S&P Capital IQ

CONTENTS


| | |
|---|---|
| CALL PARTICIPANTS | 2 |
| PRESENTATION | 3 |
| QUESTION AND ANSWER | 8 |


# Arch Capital Group Ltd. NasdaqGS:ACGL

*FQ3 2013 Earnings Call Transcripts*

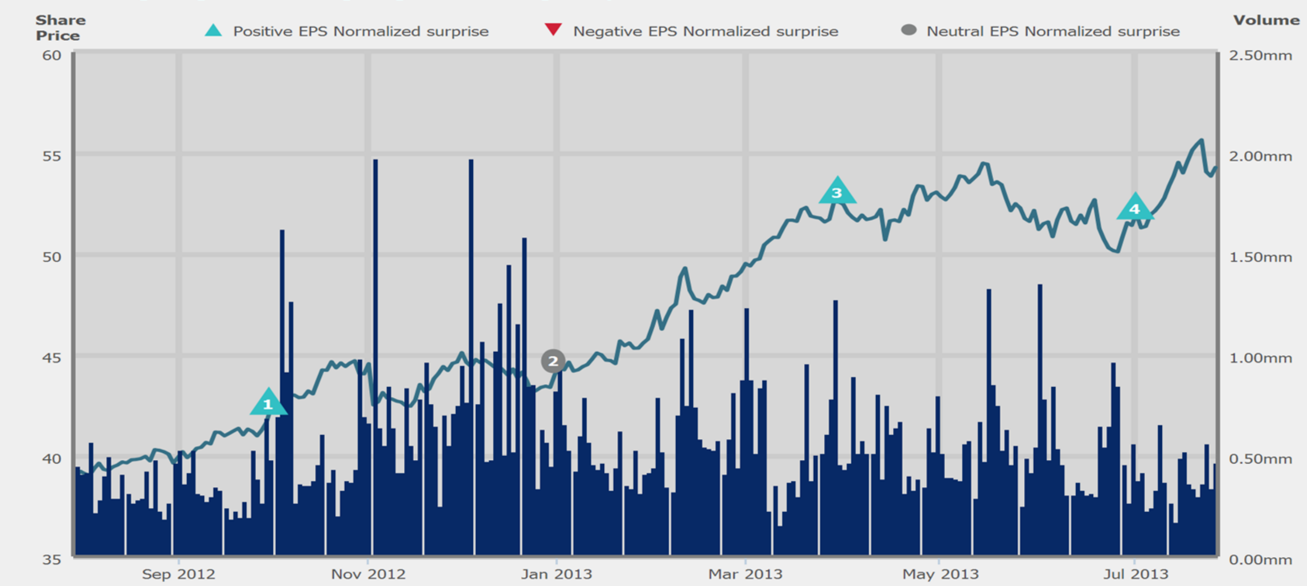
Tuesday, October 29, 2013 3:00 PM GMT

## S&P Capital IQ Estimates

| | -FQ3 2013- | | | -FQ4 2013- | -FY 2013- | -FY 2014- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| **EPS Normalized** | 0.91 | 1.10 | ▲20.88 | 0.86 | 4.02 | 3.37 |
| **Revenue (mm)** | 796.35 | 839.14 | ▲5.37 | 638.14 | 3239.90 | 3514.40 |

Currency: USD
Consensus as of Oct-29-2013 12:26 PM GMT

**Stock Price [USD] vs. Volume [mm] with earnings surprise annotations**




**- EPS NORMALIZED -**

| | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| **FQ3 2012** | 0.76 | 0.87 | ▲1 14.47 % |
| **FQ4 2012** | (0.53) | (0.18) | NM |
| **FQ1 2013** | 0.96 | 1.17 | ▲2 21.88 % |
| **FQ2 2013** | 0.82 | 0.99 | ▲3 20.73 % |

# Call Participants

## EXECUTIVES

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

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

## ANALYSTS

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# Presentation

**Operator**

Good day, ladies and gentlemen, and thank you for standing by. Welcome to your Q3 2013 Arch Capital Group Earnings Conference Call with Mr. Dinos Iordanou and Mark Lyons. My name is Marie, and I'll be your operator for today. [Operator Instructions]

However, before the company gets started with this update, management wants to remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the federal securities laws. These statements are based upon management's current assessments and assumptions and are subject to a number of risks and uncertainties.

