S&P Capital IQ

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Arch Capital Group Ltd. NasdaqGS:ACGL

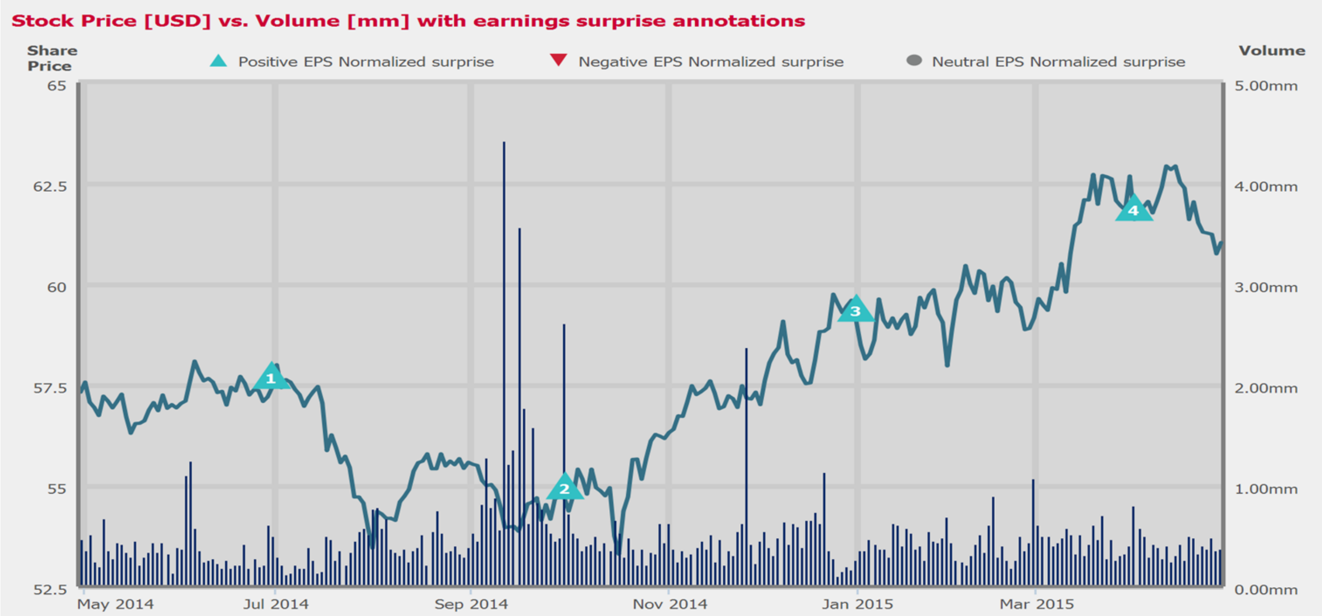
FQ2 2015 Earnings Call Transcripts

Thursday, July 30, 2015 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2015-			-FQ3 2015-	-FY 2015-	-FY 2016-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.07	1.16	▲8.41	0.88	4.22	4.13
Revenue (mm)	1014.60	823.39	▼(18.85 %)	988.41	3733.40	4189.31

Currency: USD
Consensus as of Jul-30-2015 12:07 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2014	0.98	1.17	▲19.39 %
FQ3 2014	0.95	1.05	▲10.53 %
FQ4 2014	1.03	1.15	▲11.65 %
FQ1 2015	1.08	1.17	▲8.33 %

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Presentation

Operator

Good day, ladies and gentlemen, and a welcome to the Second Quarter 2015 Arch Capital Group Earnings Conference Call. My name is Crystal, and I will be your operator for today. [Operator Instructions]

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

Additionally, certain statements contained in the call that are not based on historical facts are forward-looking statements within the meaning of Private Securities Litigation Reform Act of 1995. The company intends the forward-looking statements in the call to be subject to the Safe Harbor created thereby. Management also will make reference to some non-GAAP measures of financial performance. The reconciliation to GAAP and definition of operating income can be found in the company's current report on Form 8-K furnished to the SEC yesterday, which contains the company's earnings press release and is available on the company's website.

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you, Crystal. Good morning, everyone, and thank you for joining us today. Our second quarter earnings were driven by solid reported underwriting results, while investment returns were impacted by the recent rise in interest rates. On a group-wide basis, our gross written premium declined by 8% in the quarter, while our net written premium decreased by 10.5%, as underwriting actions and rate decreases in our insurance and Reinsurance businesses offset growth in our mortgage business.

Changes in foreign exchange rates also reduced our net written premium on a U.S. dollar basis by $22 million or approximately 2.4% of our volume in the quarter. On an operating basis, we earned $146 million or $1.16 per share for the second quarter, which produced an annualized return on equity of 9.9% for the 2015 second quarter versus an 11.2% return in the second quarter of 2014. On a net income basis, Arch earned $0.88 per share this quarter, which was lower than operating income primarily due to foreign exchange and realized investment losses. On a trailing 12-month basis, net income produced a 14% return in equity.

Net income movements on a quarterly basis can be more volatile as these earnings are influenced by change in foreign exchange rates and gains and losses in our investment portfolio. Our reported underwriting results remain solid as reflected in our combined ratio of 87.9% and were aided by a low level of catastrophe losses and continued favorable loss reserve development. Net investment income per share for the quarter was $0.53 per share, down $0.02 sequentially from the first quarter of 2015 due to the short term effects of share repurchases on investable assets during the quarter.

Our operating cash flow was $232 million in the second quarter as compared to $254 million in the same period last year, primarily reflecting reduced net premiums writings over the past 6 months. Our book value per common share at June 30, 2015, was $47.49 per share, a slight decrease from March 31, 2015 and an increase of 8.6% from the $43.73 per share at June 30, 2014. With respect to capital management, we continue to have capital in excess or our target levels. And in the second quarter, we repurchased 3.2 million shares for an aggregate purchase price of $199 million.

I would like to take this opportunity to review our philosophy on capital management. As always, our preference is to deploy capital in our businesses. However, if business conditions don't allow us to earn our target returns, we will look to return excess capital to our shareholders either through share repurchases or special dividends. Generally, we prefer share repurchases which benefit shareholders over the long term by increasing earnings per share. However, when our shares trade at a premium to book, as they have for some time now, we have to be prudent in those decisions.

You have seen the grid on our website, but the essence of this chart is that when we repurchase our shares at a premium-to-book value, our objective is to earn back that premium for our shareholders over a reasonable period based on the expected returns that we can achieve on equity. Now whether we can earn that premium back or not is dependent on how quickly the company generates earnings. One can have a different point of view on this, but in the current environment we think that after 3 years, our crystal ball becomes very foggy.

Current competitive conditions make profitable growth in our traditional lines of insurance and reinsurance difficult to achieve, and not surprisingly, the industry is experiencing an elevated level of M&A activity. In anticipation of your questions, I would like to take a moment to reiterate our thinking with respect to acquisitions. We like to investigate opportunities presented by the marketplace, but our preference is to invest first in the recruitment of people and teams with specialty expertise that will complement our product platform.

