheeseburgers on a Greek diner. I used to do that when I was in college.

Q - Vinay Misquith {BIO 6989856 <GO>}

Thank you very much, Dinos.

Operator

Greg Locraft, Morgan Stanley.

Greg Locraft Thanks. You guys released your global triangles in the quarter, just wanted to see if there was anything in particular that you wish to call out. They look pretty strong, continue to be strong. I don't know if there is any lines or anything that are worth mentioning.

A - Dinos Iordanou {BIO 2397727 <GO>}

Mark, do you have anything? I like what we released and I like the taste of that meal, too.

A - Mark Lyons {BIO 6494178 <GO>}

I have nothing to add.

Q - Greg Locraft {BIO 4221265 <GO>}

Okay. Great. Thanks, guys.

Operator

John Hall, Wells Fargo.

Q - John Hall {BIO 1497612 <GO>}

In your commentary you talked about the long-tail casualty leading rate in some segments, but some hitting adequacy. I was just wondering if you could share what some of those segments are (multiple speakers).

A - Dinos Iordanou {BIO 2397727 <GO>}

It is pretty simple. I think lead umbrella is still shy of adequacy. Don't forget, we still have (inaudible) attachment points, like auto attaching excess of $1 million. And even long-haul trucking sometimes they are attaching excess of $2 million, which is, to me, you are in the buffer area. We are not in the lead umbrella area.

But if you get over 25 million or so and the area that we see on small, medium-size accounts and all that, that is the area that now that excess -- it's still not the excess that goes to the global markets -- Bermuda, London, etc. The Fortune 2000 per se. But Mid-America and those kind of accounts on the excess they are starting to whet our appetite where the lead umbrella is not yet where we want to be.

Then we like some of the primary. Sector by sector is different. It is different exposures, different customer groups, but those are the primarily E&S, the first million of exposure over either deductibles or SIRs. So you got the primary we like and we got kind of mid-excess that we like. We don't like the umbrellas, lead umbrella, etc.

But we are watching it and we are measuring it. I'm not saying we are right, it is just one company's opinion. That is what makes the marketplace. But I do pay a lot of guys a lot of money to make sure that they keep monitoring, monitoring, monitoring and making decisions. We are not going to make everything and be correct in every decision we make, but we try very hard.

Q - John Hall {BIO 1497612 <GO>}

Great, understood. And I just want to ask about the mortgage insurance acquisition. I guess when you first started doing all your work the field was not very crowded and the incumbents were pretty beaten up. And by the time you closed at the end of the year and then frictional start up and the like, it is going to be pretty far out there when you really start ramping up in that business.

I guess the question is will the opportunity that you saw six or 12 months ago be there in another 12 or 18 months?

A - Dinos Iordanou {BIO 2397727 <GO>}

Yes. We wouldn't have gotten into that in the permanency of such if we didn't think the runway is seven to 10 years out. Don't forget, if I thought the market opportunity was temporary I would have stuck just with reinsurance transactions, so I can do them when they are needed, one or two or three years, and then move on when they are not needed.

We view that marketplace, the need for good capacity. And the field is not crowded. It is going to be six or seven of us in a field that has potential to expand significantly, especially depending what our legislators do in Washington as they are trying to push more and more of the credit risk to the private market instead of government-sponsored enterprises, etc.

FHA still is the predominant insurer with maybe -- I don't know if they have dropped below 60% of the market, but they still have 60% of the market. In normal conditions it is supposed to be the insurer of last resort, kind of the assigned risk, and they are in their 15% to 18% market share.

So we got a long way to go and we view the opportunity today as good as it was six months ago. We wouldn't have moved towards that if we didn't think this has a seven, to 10-year horizon in front of it. A lot of things can happen and that might change, but that is our view for the present time.

Q - John Hall {BIO 1497612 <GO>}

Got it. Appreciate it. Have a nice weekend.

Operator

Jay Cohen, Bank of America Merrill Lynch.

Q - Jay Cohen {BIO 1498813 <GO>}

Thank you. A couple questions. Mark, can you talk about the difference now between the new money yields and your portfolio yields, assuming you are investing in a similar asset class?

A - Mark Lyons {BIO 6494178 <GO>}

Well broadly speaking, we quoted the embedded yield on fixed income, which Dinos said is a piece of the action at 243 bps, which is pretty flat from the last quarter. The 50 bps improvement that we quoted really about all I am prepared to really comment on.