Consequently, actual results may differ materially from those expressed or implied. For more information on the risks and other factors that may affect future performance, investors should review periodic reports that are filed by the company with the SEC from time to time.

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

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

But now I'd like to hand the call over to Mr. Dinos Iordanou. Please proceed

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Thank you, Marie. Good morning, everyone, and thank you for joining us today. We had a good third quarter from just about every perspective. Earnings were solid, driven by excellent underwriting results. On a consolidated basis, our premium revenue grew by approximately 12% on both gross and net basis, although there were noteworthy items that I will get into in a few minutes.

On an operating basis, we earned $1.10 per share for the quarter, which produced an annualized 11% return on equity for the third quarter. On a net basis -- on a net income basis, Arch earned $0.80 per share, which corresponds to a 9% annualized return on equity. Reported net income was adversely affected by foreign exchange losses.

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

Our reported underwriting results in the second quarter was solid, as reflected by a combined ratio of 86%. They were aided by better-than-average performance on cat underwriting and continued favorable prior year reserve development. Net investment income per share on a reported basis declined to $0.49 per share, reflecting the effects of lower yields available in the financial markets, in a total return approach to investments.

Our operating cash flow for the quarter was $239 million, a $96 million decrease from the same period last year substantially due to higher paid losses, including claim payments on prior year cat events. The total return of the investment portfolio was 143 basis points inclusive of fluctuations in foreign exchange rates. Our book value per common share increased by 4.2% primarily due to our operating performance.

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

The movement of business from the admitted market back to the E&S market continued. On prior calls, we mentioned our expansion into the binding authority insurance business that caters to small units accounts written through the wholesale distribution channel. This group is off to an excellent start. They are producing an increasing level of business and have begun to leverage Arch distribution platform and relationships to access more opportunities. In our view, on an absolute basis, while most long-tail casualty business still require further rate improvements to meet our return requirements, some segments are approaching rate adequacy.

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

On the reinsurance side of the business, in terms and conditions, we see pressure in 3 areas. First, in property cat, alternative capacity is putting pressure on rates. Second, although the profitability of primary insurance has improved, cedents has pressed -- have pressed successfully for additional seating commissions generally in the range of 1 to 2 points. So the improve economics remain with the primary insurers. Finally, cedents are moving to excess of loss instead of pro rata coverage, which increases the risk to reinsurance of arbitrage by cedents.

Net written premiums of the reinsurance segment grew by 24% while the insurance segment increased their net written premiums by 4%. The increase in the reinsurance segment stems primarily from one significant treaty, as was the case in 2002 and 2003. Certain cedents, based on their financial conditions, are looking to the reinsurance market to provide capital. The treaty I just mentioned fell into this category, and we recorded approximately $55 million of written premium in the third quarter of 2013, including the transfer or approximately $40 million over non-premium.

In addition, as you may know from press reports, we entered into a transaction with Ethniki, the insurance subsidiary of the National Bank of Greece. Although the reserves reinsure on a nominal basis were in excess of EUR 400 million, under U.S. GAAP, this transaction will be accounted on a deposit basis. Due to the long-term nature of the liabilities, we expect that margin will be earned over several years and is not expected to have a material effect on any individual year.

The insurance segment had a net written premium growth predominantly emanating from the U.S. operations, which represent approximately 75% of their worldwide volume this quarter. The U.S. operations grew net written premium by nearly 15%, partially offsetting strategic reductions elsewhere in the world. The U.S. growth came predominantly from increases in exposures on existing accounts, new business including our contract binding business and, of course, rate increases. Groupwide, on an expected basis, we continue to believe the ROE on the business we underwrote this year will produce an underwriting year ROE in the range of 11% to 13%.

Let me now update you on the status of our previously announced agreement to acquire certain assets of PMI and CMG. We're continuing to work on obtaining the regulatory and other approvals required to complete the transaction. As part of that process, we're continuing our discussions with the GSEs in order to obtain their approval of Arch as an eligible mortgage insurance carrier. This process takes time. If the required approvals are obtained, it is expected that the transaction will close near the end of 2013 or during very early part of 2014.