Our second choice would be renewal rights transactions. And last, our acquisitions of business units. We consider acquisitions of business to be the most difficult because by their nature they involve greater uncertainty. The criteria that we use in evaluating potential acquisitions have not changed. First and foremost, the business should be complementary to our long-term strategic goals. Second, there needs to be a cultural fit as management have similar DNA to ours. That's very critical and very important to us. And third, is the balance sheet transparent and we can get our arms around it. When all those 3 conditions are met, then we look at price last.

As it respects to price, similar to approach on share repurchases, we consider, among other things, the length of time and the relative certainty it will take to recover any premium to book value paid. With respect to overall market conditions, it is starting to feel like the late 1990s where reinsurance is available at attractive prices and where favorable terms to the buyer are easily obtained. We have not yet seen significant erosion in the insurance business with the exception of certain lines, which I will discuss in a moment. We believe, however, that the ability to buy reinsurance on favorable terms will eventually lead to more competitive conditions across the insurance business.

As I indicated, there are several areas in the insurance sector that are experiencing increasingly severe price competition. They are E&S and large global property markets; professional liability lines, including D&O, especially in foreign markets; as well as marine, aviation and energy. These business lines -- in all these business lines, we have significantly reduced our exposure.

At Arch, underwriting discipline has always been the foundation of our success, and it will continue to be the #1 priority and focus of our management team. Over our history, we have built underwriting systems and controls, which allow us to monitor not only changes in premium rates, but also changes in terms and conditions. We believe that our culture and systems in combination should allow us to better navigate phases of the property casualty cycle.

Turning back to our quarterly results. The insurance segment grossed a net written premiums on a constant dollar basis fell 11.1% and 10.7% in the quarter over the same -- compared to over the same quarter in 2014, partially due to the timing of certain renewal businesses obtained in a renewal rights transaction in our alternative markets business that we have discussed in previous calls. In addition, volume was affected by underwriting actions in our international and program units. Mark will comment further on premium volume in a few minutes. In our reinsurance segment, softening pricing and continue pressures on terms and conditions led us to reduce on a constant dollar basis net written premium by 8.3%. In addition, purchases of retro protection reduced net premiums volume in the quarter.

Our mortgage segment includes primary mortgage insurance written through Arch MI in the U.S., reinsurance treaties covering mortgage risks written globally as well as other risk-sharing transactions. Gross written premium in the mortgage segment were $68.6 million in the second quarter 2015 or nearly 24% higher than in the same quarter of 2014. Net written premium grew 22% over the same period to $61.7 million.

Our U.S. Mortgage Insurance operations acquired in late 2014 produced approximately half of the segment net written premium in the second quarter, with $24 million of net premiums written in the credit union channel, where the bank channel produced $7 million of premiums written for the quarter. We continue to make good progress in the expansion of the bank channel and have approved more than 748 master policy applications from banks, and more than 264 of these banks have already submitted loans for our approval. Of these master policies, 40 represent national accounts and the balance are regional banks.

We also continue to see opportunities in GSE risk-sharing transactions, which produced $3.7 million of other underwriting income for the 2015 second quarter versus $1.2 million in the same quarter of 2014. No premium was reported for these transactions as current accounting treatment requires us to continue to use derivative accounting. We fully expect that future transactions involving Fannie Mae and Freddie Mac will receive insurance accounting treatment.

Although competitive pricing conditions have intensified a bit, Arch's strong balance sheet, diversified mix of business and our willingness to exercise underwriting discipline should allow us to continue to generate acceptable returns. Group-wide, on an expected basis, we believe the present value ROE of the business we wrote this year, first 6 months will produce an underwriting year return on equity in the range of 10% to 12%.

Now before I turn it over to Mark, I would like to discuss our cat PMLs. As usual, I would like to point out that our cat PML aggregates reflect business bound through July 1, while the premium numbers included in our financial statements are through June 30, and that the PMLs are reflected net of reinsurance purchases and retrocessions. As of July 1, 2015, our largest 250-year single event PML was essentially flat and is in the Northeast at $541 million or approximately 9% of common shareholders equity. Our Gulf of Mexico PML increased slightly to $522 million at July 1, and our Florida Tri-County PML stands at $445 million, a slight increase.

I will now turn it over to Mark to comment further on our financial results. And when Mark concludes his prepared remarks, we'll come back and take your questions. Mark?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Great. Thank you, Dinos, and good morning to all. As is true on last quarter's call, my comments that follow today are on a pure Arch basis, which excludes the other segment, that being Watford Re, unless otherwise noted. As in previous calls, I will be using the term core to denote results without Watford Re, and the term consolidated when discussing results including Watford Re.

Okay. Now with that said, the core combined ratio for this quarter was 87.9%, with 1.9 points of current accident year cat-related events net of reinsurance or reinstatement premiums compared to the 2014 second quarter combined ratio of 86.2%, which reflected 1.8 points of cat-related events. Losses recorded in the second quarter from these cat events, net of recoverable and reinstatement premiums, totaled $15.9 million versus $16.5 million in the corresponding quarter last year. This quarter's cats primarily emanated from U.S. spring tornado and thunderstorm events, and some Australian weather activity.

The 2015 second quarter core combined ratio reflected 9.2 points of prior year net favorable development, net of reinsurance and related acquisition expenses, compared to 9.4 points of prior period favorable development on the same basis in 2014's corresponding quarter. This results in a core accident quarter combined ratio, excluding cats for the second quarter 2015, of 95.2% compared to the 93.8% accident quarter combined ratio in the second quarter of 2014.

In the insurance segment, the 2015 accident quarter combined ratio, excluding cats was 97.6%, compared to an accident quarter combined ratio of 95.9% a year ago. This 170-basis-point increase was driven by 120 bps in the loss ratio and 50 bps in the expense ratio, with the loss ratio increase reflecting higher large loss attritional activity that in the second quarter of 2014, emanating primarily from aviation war and offshore energy claims. Taking this increase into account, the insurance segment accident quarter loss ratios were nearly identical this quarter versus the second quarter of 2014.

The reinsurance segment 2015 accident quarter combined ratio, excluding cats, was 94.0% compared to 92.1% in the corresponding quarter of 2014. As noted in prior quarters, the reinsurance segment's results reflect changes in the mix of premiums earned, including a lower contribution from property cat and other property businesses. One should also note that this quarter we did receive regulatory approval for the acquisition of Gulf Re and accordingly, have consolidated Gulf Re's results as a subset of the reinsurance segment, whereas previously it was accounted for under the equity method as a single line entry, although its impact was immaterial this quarter.

This reclassified business falls within the "property other -- or property excluding property cat" line in our financial supplement. The mortgage segment 2015 accident quarter combined ratio was 77.4% compared to 84.9% in the second quarter of 2014. This decrease is predominantly driven by continued low levels of reported delinquencies benefiting the loss ratio associated with the CMG business we acquired in 2014, along with better underlying credit risk on business written since the acquisition.