But since we are a total return-focused entity and that is total return, irrespective of the geography of where it's put and irrespective of the asset classes, it is hard for us to answer that question without the alternative investment side and everything else coming into play. So --

Q - Jay Cohen {BIO 1498813 <GO>}

We can make our own assumptions on the alternative, but the fixed income is still a big portion of the portfolio and so that is why I was (multiple speakers).

A - Dinos Iordanou {BIO 2397727 <GO>}

But, Jay, you don't know how much is rolling on and off. Don't forget, you are getting maturities that you got to reinvest so you got to see what the reinvestment -- and I don't have those numbers in front of me. But maybe we can do some calculations and share some comments. Give us a call and then we will go through it with you.

A - Mark Lyons {BIO 6494178 <GO>}

But by common geography, as more treasuries and other things that rolls, it is going to be higher coupons. You guys tend to focus more on the income statement NII, which is going to get the benefit from it. As Dinos said earlier, over the term of the duration of the portfolio it is going to unwind itself. But geography base this year going to see some improvements because of the higher coupons.

Q - Jay Cohen {BIO 1498813 <GO>}

Right, right. I guess the second question is really a follow-up on the insurance pricing question where you suggested that the price increase decelerated a bit in the quarter. But pointing out that it's still good to get increases above claims inflation, which is clearly true.

I guess a concern that the equity markets have is that this is a trend we will see for the next two or three quarters and whatever cushion there is in pricing is going away pretty quickly. So my question to you is, while you did see that deceleration (multiple speakers)

A - Dinos Iordanou {BIO 2397727 <GO>}

That premise is not what we have said, but go ahead, finish your question.

Q - Jay Cohen {BIO 1498813 <GO>}

Well that's not really the question. The question is are you -- the tone that you are seeing in the market, the behavior you are seeing, does it really represent -- do you see a big change in how your competitors have been behaving that would make you nervous that this slide, if you will, will continue?

A - Dinos Iordanou {BIO 2397727 <GO>}

No. We don't see aggressive behavior, so to speak, in the marketplace. I think people they are pushing for improved terms and pricing on the primary markets. Also we see the trend that we mentioned that the primary insurers don't want to share as much of that with the reinsurers.

They say, hey, you guys had pretty good numbers for a long time. We need the improvement so we are going to -- you got to stick to our ribs, so pay us a little more seating commission if you want our business. And we see that.

But this is an improving environment. An account, even though you are not getting the same rate increase that you got a year ago, it doesn't mean on absolute basis is marginally better. As long as that continues that is a good thing.

I hear about this second derivative BS and all that, and at the end of the day maybe those are trying to be predictors of what is want to happen into the future. I don't know what is going to happen into the future.

But as long as we are getting as an industry, and we are, we are getting price increases that are ahead of claim inflation, things are getting better, not worse, and there is no other way to interpret it. If people have a crystal ball and they say this now is going to go into a dive and the rate increases are going to be below claims inflation, you can get into a different conclusion. But there is no evidence in anything that we see or anything else that every competitor has reported that is pointing to that.

Q - Jay Cohen {BIO 1498813 <GO>}

Great, that is helpful. If I could squeeze in one more question, the expense ratio on the reinsurance side, the G&A expense ratio was up a little bit and one of the things you mentioned in the release was some investments in that business. Can you talk more about that, exactly what that (multiple speakers)?

A - Dinos Iordanou {BIO 2397727 <GO>}

It was two things, it's very simple. You guys read 8-Ks sometimes, but you don't pay a lot of attention to it. We did a big retention grant at year-end, so there is equity cost that is coming through. Especially if you are familiar with accounting rules -- and believe me I got so many accountants I take three Advils every time I meet with them. If a lot of our employees they are retirement eligible, you got to take that cost in one year immediately. So you can't spread it over the five-year cliff vesting and all that that we have.

Second then we had to beef up some of our teams, both on the -- starting to hire on the mortgage side and starting to hire in the life reinsurance sector a few individuals. And of course, on the insurance side we brought a big team, which is starting to produce already, in the contract binding business.

So the retention grant was done for the right reasons. We have good employees and we want to retain them, and we create another obstacle for competition to take them. We are paying for it and we are happy about it.

But that is the two explanations. There is nothing more into those numbers other than those two things.

Q - Jay Cohen {BIO 1498813 <GO>}

Got it. That is really helpful. Thank you.

Operator

There are no further questions at this time.

A - Dinos Iordanou {BIO 2397727 <GO>}

Thank you for giving us the time and the opportunity. We are looking forward to seeing you and talking to you next quarter. Have a good afternoon.

Operator

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