Before I turn it over to Mark and discuss our PMLs, it is worth noting that our cat PML aggregates reflect business bound through October 1 while the premium numbers included in our financial statements are through September 30. As of October 1, 2013, our largest 250-year PMLs for a single event increased slightly to $868 million in the Northeast or approximately 17% of our common shareholders' equity, while Gulf PMLs increased somewhat to $736 million where our Florida Tri-County PML now stands at $615 million.

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

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

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

Losses in the 2013 third quarter from catastrophic events totaled $19.5 million, emanating from a variety of events around the world. The 2013 third quarter consolidated combined ratio also reflected 8.2 points of prior year net favorable development, again, net reinsurance and related acquisition adjustments, compared to 7.1 points of prior period favorable development on the same basis in the 2012 third quarter. This results in a 91.7% current accident quarter combined ratio excluding cats for the third quarter of 2013 compared to a 93.6% accident quarter combined ratio in the third quarter of 2012.

The 2013 accident quarter combined ratio excluding cats for the reinsurance segment was 83.7% compared to 84.3% in the 2012 third quarter. In the insurance segment, 2013 accident quarter combined ratio excluding cats improved to 97.0% compared to an accident quarter combined ratio of 99.6% in the third quarter of 2012. Approximately 80% of the net favorable development in this quarter was from the reinsurance segment, with approximately 60% of that due to net favorable development on short-count lines concentrated in the more recent underwriting years.

The other 40% of the reinsurance segment net favorable development was attributable to longer-tailed lines spread evenly over all underwriting years, 2010 and prior. The remaining aggregate 20% of net favorable development was attributable to the insurance segment and was primarily driven by short-tailed lines from the more recent accident years.

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

On a consolidated basis, the third quarter of 2013 expense ratio was 32.3% compared to the prior year's comparable quarter of 30.9%. This 140 basis point increase is driven by 150 basis point rise in the acquisition expense ratio while the operating expense ratio dropped 10 basis points. The acquisition expense is a combination of higher ceding commissions on proportional treaties within the reinsurance segment along with some lift in insurance segment, premium taxes and cedent treaty commission adjustments on older years.

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

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

Our U.S. insurance operations achieved a 4.7% effective rate increase this quarter, which translates into the margin expansion of 170 basis points that Dinos referenced earlier. This is a 20 basis point improvement over the 150 basis point expansion achieved during the second quarter of 2013, driven mostly by changes in mix. These figures represent the excess of written effective rate increases over estimated loss trend and provide continuing evidence of improving market conditions. This average ranged from having some margin contraction in some units such as miscellaneous facilities, healthcare and some professional liability areas to large improvements in our private, mostly primary executive assurance growth and middle market operation. Other areas of note in margin expansion were E&S casualty and our program businesses.

Property lines experienced low single-digit rate increases again this quarter and therefore, like last quarter, did not experience additional margin expansion. Specialty casualty, worker's compensation and national account businesses have now experienced 10 successive quarters of rate increases. Whereas our executive assurance, middle market and alternative asset protection books, along with our retail construction unit, have each experienced 9 consecutive quarters of rate increases. Furthermore, our excess workers' compensation and umbrella books have now enjoyed 8 consecutive quarters.

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

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

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

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

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

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

Reported net investment income in the quarter was $66.1 million or $0.49 per share versus $73.2 million or $0.53 per share in the 2012 third quarter. This difference is attributable to a reduction of interest income from fixed income securities and an increase in investment expenses relative to third quarter of 2012.

During 2013, however, fixed income earnings have been relatively flat each sequential quarter as have investment expenses. Our effective tax rate on pretax operating income for the third quarter of 2013 was an expense of 5.6% compared to an expense of 3.1% in the third quarter of 2012. Approximately 41% of this third quarter tax expense or $3.8 million is associated with catch-up of the first 2 quarters to this higher effective rate and $2 million of withholding on equities -- tax withholdings on equity securities.

The September 30 year-to-date effective tax rate on operating income, excluding some minor discrete items, is 3.3%. Fluctuations in the effective tax rate can result from variability in the relative mix of income or loss reported by jurisdiction. Our total capital was $5.84 billion at the end of this quarter, up 3.7% relative to June 30 and up 4.9% relative to year end 2012.

We repurchased only 1.3 million of share value during the quarter or $57.8 million year-to-date as of September 30. We have $712 million of authorization remaining for additional share repurchases.