The insurance segment accounted for roughly 24% of the total net favorable development this quarter, excluding associated impacts on acquisition expenses, and this was primarily driven by shorter-tailed lines from the 2011 to 2014 accident years, with some contribution from longer-tailed lines spread primarily across older accident years.

The reinsurance segment accounted for approximately 75% of the total net favorable development in the quarter, with approximately 37% of that due to net favorable development on short-tailed lines concentrated in the more recent accident years, and the balance due to net favorable development on longer-tailed lines primarily from the 2003 through 2009 underwriting years. Similar to the past, approximately 2/3 of our core $7.3 billion of total net reserves for losses -- loss adjustment expense are IBNR and additional case reserves, which continues to remain fairly consistent across both the reinsurance and insurance segments.

The core expense ratio for the second quarter of 2015 was 35.1% versus the prior year's comparative quarter expense ratio of 32.8% driven by an increase in the operating expense ratio of 210 bps, along with an increase in the acquisition expense ratio of 20 bps. The increase in the operating expense ratio component reflects a 6.5% decrease in net earned premiums; a 5.7% increase in operating expenses, which also continues to reflect the addition of our U.S. mortgage insurance operations, which, as we've have said in the past, is operating at a higher expense ratio until that business reach a steady state. However, as I will get into shortly, it is best to look at the expense ratio in totality rather than by each component separately due to the accounting for reinsurance ceding commissions.

The insurance segment expense ratio increased 50 basis points to 32.5% for the quarter compared to 32.0% a year ago. The net acquisition ratio decreased 10 basis points, whereas the operating expense ratio increased 60 basis points. This separation, as mentioned earlier, is artificial since reinsurance ceding commissions reimburse ceding companies not just for front-end acquisition expenses, but also for the overhead associated with writing the primary business. But in most cases, an overwrite in addition to this reimbursements.

It has been the convention to categorize the entirety of reinsurance ceding commissions in the net acquisition lines, whereas a portion of these commissions contemplate operating and unallocated loss adjustment expense reimbursements, but are not classified there. So the increased ceding commissions actually provide offsets to the operating expense ratio, which is why I said initially looking at things in totality to deal with those issues, as opposed to swapping it from one place to another.

The insurance segment net acquisition ratio reduction primarily reflects material improved ceding commissions on an earned basis associated with a quota share contracts ceded. It's important to note, though, that on a written basis, the front-end gross commission ratio worldwide actually increased 40 basis points; whereas the average cede commission ratio improved substantially by 260 basis points. Taken together, this increased treaty commission benefit overcame the increase in the gross commission, resulting in a 60-basis-point net commission improvement, again on a written basis.

Lastly, one has to reflect the premium tax component, which is a part of the net acquisition expense but is not considered to be commission expense. That increased approximately 40 basis points quarter-over-quarter. That's mostly a function of mix. This reflects traditional premium taxes, second injury funds, guarantee fund cost, et cetera, which also, though, signal some shift from not admitted paper to admitted forms as the market softens. These overall net acquisition improvements, however, will continue to be felt as the ceded written premiums are earned over the next few quarters.

The reinsurance segment's expense ratio increased from 30.9% in the second quarter of 2014 to 35.5% this quarter, primarily due to the lower level of net earned premiums, a higher level of treaty ceded commissions associated with bound contracts and a slight increase in operating expenses. The net acquisition ratio increased 160 basis points due to market forces, whereas the 300-basis-point increase in the operating expense ratio is almost exclusively driven by the 18.4% reduction in net premiums earned.

The ratio of net premiums to gross premiums for our core operations in the quarter was 71.3% versus 73.2% a year ago. The insurance segment had a 68.3% ratio, which was very comparable to the 67.9% a year earlier; whereas the reinsurance segment had a net-to-gross ratio of 73.9% this quarter compared to 83.1% a year ago, primarily reflecting increased property and property cat retrocessions and increased cessions to Watford Re as a reinsurer.

Shifting now towards the market. Our U.S. insurance operations saw an 80-basis-point effective rate decrease this quarter net of reinsurance. As commented on the last couple of quarters, the pricing environment is quite different for short-tailed versus longer-tailed lines. Our short-tailed first-party lines of business had an effective 6.5% rate decrease for the quarter, compared to a 1% effective rate increase for the longer-tailed third-party lines, both on a net of reinsurance basis. Rate increases on longer-tailed lines in the aggregate have now dropped below our view of weighted loss cost trends.

Looking more deeply, some lines incurred rate reductions, such as the 10.5% decrease in property and a 5% decrease in high-capacity D&O lines. While others enjoyed healthy increases, such as plus 6.5% in our lower-capacity D&O line, 5.5% in loss-sensitive construction and 3% in our program business. Also, as I've mentioned on prior calls, our lower-capacity D&O business lines have now achieved 16 consecutive quarters of rate increases.

Now turning to our continuing market cycle management. The insurance group worldwide reduced net written premiums in the volatile lines of E&S casually, E&S property, global property and professional liability in excess of 20% quarter-over-quarter. By contrast, lower volatility lines of contract binding, travel and charity expanded north of 15%, partially offset by a decline in program business due to underwriting actions.

Professional liability is down due to our continuing reduction of European exposures plus a subset of SME professional business changed its common ex-date, or expiration date, from June into July. One anomaly to be aware of is in the U.S. alternative markets business, as Dinos alluded to, which on the surface appears to have had a 25% reduction in net written premium, but in reality, back in the second quarter of 2014 when the previously discussed renewal rights agreement was completed, most risks wanted to attain Arch's A+ paper as soon as possible, and were bound with odd-time policy terms that are now naturally renewing throughout the balance of the year.

The reinsurance group only had 8.9% of its net earned premium represented by property cat this quarter, and property cat net written premiums were reduced by another 15% quarter-over-quarter. Property -- other than property cat or excluding property cat, had a net premium increase of just shy of 4% this quarter. However, this was driven by our property facultative unit. Additionally, the reinsurance group reduced net volume in motor quota share, trade credit and crop hail by at least 20% in response to market conditions.

The mortgage segment posted a 75.3% combined ratio for the calendar quarter. The expense ratio as expected and as denoted earlier continues to be high as the operating ratio related to our U.S. primary operation will remain elevated until that proper scale is achieved. The net written premiums of $61.7 million is driven by $30.6 million from our U.S. primary operations, as Dinos mentioned, and $31.1 million of net written premiums for our reinsurance mortgage operations. The segment also had $3.7 million of other underwriting income in the quarter versus approximately $1.2 million in the second quarter of 2014 due to risk-sharing transactions, which are treated as derivatives and mark-to-market each quarter. You may recall that, that type of income, in the last quarter sequentially, was around a little north of $7.5 million, which incorporated some catch-up premiums that aren't reflected in this quarter.