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

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

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

# Question and Answer

**Operator**

[Operator Instructions] And we have our first question and it comes from the line of Michael Nannizzi from Goldman Sachs.

**Michael Steven Nannizzi**
*Goldman Sachs Group Inc., Research Division*

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Well, at the end of the day, when we write any line of business, including cat, we look at opportunity by opportunity, contract by contract, and we have an expectation based on the volatility of that business, what the proper return should be. And our cat teams determined that in some areas, the erosion was more than we can stomach. So for that reason, we let some of that business go. But we're still bullish on the cat business. I don't want to give you a misleading conclusion. We still like it, but we're cautious about what our expected return should be. And we continue to price it with the expectation that we're going to have very high returns because of the nature of the business and the volatility that brings. Mark, you add anything?

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

No, you nailed it.

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Yes.

**Michael Steven Nannizzi**
*Goldman Sachs Group Inc., Research Division*

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Well, I think is -- I'm not telling you anything that the market doesn't know. The additional cat without entering the market has put pressure on rates in the 10% to 15% rate reduction. That by itself has not really changed significantly the prospects of profitability. But in certain segments like on the low end of the curve, because especially the unrated vehicles that they have to collateralize the limits, they're looking for the high-rate online business, which, of course, is on the front end of the curve. In that part of the curve, I think we don't find the returns attractive. Some of those returns, they have moved into the sub-2-digit, high single digits. For some investors, high single digits for the cat business might be an acceptable return. I can tell you it's not for Arch. And so we have business that it was on that low end of the curve, and we're not getting the proper return, that's the business that you let go. And of course, that will magnify also because the high-rate online business also have big premium numbers. So if you don't do 1 or 2 of those, in essence, you're not using a lot of PML, but you're losing a lot of premium. But the profitability is not there.

**Michael Steven Nannizzi**
*Goldman Sachs Group Inc., Research Division*

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

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

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

**Michael Steven Nannizzi**
*Goldman Sachs Group Inc., Research Division*

And you expect that should continue from here?

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

It's hard to say based on what happens in the market. So just like any insurance business, we're going to react to what's there. So it depends on what [indiscernible] effects.

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

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

**Operator**

And our next question comes from the line of Greg Locraft from Morgan Stanley.

**Gregory Locraft**
*Morgan Stanley, Research Division*

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Well, the first thing -- the thing is our ability to put that capital to work in the marketplace because that's what we've been hired to do as managers. And hopefully by year end, we'll close the MI deal. In addition to that, I don't know if you've been following that space, not only there is opportunities for us that they're going to comp with PMI and CMG. But also, there is transactions in the market that both Fannie and Freddie, the testing in putting more of the credit business to the private sector, and we intend to be a participant of that. So the prospects of us actually deploying more capital and utilizing in our business, including the mortgage insurance space, it's very high. Also, as you've seen with 2 transactions that we've done in the third quarter, the Ethniki transaction with a significant EUR 400 million of reserves and the Towers Group transaction. We're seeing other transactions of similar nature and similar size. I'm not predicting anything. These things are lumpy. Sometimes you're successful in landing them, and sometimes you're not. But I'm optimistic in utilize more of a capital in the business going forward. Absent of that, we'll refer back to share repurchases, and we will not rule out an extraordinary dividend if that's appropriate to return capital to shareholders. We'll be good stewards of capital. We don't try to hoard it, but I can tell you, when I look into the future, I see opportunities. So I'm not going to be too anxious to let that capital go right now.

**Gregory Locraft**
*Morgan Stanley, Research Division*

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Well, given the -- given where the market opportunities, I -- don't forget, the mortgage insurance space is going to eat up some of our capital. I mean, it's -- we got to fund those, and like I said, the opportunity is not only with what we're going to write direct through PMI and CMG. It's also these transactions that -- the bulk transactions that the GSE, they're putting into the marketplace.

**Gregory Locraft**
*Morgan Stanley, Research Division*

Yes, yes. Okay, good. And then you actually have mentioned buybacks ahead of a special dividend. Would you reverse that at this particular price? I mean, you -- again, I think you guys are somewhat valuation-sensitive on the buyback front.