At June 30, 2015, our risk-in-force of $10.7 billion includes $6.1 billion from our U.S. Mortgage Insurance operations, $3.9 billion through worldwide reinsurance operations and $684 million through risk-sharing transactions. Our primary U.S. Mortgage Insurance operation bound $2.7 billion of new insurance written during the quarter, which was approximately evenly split between bank and credit union clients, and which statistically represents the aggregate of original principal balances of all loans receiving new coverage during the quarter.

The weighted average FICO score for the U.S. primary portfolio remains strong at 735, and weighted average loan-to-value ratio held steady at 93.2%. No states risk-in-force represents more than 10% of the portfolio, and our U.S. primary mortgage insurance company is operating at an estimated 9.7:1 risk-to-capital ratio as of June 30, 2015.

The other segment, which is still, as of now, exclusively Watford Re reported a 103.8% combined ratio for the quarter on $120.2 million of net written premiums and $107.2 million of net earned premiums. As a reminder, these premiums reflect 100% of the business assumed, rather than simply Arch's approximate 11% common share interest. As for business sourcing, approximately 40% of the $128 million in gross written premiums this quarter was written directly on Watford paper with the remainder ceded by Arch affiliates. It should be noted, however, that this sourcing mix can vary materially quarter-to-quarter.

The total return on our portfolio was a reported negative 4 basis points on a U.S. dollar basis in the quarter, primarily reflecting declines in our investment-grade fixed-income portfolio driven by rising yields and widening spreads, partially offset by a positive return in our alternative investment equity and noninvestment grade sectors. Total return also benefited from the weakening U.S. dollar on most of our foreign-denominated investments.

Excluding foreign exchange, total return was a negative 38 bps in the quarter. Our embedded pretax book yield before expenses was 2.07% as of the end of the quarter compared to 2.18% at December 31, 2014 while the duration of the portfolio shortened to 3.05 years. The current duration continues to reflect our conservative position on interest rates and the current yield environment. However, movements in duration are not necessarily indicative of longer-term strategy or the insurance/reinsurance portfolio composition due to this duration statistic being reported on a single-day balance sheet view.

Reported net investment income in the quarter was $0.53 per share or $67.2 million, versus an identical $0.53 per share in the 2014 second quarter or $72.5 million. As always, we evaluate investment performance on a total return basis, and such, invested asset sectors which may not generate net investment income. Cash flow from operations for the quarter on a core basis excluding the other segment was approximately $232 million compared to $254 million in the second quarter of 2014. This was caused primarily by reduced premium inflows net of commissions and net of reinsurance cessions.

Interest expense for the quarter was $4.0 million, which is a significant reduction from the last 2 quarters and from the corresponding second quarter of 2014. This reduction is due to a favorable adjustment involving a certain loss portfolio transfer entered into effective January of 2013. This deposit accounting transaction had a downward reevaluation in the quarter of the underlying ultimate loss, which resulted in an $8.4 million reduction in interest expense.

As you may recall, there was a similar adjustment for this in the third quarter of 2014. However, the run rate interest expense, which includes approximately $12 million from Arch's senior notes and variable amount of Arch's revolving and credit borrowing and other items is expected to be under $13 million per quarter for the foreseeable future. However, reevaluation for the underlying ultimate loss attributable to this loss portfolio transfer will occur periodically and could potentially produce significant further adjustments.

Our effective tax rate on pretax operating income available to Arch shareholders for this quarter was an expense of 3.9% compared to an expense of 3.6% in the second quarter of last year. There was no tax catch-up this quarter as the tax rates on pretax operating income were identical for both quarters of 2015. As always, fluctuation in the effective tax rate can result from variability in the relative mix of income or loss projected by jurisdiction.

Our total capital was $7.03 billion at the end of the quarter, which is virtually flat with total capital at prior year-end, but down 2.1% relative to total capital as of March 31, 2015. During this quarter, we repurchased 3.2 million shares, as Dinos mentioned, at an aggregate cost of approximately $199 million. These repurchases represented a multiple of 1.32x of the quarter's average book value and had the effect of reducing quarter ending book value per share by $0.39. Additionally, approximately $525 million remains under our existing buyback authorization as of the end of the quarter.

The effective foreign exchange on book value was a loss of approximately $0.22 per share as the negative impact of restating insurance and reinsurance liabilities outstripped the gain in non-U.S. denominated investments. Our debt-to-capital ratio remains low at 12.7%, and debt plus hybrids represents only 17.3% of our total capital which continues to give a significant financial flexibility, and we also continue to estimate having capital in excess of our targeted position. Book value per share was $47.49 at the end of the quarter, down 0.6% versus the prior quarter and up 8.6% relative to 1 year ago. This change in book value per share this quarter primary reflects unrealized losses and foreign exchange impacts from fixed-income securities, which exceeded the company's continued strong underwriting results.
Although there was a lot of activity this quarter affecting book value, we shouldn't lose sight of the fact that the $0.31 per share drop in book value can be totally explained by the $0.39 per share impact of the share buybacks this quarter. With that and these introductory comments, we're now pleased to take your questions.

Question and Answer

Operator

[Operator Instructions] Our first question will come from the line of Michael Nannizzi from Goldman Sachs.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Mark, just one question I had on the Watford premiums, maybe you alluded this in your comments. The premiums there were higher than the ceded premiums out of the reinsurance business. Did you -- did business come from somewhere else or was there some accounting there just to be aware of?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Well, no. I mean, we did say that 40% of that was natively on their paper, so it wouldn't have ceded from any Arch affiliate. And there was a slightly higher contribution from the insurance group this quarter than the reinsurance group. I think that answers your question.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Yes, got it. Great. And then in terms of the expenses, I mean, you talked about the G&A ratio coming up just from a denominator effect of premiums being lower. I mean, is there a level where you want that to be? Or are you comfortable kind of letting the business pulling back and taking appropriate underwriting actions and holding on to your infrastructure just for the potential for conditions to change and being able to leverage that infrastructure again down the road?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Well, Dinos and I both have an opinion on that. I'll go first on it. It's a balance beam. There's things that you need to mindful of and be efficient and make the right tough decisions. And there's other things you have to recognize you might be going into bone and muscle, and you -- I mean, as Dinos says, we -- our business is to make decisions. You don't want to lose that decision-making ability, so there's some level of carrying intellectual property we're willing to have irrespective of what it does to the expense ratio.

Constantine P. Iordanou
Chairman and Chief Executive Officer

No company went bankrupt or had significant problems because of expense ratio. Most of the companies, they have difficulty with results is due to loss ratio. So in that point, what Mark said, anything that is dear to us -- and dear to us is our underwriting capability we have as a corporation, we will protect that. Of course, we will be prudent managers and try to manage expense with that parameter. So at the end of the day, if it comes to what we call muscle, which is underwriting capability and knowledge in that might be fully usable at this point of time, we will retain that because we make decisions for the long term not the short term. And when things we can eliminate and they don't have a long-term or short-term effect to what we do, we'll be prudent managers, too, and do so, so we can get a more reasonable expense ratio. So that's our philosophy and that's what we want to practice as a management team.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it. I mean, as far as reinsurance is concerned is then the view there still that, at this point, the changes that are taking place in the market are cyclical, so you'll make that sort of bone-muscle decision according to that as sort of a baseline?

Constantine P. Iordanou

Chairman and Chief Executive Officer

Absolutely, absolutely. Because at the end of the day, there is wonderful things you can do in a good market in reinsurance and -- but you need to have the capability. And I think we have proven that our reinsurance team is one of the best in the industry over the last 12, 13 years. All you got to do is look at their performance.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it. And if I could, just one quick one on the MI. Could you -- is it possible to break down what the underlyings were or what the loss ratio was even on a stated basis between the MI reinsurance and the flow business, the U.S. MI business? Or are they relatively similar?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

We can do that. It'll make me dig, Michael.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Oh, I'm sorry.

Constantine P. Iordanou
Chairman and Chief Executive Officer

He's going to give you specifics, but I can tell you the reinsurance business was slightly better than the -- our own MI business for the simple reason most of our reinsurance business that we wrote is in the very best years in the business. This is '11, '12 and '13 commitments. So you want to get more specific, Mark?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Yes, yes. I'll do more directional than order of magnitude. But the U.S. operation continues to improve like per our comments with the good improvement in delinquencies. The reinsurance was lower still, and a lot of that is due to a calendar quarter effect of recognizing favorable results on reinsurance treaties issued a couple of years ago. So -- because you don't have gigantic earned premium numbers coming through a calendar quarter, so you make a change on a prior treaty on an exception-a-day [ph] basis and it can move the numbers.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it. And then real quick, any impacts from the PMI quota share reinsurance in 2Q results? Or is that embedded in the reinsurance discussion you just gave?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

There was no real impact from that.

Operator

Our next question will come from the line of Sarah DeWitt from JPMorgan.

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

On the mortgage insurance business, you showed some nice growth in the quarter in terms of the U.S. risk-in-force. And now that you have all the key bank approvals, do you expect a positive inflection point in the risk-in-force in the second half of the year, or could you just talk about how we should think about the trajectory on the growth?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it will be a steady improvement. Not only you have to get the -- to sign up the banks. But eventually, you got to make sure that from a IT point of view all the pipes, they're open, and we're starting to receive that. So I wouldn't say you're going to see an abrupt change in that trajectory. But as you know with the mortgage business, every quarter adds, and we're pretty happy with the progress that our sales force is doing and also the business that we're receiving. We have received from 270 banks applications to write the business. And we're still working, we're not at optimum pace yet. I'll be happy when I'm receiving from all 700 or so. And I don't know how long that it will take because these projects, they get into the IT department and sometimes they take 6 weeks, sometimes they take 6 months. So I can't predict that.

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

Okay, great. And then just from a high-level in U.S. mortgage insurance, how are you winning? What do you view is your competitive advantage there?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, we're one of the highest-rated MI paper. So from a credit point of view, we should be. And we have a terrific reputation on service. With everybody that we have done business so far, we're getting very, very, very good comments about our responsiveness and our service capability. So the combination of those 2, I think, it fares well for us for the long term.

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

And Sarah, I would also add, we have Arch Mortgage Guaranty, which I tend to -- kind of phrases like an E&S carrier for the mortgage space in that it will do jumbo loans and other things that are nonconforming, right.

Constantine P. Iordanou
Chairman and Chief Executive Officer

That's an additional service we give to all these banks for loans that they might retain on their books and they won't go to the GSCs. We have that capability with a very -- and let me reemphasize, very highly-rated paper.

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

Okay, great. And if I could just get one more in. On all the consolidation we've seen in the industry, can you just talk about what the implications are of this for Arch from a competitive standpoint? And what inning do you think we're in, in this consolidation wave?

Constantine P. Iordanou
Chairman and Chief Executive Officer

As far as your baseball question, I have no clue. I don't see how -- they come out of the blue, and there is a lot of dating and there is a lot of marriages and all that, but I don't know. From an effect point of view, let me give you our view. Our view is that by consolidating on the primary side, you have less buyers or more concentrated buyers of reinsurance. So I think that will put some pressure, probably further pressure on the reinsurance purchasing, because the bigger the buyer, the more they buy, the more the leverage they have. And also they can use even alternative structures as we have seen with some. On the insurance side, I view it as opportunities for the simple reason that history tells us that never in a consolidation of insurance operations 1 plus 1 equals 2-plus. It's usually 1.5 to 1.75, and there is things that fall off of the table. It could be people who want to make a change in their careers. It could be over lining of lines and depending on coverages, and the client says, "I don't want to put all my eggs in a bigger basket now." So we're ready and willing, and we have instructed our underwriting units to be a participant in that activity when it occurs, and some of that will occur.

Operator

Our next question will come from the line of Charles Sebaski from BMO Capital Markets.

Charles Joseph Sebaski
BMO Capital Markets Equity Research

Want to just talk about the ROE profile on a consolidated basis for you guys, and how that plays into if more capital needs to be returned? I guess, Dinos, you've talked about for some quarters now that the current business return profiles' been in the 10% to 12% range. And we have a period like this, and I realize it's only basis points below that double-digit level. But at the low end of that range, in a period that's relatively light on cats and relatively strong on favorable development, how should we think about how you guys manage to the consolidated ROE profile? And how much capital you need to hold, and whether there's capital in MI that's kind of affecting that, that would help?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, let me take you back a little bit because I think based on your question, I think you might be confusing underwriting ROE versus calendar reporting. We don't pay any attention to calendar reporting. Because that's an accounting and underwriters love accountants but they don't pay a lot of attention to it, right? The ROE that we calculate is on an underwriting basis, meaning how much capital I need to support this business, and what is the return when I write a new piece of business. That's the way we base those numbers. So prior year reserve releases or additions will not affect that, et cetera. The 10% to 12% we calculate based on a pricing model that comes our pricing actuaries, the mix of business we have. And just to give you a little flavor is that we're very happy with our reinsurance business, especially on the small to medium-sized accounts, they're producing good ROEs. We're not so happy, but you can't eliminate all of some of our larger accounts or ROEs. On the insurance sector, the ROEs have been very good for many years, but they're coming down as the pressure continues. Including a big component of good ROE was the cat business, but that now is not producing what we fully expected for a high volatility line in ROEs. And then were very, very happy with the ROEs on the mortgage insurance. So we put that all in a hamper, our actuaries go through that, and that's how we estimate the underwriting ROE. I'm not telling you that every single thing that we do has a double-digit ROE component. If that was the case, we would have had better than the 10% to 12%. We've got businesses out there running maybe 5, 6 or 7, and the question is should we get out of it or not? And that's not an easy question. But usually, we'll you look at what the prospects are over a longer period of time. And sometimes, you got to stay in those accounts and in those classes for a while at a lesser return in order for you to be a player when things get better. So that's the way we think about it, and you saw underwriting ROE calculations not calendar year ROE.