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

The -- yes, we are. We're looking at the -- a kind of a light post, the guiding post that says we recover it within 3 years is the right mix. But we still believe there is a lot of intrinsic value in the company. So it will not stop us to even buy our stock at 1.50 multiple.

**Gregory Locraft**
*Morgan Stanley, Research Division*

Okay, okay. And then last, I just want -- on the special dividend, it sounds -- you brought it up. Is it you guys don't like a regular dividend? How do you compare and contrast a special versus a regular? And what would cause you to do a special?

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Well, a regular dividend is not a way to manage capital, right? This is a capital-intensive business. In the soft cycle, you have a lot of excess, and you've got to return it to shareholders. And when things get into a very good cycle, you probably -- you can utilize as much capital you can get your hands on. So by introducing an ordinary dividend of 1% or 2%, it's not really going to manage your capital. You might expand your shareholder basis because some funds might not invest unless you're paying a dividend. But we don't think in those terms. We don't try to make actions because they're going to be a reaction by investors. Our focus is what's the proper way to run the company, how the capital structure needs to behave depending if we're on a soft, on a hard cycle, how much leverage we have in the capital structure. All those thoughts go into it and how much excess capital we need to keep because we got our high ratings, and also, we want to have the financial flexibility because when the markets turn, they turn very quickly. This gradual improvement in the market is not what I would call a hard trend to a hard market. But if you have continuation of pressures, as we've seen with some small companies because of either reserve deficiencies or other issues they have, if that, for some reason, accelerates, you're going to see a hard market. We don't see in the next year or 2, but we're always -- our responsibility is to be prepared for it. And we take that all into consideration before we make this decision. So we never believe on an ordinary dividend. Now if you have excess capital, and let's say you believe that the marketplace is not giving you the right multiple, you might consider the extraordinary dividend because it's a quick way to return capital to shareholders and let them decide what to do with it.

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

Yes, Greg, I would just add to Dinos' is you can have a high-level look at it that any special dividend would be the excess over all contemplated uses. What Dinos said is more optimistic. It's because at marketplace opportunities, we have higher odds in our minds these things might close. So a special dividend would just be -- any potential uses outside of that plus the guardian of our high ratings and just any leftover, only that would be considered discussion-worthy.

**Operator**

Our next question comes from the line of Arash Soleimani from KBW.

**Arash Soleimani**
*Keefe, Bruyette, & Woods, Inc., Research Division*

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Well, the way I will answer is that 60% of our business is primary, 40% is reinsurance. We don't have any target. It can switch. It depends on market conditions. What we see today, and it's fair to say, I think we had phenomenally good results in the reinsurance market, and that is not deteriorating. What I'm saying is basically, we're not getting incremental improvement on the reinsurance sector because when we talk to cedents, they are seeing the improvement on the insurance side. They want to keep it. It's sticking to their ribs, not ours. But having said that, it doesn't mean that transactions that we do are worse than they were a year ago. They just don't have the improvement. All the improvement stays with the primary. On our Insurance Group, as you've seen from the numbers that Mark mentioned, we've seen their margin and their combined ratio on an accident year basis coming down. And as the market improves, we expect that to continue. So on the 6% of our business, we're getting the benefit of it. On the reinsurance, I think we're remaining steady. The reason that we haven't changed the 11% to 13% ROE, when you put everything in the hopper, we see improvement on the insurance side. We see steadiness on the reinsurance. But we're losing a bit on the cat business from a margin point of view, plus, we're losing a bit on the investment income side. So when you put it all together, I didn't see a reason for us to go beyond the 11% to 13% because that's what the numbers indicate.

**Arash Soleimani**
*Keefe, Bruyette, & Woods, Inc., Research Division*

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Well, I'll give you the short answer. The FHFA is in the process of coming up with new capital requirements. We know that the capital requirements are going to be somewhere between 15x to 20x a value at risk. So we don't know exactly when they're going to come, but basically, we believe the business is still very attractive from the low end of that range to the high end of that range. And I don't know how long the transition period is going to be, especially for some of the existing mortgage insurers who right now, they're not meeting that -- those thresholds from a capital point of view. So there might be a transition period, 1 year or 2, for people to come within those ranges, but we don't know that yet. We're waiting for the regulator to come with the requirements.

**Operator**

And our next question comes from the line of Vinay Misquith from Evercore.

**Vinay Gerard Misquith**
*Evercore ISI, Research Division*

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Well, I mean, growing at double digits in the U.S., that's a pretty good growth. And like I said, it's not only coming from -- first of all, some of our customers, they're seeing a slight improvement in their business. So the exposure bit goes up, so you get a little more premium. On top of it, you have the rate increases. That helps. And of course, we're gaining a bit of a market share, and the market share we're gaining predominantly is coming in the small E&S market through a binding authority business and, I think, in our program business. A lot of our program administrators, they have seen both growth in exposure units and very good rate increases. So the combination of those gives you that. Now on -- we expect that to continue, but you never know. This is -- the insurance business has always been very, very competitive, so I don't know what the competition is going to do. If there is no changes and the trajectory continues to go, we expect to continue to grow, especially in the U.S. That's not the same story in other parts of the world. As a matter of fact, you saw that we decided to shrink in some other parts of the world, U.K. and Australia and Continental Europe, in some lines, professional liability lines and B&O lines, et cetera. So we look at it, we look at the profitability, and then growth is not what drives us. I think bottom line results is what drives us, but we're not bashful. If we see opportunity, we'll seek it and we'll go out and write the business. Go ahead, Mark.

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

Vinay, just as a follow-up to Dinos' comment, I would note that the -- there's some similarities in the 2 major areas in the U.S. where there was growth: one, programs and the second, contract binding, as Dinos pointed out. First off, they're all -- both smaller accounts. They got a good overall spread. It's more stable. It's less volatile. As a result, we keep a massive amount of that net, so compared to other lines of business that might be getting similar rate increases, this will stick to the ribs more, a lot more than they would.

**Vinay Gerard Misquith**
*Evercore ISI, Research Division*

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

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

**Vinay Gerard Misquith**
*Evercore ISI, Research Division*

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

**Mark D. Lyons**

*Chief Financial Officer, Executive Vice President and Treasurer*

Well, yes, good question. It's -- it had a marginal impact. I mean that if -- I prefer to look at the combined ratio impact more than each piece, but I'm happy to address that. On the acquisition side, as we commented, the acquisition quarter-over-quarter is up 180 basis points, but if you control for that large transaction, it will be 130 basis points. It was 50 basis point impact on the net acquisition ratio. But you really can't stop there because you got to look to get to the different premium base and what it does on your operating expense ratio. And that really takes it back to another 60 basis points the other way. And there's a point difference because of just sheer premium size and where the loss ratio is on that as well. So on a combined ratio point of view, it's hardly noticeable. On a component point of view, it had 50 basis points on acquisition. So depending on where you're looking, that's the answer.

**Operator**

And our next question comes from the line of Mike Zaremski from Crédit Suisse.

**Michael Zaremski**
*Crédit Suisse AG, Research Division*

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

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

**Michael Zaremski**
*Crédit Suisse AG, Research Division*

I know what you mean.

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

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Go ahead, Mark.

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

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

**Michael Zaremski**
*Crédit Suisse AG, Research Division*

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

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

Okay. Well, you'll -- I think in the insurance Group, it was -- I mean, it was improvement in the operating ratio, but that was really driven by the denominator more than anything else. There wasn't big movement in it. Where you saw some movement was in the Reinsurance Group because there's some platform expansions. And as we've said in some other quarters, there's always some differences in quarter-to-quarter because of equity and how equity's recognized, especially with retirement-eligible people, it creates some differences. But -- so -- and there's a little bit, of course, of some front-ended, mortgage-related acquisition expenses that hit prior to receiving the premium that would be in this quarter.

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

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

**Michael Zaremski**
*Crédit Suisse AG, Research Division*

Got it. And on the equity method investment income?

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

Well, when it comes to that, there's not a ton that really jumps into my mind. I mean, that stuff from quarter-to-quarter could -- can be all over the place. So we do various analysis, of course -- unlike, you might think. But it's really -- there's no underlying causative trend that can be predicted if you're thinking in a forward sense.

**Michael Zaremski**
*Crédit Suisse AG, Research Division*

So we should just kind of think of it as alternative investments?