Charles Joseph Sebaski
BMO Capital Markets Equity Research

Okay. No, I appreciate. I just was thinking, and I realized you guys look at it that way. I guess I was thinking a bit in the view of -- if the underwriting ROE profile is 10% to 12% over a 3- or 4-year basis, it kind of ends up mirroring up with the calendar year. No? I mean, if you're always writing 10% to 12%, over time the calendar year and the underwriting year should mirror each other, I guess. But I do appreciate the color.

Constantine P. Iordanou
Chairman and Chief Executive Officer

If you were to stay 10% to 12% for all times. What I tell you, the underwriting ROEs in the '02, '03, '04, '05 years, they were in their 20s-plus. And that helped us have mid-teen ROEs for some years when actually the underwriting ROE was in the low-teens. So we look at it at both ways. But I can tell you from underwriting decision-making and viewing the healthiness of our business, we're religiously looking at underwriting ROE. We allocate capital to our treaties. We allocate capital to a primary business by sector and then we have an expectation of return out of that based on our pricing and then we calculate the ROE on that basis.

Charles Joseph Sebaski
BMO Capital Markets Equity Research

I guess just one additional and into the business, you mentioned that a couple of the programs were terminated this quarter. I'm just wondering what programs and how many programs are left? And what was going that's kind of said, was it an ROE, was it just people, what happened? Because that was -- has been one of the growth drivers for the insurance business and a couple of quarters where it's kind of slowed down a little bit?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, you -- with anything that we do, everything goes through our underwriting review once a year. I don't care if it's programs or the D&O division or the E&O division, et cetera. At that point in time, there is an actuarial indication as to what rates we're charging, what is the profitability of that book of business. And then there is what we will call the rate indication. Then there's a discussion with our partners. We -- our approach with our program business is that we want to be profitable but also we want our MGUs to be profitable. You don't have a partnership if one makes money and the other one doesn't, and vice versa. We want all of our MGAs, MGUs to be profitable, and we want ourselves to be profitable. And then there was that discussion. This is the market, and this is what we believe we should be charging. And sometimes there is disagreements. If the disagreement is large enough and we don't believe we can achieve that partnership going forward, that both of us will make money, then we'll make the hard decisions and then we decide to part companies. And unfortunately, it did happen for 2 of our programs, that our rate indications and what we wanted to file and price that business in the marketplace was not in agreement with our partners and they chose to go elsewhere.

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Yes, Chuck, just for a little extra color. Those 2 programs annualized for about $45 million of gross written premium. We keep high nets on that so it's not far from a net written premium, firstly. Secondly, and then it was pretty much even in terms of they're both north of 20 each. One thing to keep in mind, though, is that this quarter, one of those programs is very heavy in the second quarter. So it was to the tune of 50% of the total program. So the loss of that program is going to be more felt in this quarter than any other quarter for the balance of the year for that program.

Charles Joseph Sebaski
BMO Capital Markets Equity Research

What kind of products were these programs?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Best Food was one, I prefer not to really get into it. But then the underlying products themselves are really package policies.

Operator

Our next question will come from the line of Jay Gelb from Barclays.

Jay H. Gelb
Barclays PLC, Research Division

On the M&A front, Dinos, you were very clear about focusing on adding teams of people and renumerized transactions and then seemingly third -- way third down the list is acquisitions of businesses. Since going back to even the recap of Arch in 2001, I don't think the company's ever issued shares for acquisitions. Is there any circumstances where you could see that occurring in the future, given the massive phase of M&A in the industry?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, we care a lot about our shares. It's our shareholders value. But if the transaction is large enough and our cash capability, even though there is not significant leverage on the balance sheet so we do have borrowing ability to a certain degree, depends on how big the transaction is, we will consider issuing shares. But that's the last consideration, not the first. We try, with all of our decisions, not to dilute our common shareholders. We don't like a lot of dilution.

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

And as a follow-up to that and the way -- part getting back to Dinos' comments, think of it this way, that the recruitment of any goodwill or any excess premium you'd pay relative to what we do in share buybacks. So if we're looking for 3-year paybacks in share buybacks, where we know our operations, it's us, we know what's going on, versus something that Dinos' mentioned with a lot more uncertainty. The 3-year payback is an upper bound for a recruitment of tangible book value hit towards an acquisition. So we're very mindful of that.

Jay H. Gelb
Barclays PLC, Research Division

Okay, that's in line with what I would've thought. With -- Mark, with regard to that buyback comment, I mean you're in a enviable position of having a high multiple. The stock today, I think, is right around 1.5x book, and I think that's starting to bump up against your tipping point on whether Arch does buybacks as opposed to special dividend. Can you give us your perspective on that?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

That's exactly Dinos' comment about us being prudent and how we do it. At 1.5x, I'll be honest with you, it's more of a stretch to do that unless you can find a profitable block trade or something.

Constantine P. Iordanou
Chairman and Chief Executive Officer

But based on recent transactions, it's a cheap stock.

Operator

Our next question will come from the line of Josh Shanker from Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

Two questions. First of all, Mike Nannizzi asked a question about mortgage reinsurance versus mortgage primary. And it's on the margin, the reinsurance is more profitable because of the good accident years. If I think about reinsurance in general, companies have been bumping up commissions, and when I talk to a lot of reinsurance, "Our book, we use a lot of local players so we get better deals. I mean, clearly the large companies are going to arb you out." And when it seems that mortgage insurance is so profitable these days, how is mortgage reinsurance so profitable? Why aren't the large players charging to see that risk?

Constantine P. Iordanou
Chairman and Chief Executive Officer

For the simple reason that when these transactions are actually were taken. In the mortgage space, you make a transaction in a particular year and you have a stream of revenue that comes over 6, 7 years. At the time that these transactions took place, we were providing very valuable capacity to people, but they needed capacity. And for that reason, I think we had equal negotiating leverage as they did. They needed our capital as much as we needed the business so that's a good combination. And for that reason, we got terms that they're not disadvantageous to them but they're not disadvantageous to us either.

Joshua David Shanker
Deutsche Bank AG, Research Division

Okay, that makes sense. Number two, Mark went through in detail on the expense ratio for the insurance business, mortgage insurance has grown dramatically over the past 12 months but expense ratio really hasn't come down. When should we think that's going to occur? And why isn't that proportional with the growth rate of the new insurance written?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, the growth is starting to show. But don't forget, also, we had an acceleration of expenses because we were building this marketing team that is out there. We added in the last, I don't know, 5 quarters, some 60 people purely in the sales and marketing area. I think now we're at a steady state. So when it comes to that, it's not going to be a significant addition in personnel in our mortgage business. And as the volume starts going up, you're going to start seeing the reduction in the expense ratio.

Joshua David Shanker
Deutsche Bank AG, Research Division

And one last MI question, how should I think about growth and capital? Do you need a dividend money down into Arch mortgage U.S. in order to fund future growth?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No. We gave you that number, Josh. I think now we're operating at around 10 -- 9.7, I think, is the exact number.

Joshua David Shanker
Deutsche Bank AG, Research Division

Or you could give me 15, if you want.

Constantine P. Iordanou
Chairman and Chief Executive Officer

As I'm getting older I don't like to be exact because I forget things. But -- and we got a lot of room to go to 15:1. So I don't see us requiring to downstream capital into those operations for a couple more years until we -- I think I used a size 3 shoe to a size 9 foot. We still got the opposite, our foot is size 3 and the shoes is size 9. We've got a long way to go to fill it.

Joshua David Shanker
Deutsche Bank AG, Research Division

You just got to walk carefully though.

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

But they don't have that nice shoehorn. So if you're asking more mechanically, there's money in the U.S. holding company that is there for when the need is. That's the mechanism through which we'll get it.

Operator

Our next question will come from the line of Ryan Tunis from Crédit Suisse.

Ryan James Tunis
Crédit Suisse AG, Research Division

I guess my first question is probably just for Mark, it's a quick one. Just on the E&S MI, you're talking about the jumbo loans. Is there any of that showing up in the insurance and the mortgage NIW yet?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

It's very, very tiny. So it's really part of a value proposition that helps us. But as of yet, it doesn't have any material volume.

Ryan James Tunis
Crédit Suisse AG, Research Division

And I guess maybe looking out over the next couple of years, do you have a view on how much that type of stuff could make up of the total U.S. MI business?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

No. It's like real crap shoot of what's going to happen macroeconomically.

Constantine P. Iordanou
Chairman and Chief Executive Officer

And how these banks are going to -- it's very hard. The fact that we have that capability, though, it opens doors and it allows us to a better conversation as to what we can do for these banks. Beyond that --or are you going to be cheaper than somebody else.

Ryan James Tunis
Crédit Suisse AG, Research Division

Okay. And then I guess for Dinos, just on expenses, I guess, in primary reinsurance. Just trying to think about a level -- is there may be a level of growth that you think you need in the medium term to support your current expense growth profile? It doesn't seem like there's a crisis.

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, no. We don't -- we never really run the company in any segment with the exception of MI because we think it's a very, very good time to grow on a growth prospect. Now having said that, you got to match revenue with expense as long as you don't cut muscle. And I will accept 1 or 2 points higher expense ratio than normal as long as I'm not losing underwriting capability. Because that underwriting capability can't produce what it will cost you to maintain for a year or 2 or 3 in 1 quarter. Let me remind you guys that in the 2002 year, our reinsurance operations produced, on an underwriting basis, $790 million worth of premium and we had 22 people, right? And it can come, and I can tell you the profit coming out of that was significant. So at the end of the day, it's that balance and you got to make those hard judgments. But I can tell you if I got good, experienced underwriters, they don't have to worry about their jobs as long as with us. We'll find things for them to do. And if they don't, we'll have -- ask them to play golf until the good market comes.

Operator

Our next question will come from the line of Meyer Shields from KEBW (sic) [KBW].

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Mark, you mentioned that you can't necessarily infer anything strategic from the shortening the portfolio duration? So think of that is more a direct question. It also could reflect something. Is there anything that we should read from the second quarter change?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

No. But let me expand on it a bit. It is a point in time, as I may -- as I mentioned, but we continue to have the same exact process where we look at the liability stream and we duration-match it. And, however, the assets underlying shareholders equity are shorter. So there's no fundamental change to the overall philosophy and the overall approach of matching lost reserve duration, which I think is the most important thing. So there's going to be tactical moves that happened from quarter-to-quarter, so I wouldn't look for some big theme.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Okay, that's helpful. And then just a quick numbers question. We look at the other expenses. I mean, on a the consolidated basis, came in at $17.4 million, up almost 17% year-over-year. Was there anything unusual there, or is that new good run rate?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Well, let's see. You have a slight increase in overall stock-related compensation expense for old dogs like me that are retirement-eligible. There's a different accounting treatment of quicker recognition of those kinds of things. And it's a series a bunch of tiny things. So it's not that I can asterisk for you, for that's a main driver.

Operator

Our next question will come from Brian Meredith from UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

A couple of questions here for you. First, Mark, when you talked about rate on the portfolio, the minus 0.8%, you said that's net of reinsurance. What does that look like on a gross basis before reinsurance? And I'm wondering the advantages you're getting and how that's look over the last maybe year or 2 so we can get a...

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Yes, it's a little worse but it's converging now. Because it was really the benefit of property cat really and some other that really drove the differentials. So without getting to exact numbers, it's a little bit worse on a gross basis. But that's exactly why you protect yourself with effective reinsurance.

Brian Robert Meredith
UBS Investment Bank, Research Division

Got you. And then a second question. Looking at Watford Re, I'm just curious. Obviously, a lot of growth there on a year-over-year basis, it's relatively new. But are we getting to a point in the marketplace where even Watford's going to potentially have to pull back a little bit given the rate competition out there?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it will depend. It's the same underwriting process that we have for everything else we do. The only difference between what Watford will do versus what Arch will do is we believe that their ability as they take a little more risk on the investment side to produce a higher return on the investments gets factor in. But they can be -- they're turning down business too. So without having something in front of me, an account to go through, is very hard to predict as to -- and that's why we whenever predict volumes because the market can be very fickle. It can turn on a dime either way. It can get much worse quickly, and it can get much better quickly depending on what happens. Our projection is that it's probably getting worse before it will get better. And for that reason, we're very, very careful in our underwriting processes so we don't have these kind of failures that we get too optimistic on the basis that things will change quickly and then we can make it up in the future. We try to write accounts that, in our view, will produce an adequate return, and that's why you saw our volume go down a bit.

Brian Robert Meredith
UBS Investment Bank, Research Division

Right. Is there any business that you perhaps would have kept on Arch's balance sheet last year, that now all the sudden is going to Watford's balance sheet because of what's going on with rates? Are we seeing that?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, there is some of that. Yes, absolutely. That's why -- and that was the purpose of us creating Watford. Instead of throwing that business totally out, at least, it can go to a place that we get a participation. We have an investment in it. It keeps us aligned in that. And also, we can benefit on sharing some of the cost. Because if you discard that business, you have no revenue at all. Where if you're writing it, you're getting reimbursed for the cost of writing it. And then potentially, you have also the profit sharing in the back end. So yes. There is some of that business that otherwise would have been lost by us has gone to Watford, yes.

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

But be cognizant, Brian, that remember they had the -- Watford has its own management team. And they have the ability on yay and nay on contracts. But that's move forward a year. It's possible Watford, forget Arch and Watford, that Watford itself may decide to not renew something that they filed in the prior year because of ongoing rate suppression or yields not being realized or something of that nature. So it's not just an Arch sense, it's completely a Watford sense in their evaluation.

Operator

Our next question will come from the line of Jay Cohen from Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Most of my questions are answered. Just I guess one question of the mortgage segment. The accident year loss ratio jumps around quite bit quarter-to-quarter. It's relatively new business. I understand that. At some point, should we expect that number to kind of settle down to a more narrow range going forward?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Jay, good question. The answer is accident year in mortgage business doesn't make much sense. It's, after all, it's a function of the delinquencies, and then claims emanating from those delinquencies. Until there's a claim, you can't put a reserve up on it. You can't anticipate performing loans becoming nonperforming having claims emanate from it. So we've railed against the accounting precedes, that's [ph] accounting in that business. So it's going to jump around. I think you...