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

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

**Michael Zaremski**
*Crédit Suisse AG, Research Division*

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Well, I mean, the business is July 1 to year end. So we don't know how much. Because of the downgrade, we don't know how much they're going to write in the fourth quarter. But in essence, there was the non-premium reserve coming in, plus what they wrote in the third quarter, and then what they're going to write in the fourth quarter. After that, it depends what they want to buy. If there is any opportunities to come into an agreement on a going forward basis, all that is up to future negotiations, et cetera. But this transaction has that finality to it. It's July 1 to December 31 of this year, including the non-premium reserve coming for certain parts of their business. We didn't cover everything that they had.

**Operator**

And our next question comes from the line of Josh Shanker from Deutsche Bank.

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

Yes. I just want to talk about tax a little bit. I -- there was -- and I listened to Mark's disclosure. I'm trying to sense what the true-up is. And is tax rate a little higher than it used to be based on where you're writing business? Or am I just imagining things?

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

Well, it's -- the interesting thing that I've found out once I took over this job is how tax rates can move really as a -- the function of either where cats or where prior period development winds up being by jurisdiction. So when you -- I mean, here is the big picture. The operations in the U.S. on both the reinsurance side and the insurance side are improving. We've been talking about that because of the margin expansion. So that's naturally going to gravitate to US-based enterprises, on what remains onshore is being subject to tax. In the quarter by itself, because of prior period development, you got to -- you have to look at more the skin underneath the onion, but -- as to where the prior period development was coming from. When we look at what's always annualized, we never forecast prior period development on a go-forward basis. So when that actually emerges in the quarter, we have to react to it, be cognizant of where it emanated from by jurisdiction and give it the appropriate tax rate.

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

Okay, and so [indiscernible].

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Well, let me give you an example. This way, you can focus on the example. If euro cat business 1 year ago or 2 years ago and for whatever reason, their reserves, they were higher than needed and now you're dropping those reserves in this quarter, that business will show a lot of underwriting profit. And for that reason, you're going to pay the appropriate tax because it's emanating from the U.S. So just an example just to see as to how improvement in results and increased profitability will increase the tax by depending where you're writing the business.

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

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

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

Quite frankly, I can't really predict that, but let's follow on to Dinos' example for a minute. First off, we'd like to use the cat example. Cat's only a piece of the pie here. It's all lines of business and what year -- what prior year's the prior period development is coming from. So for example, next quarter until B&O fees are done, I can't tell you what jurisdiction, what lines of business and what accident years are going to show pluses or minuses. So it's -- I'm not being coy. I'm just simply saying until the analysis is done, we -- I can't tell you.

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

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

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

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

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

But it will -- I'm assuming you'll be reinsuring -- try and reinsure part of that back to Arch reinsurance in Bermuda?

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

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

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

But I will remind you, though, if you're asking a tax question, we don't expect it to be accretive until year 3, maybe later into year 3. So just keep that in mind.

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

Understood. Well...

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

The earnings are not going to be on day 1. It might be very profitable based on ROE, but by the time it starts dropping to the bottom line, it will take effect couple of years.

**Operator**

And our next question comes from the line of Charles Sebaski from BMO Capital Markets.

**Charles Sebaski**

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Well, our -- listen, our expectations will be somewhere between 15% and 20% of what we do. It can be as high as 1/3. We won't let it go beyond that because like I said, we're in 3 business. We're in the reinsurance business, we're in the insurance business and with the mortgage insurance business, both insurance and reinsurance. So that's the 3 legs of the stool. It balances a little better. I used to balance on 2 legs. Now I got 3. But at the end of the day, we like to be diversified. We don't like to overload. I don't care if it's the cat business or anything else and put a lot of our eggs in one basket. And the way we structure that, if the opportunity is bigger, we have abilities to bring additional investors into the mix and not own 100% of the mortgage insurance enterprise. We can own 80% or 70% with other investor that showed interest to come and partner with us. So we got a lot of flexibility there. But my projections over the next 3 to 5 years, think of it as a 15% or 20% of our business. That -- if things happen the way I envision them to happen, that's what's going to be.

**Charles Sebaski**

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

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

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

Yes. I think in the -- on that range of the 15% to 20%, I mean, there's so many unknowns. But to the extent that the core business gets harder, quicker. Of course, there's going to be more growth there relative to mortgage deterrents. Might be on the lower end of that 15% range. As the business stabilizes, though, there's a whole reason we went into it. It should become a higher proportion of the net income.