Constantine P. Iordanou
Chairman and Chief Executive Officer

Our focus more is on the delinquencies. It's a better measure than anything else.

Operator

Our next question will come from the line of Ian Gutterman from Balyasny.

Ian Gutterman
Balyasny Asset Management L.P.

So I actually was going to ask something similar to Jay. So just to follow-up, Mark can you just walk through a little bit. You've mentioned it was mostly the reinsurance last year, should have come in low, weren't going to sound like there were some contracts that were reviewed. I guess can you sort of walk through that process? Is that sort of an annual review? Or was it just you got new information in the quarter and you reflected that? Or sort of what led you to make that revision now?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Sure. Ian, it's no different than any sector of our business. There's reserve reviews by the business unit actuaries that occur every quarter. And it just happened that those particular treaties had enough information for review points, that it was going to develop more favorably and it was recognized.

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's the reporting from the clients. When they're showing significant improvement, you can't ignore it, and they have shown significant improvement.

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

But just like the P&C reinsurance side. It's completely analogous.

Ian Gutterman
Balyasny Asset Management L.P.

Well, that's why I'm wondering. Was it the reports from client or it's a little bit to the market?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, reports from the client showing significant improvement, yes.

Ian Gutterman
Balyasny Asset Management L.P.

So it wasn't that you guys went in and looked at the contracts on your own and decided to, like, lower the roll rate or something like that. It was that the incoming information was significantly better and that you had to adjust to that.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. Pleasant surprise for both them and us.

Ian Gutterman
Balyasny Asset Management L.P.

Perfect. And do you get that information from them quarterly or is that kind of a once-a-year thing or...

Constantine P. Iordanou
Chairman and Chief Executive Officer

Quarterly.

Ian Gutterman
Balyasny Asset Management L.P.

Quarterly, okay. I just wanted to make sure there wasn't a seasonal nature to this is what I was after.

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, no.

Ian Gutterman
Balyasny Asset Management L.P.

Got it. Okay. And then just on M&A, one of the things that gets speculated upon is the ability for you or some others on the island to help sponsor an inversion of someone who wants to get offshore. A, just -- is that a meaningful rationale to do a deal that is -- meets your criteria on other metrics but maybe not as strongly as another deal that was better strategically and so forth? And did you have a [indiscernible] to it, and then I have follow-up on that.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Like I said, price and financial is the fourth item. So if the first 3 main criteria will get into the fourth. But -- and by the way, our view is both in us purchasing something or somebody purchasing us. Because unless you're my wife, who would say the house is never for sale, if you have the right price, the house is for sale. I'll sell my house if somebody gives me the right price. So no emotion here. Our view is we are employed by the shareholders to do the best job for our shareholders, and there is nothing more to think about other than that.

Ian Gutterman
Balyasny Asset Management L.P.

Got it. And then specifically just to follow-up on the inversions specifically, I don't know how closely you guys have followed this. But I guess my understanding is that when Treasury made those changes last year, that if a company like Arch were to buy a company in the United States and invert then that, depending on how it was structured, there's a chance that Arch could lose its tax status. Is that your understanding that essentially inversions are on hold until Treasury clarifies that language?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I have no idea because we haven't studied that, and I don't have any more insight to it. It's highly a legal question and a structure question. I mean, if you want more, I'll do some research on it, and offline, we'll share our thoughts with you. But it hasn't come across my desk as a situation that I have to focus on.

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Yes. That topic -- we've really just focused on the fact that we recapitalized back in 2001 and all legislation and all proposals really had a grandfather clause so -- I know you're asking a forward view, but our look and evaluation of that has been the preservation of what we have.

Ian Gutterman
Balyasny Asset Management L.P.

Yes, yes. I'm asking if you could do -- if you want to do a transaction, there's no issue [indiscernible]. There is some language I read about -- I could follow-up with that offline. But if you were to buy something, it could affect the status possibly so -- I didn't know if that was a hangup. That's all I was wondering.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, and if it does, it's part of the mix, right? You think I will do something stupid for my shareholders?

Ian Gutterman
Balyasny Asset Management L.P.

Of course not. Just seeing if I was reading the language right. But if you're not familiar, we can follow-up offline.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. The salt and pepper my mother uses has no stupidity in it.

Operator

And our final question will come from the line of Kai Pan from Morgan Stanley.

Kai Pan
Morgan Stanley, Research Division

So first question on the underwriting margin going forward. It looks like the last price sparred on longtail casualty primary business, the pricing now below the cost trends. So are we expecting so under written basis, the underwriting margin will deteriorate? And anything your power, you can alleviate that or control that deterioration?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Yes, the answer is yes to both of those. We always talk about the mix of business. These guys are active cycle managers, whether it's within reinsurance or within insurance. And where you see it going negative, you can either drop some of your -- attempt to drop some of your front-end volume or perhaps, as Dinos talked about earlier, that the reinsurance market is in a place where you can get attractive terms. And you can get the benefit on that on the net basis. So the insurance group will be looking for that change in mix front-end and change of reinsurance to ameliorate some of that. So -- and mix alone could change that, Kai. So on the written basis, in a quarter or 2 from now, even with no changes in reinsurance ceded programs by the cycle managers that 1 could to be a plus 2 or plus 2.5.

Kai Pan
Morgan Stanley, Research Division

Okay. On the reinsurance side, and it looks like this quarter you said the accident year loss ratio ex-cat improved a little year-over-year. It's just because of lower level of losses or anything there?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Well, that was the insurance comment. The insurance comment, when you control from the larger threshold, is really the same loss ratio second quarter -- accident quarter second quarter last year, to second quarter this year. The reinsurance group, it did go up a bit, but that's a function of the mix business because we're writing the property cat. All right? We're near to the levels we used to in the past, which has a much lower expected loss ratio.

Kai Pan
Morgan Stanley, Research Division

Okay, that's great. And then the last question on the recently proposed IRS rules that were on PFIC, I just wondered if you had any comments. What do you think about Watford's status on that?

Constantine P. Iordanou

Chairman and Chief Executive Officer

Like I said -- I mean, we will -- Watford is an active insurer, which -- it assumes a tremendous amount of reinsurance. The proposal's a work-in-progress so we don't know the final rules. But we continue to monitor that processes, and we have no -- we don't believe there is a problem for us complying with whatever rules they come up because -- let's go back to the first thing. Watford is an active insurer that assumes a significant amount of reinsurance, and it has significant amount of reserves.

Operator

I would now like to turn the call back over to Dinos for closing remarks.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, thank you all for -- we're looking forward to talking to you next quarter. And it's time for lunch.

Operator
Ladies and gentlemen, you may now disconnect. Have a great day.