**Charles Sebaski**

Okay. And -- but just a little different side. On the insurance business in the professional lines -- and you may have said this earlier, and I missed it. But sort of 2 out of the last 3 quarters, you're seeing some pullback. Is this on the basis of pricing not being adequate where you guys want or some sort of change or anything different going on and why we're seeing the contraction there.

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

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

**Operator**

And our next question comes from the line of Ryan Byrnes from Janney Capital Markets.

**Ryan J. Byrnes**
*Janney Montgomery Scott LLC, Research Division*

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Let me -- I don't totally understand your question. The mortgage insurance will be a low loss ratio business. So as we write more of that, that will have the effect on the loss ratio on the reinsurance business because that's where we book it. But it's -- loss ratios, for us, it depends always on our mix. And since we're a company who changes mix more often than most, they -- the loss ratios -- that's why we focus more on profitability and combined ratios because the components of loss ratio, expense ratio, they're going to be moving around depending on what we do. What's coming in for the reinsurance business, it's -- is the transactions we did with one major mortgage insurer that we wrote a big quota share for them for 2 years in a row. And that -- it will continue to have that effect of lowering the loss ratio on the reinsurance sector. Now the second part of your question was?

**Ryan J. Byrnes**
*Janney Montgomery Scott LLC, Research Division*

I mean, I'm just trying to figure out if you're writing on the reinsurance side, I guess I don't know the expense ratio, but it sounds profitable. Is it just the ramp why it will take 3 years on the insurance side? Just trying to figure out why it'd take...

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Because you got to build the portfolio, and as you're building the portfolio, it's how you're earning the premium. Don't forget, the mortgage insurance duration is about 7 years, 6, 7 years, it depends because these are loans that mandated to buy mortgage insurance, but they have less than 20% down payment. And some of these loans, once the amortization schedule comes down to -- and they have more than 20% equity in the house, they drop the insurance because they're not required to have it. And for that reason -- but you getting a piece of the premium with every mortgage payment. So it will take you quite a bit of time to ramp it up. Now when you do a reinsurance transaction, you're already reinsuring an existing book that is already in steady state. That's the difference between the 2.

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

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Yes. So..

**Ryan J. Byrnes**
*Janney Montgomery Scott LLC, Research Division*

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Yes, the non-premium depends when they wrote the business. They might have wrote it in the first quarter, second quarter, maybe even a bit in the fourth quarter of '12. So the fourth quarter in '12 already earned fully, right, because by the end of the third quarter of this year, it earned. So it earned in the -- in our third quarter this year. But what they wrote in the first and second quarter, will continue to earn until it cycles over the next year. All the policies that they wrote, they're -- are new policies. So the earning pattern is 12 months.

**Operator**

And our next question comes from the line of Ian Gutterman from BAM.

**Ian Gutterman**
*Balyasny Asset Management L.P.*

First on the Tower transaction, obviously, you have that downgrade clause. It's been downgraded. Are you -- why are you still commissioned to this deal? Have you had any change of -- what would make you decide to back out given it got downgraded?

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Well, it's -- the business we underwrote, they were already wrote before they were downgraded, the bulk of it, right? It's the non-premium plus what they did in the third quarter. We don't know how much are going to write in the fourth quarter. But from an underwriting point of view, we -- and we don't expect them to deteriorate. They might have less volume because some people might not -- but they're not prepared as a company to go and just start slashing rates. In the condition they are, they're going to try to retain as much business as they have, and they try to maintain the rating structures they have. So that's our expectation. That's part of our discussions we have with them. But their fourth quarter business, highly unpredictable as to how much is it going to be. We were originally estimating about $17 million, $18 million for the fourth quarter. It might be less than that, significantly less, we don't know. Only time will tell, but overall, we're pleased with the entire transaction.

**Ian Gutterman**
*Balyasny Asset Management L.P.*

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

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Well, but don't forget, you're assuming our alternative investments is in the equity world only. We have a lot of high-yield fixed income stuff that it will be uncorrelated with that. We have special funds that they invest in special situations. One that I can mention to you is we do the development and managing of parking spaces in China. So I don't think that correlates with anything. So we have some investors -- investments that they're in sectors that there, we have floating rates. So the investments will go and follow floating rates. So it's -- think about it as more, how much of our asset allocation should be in alternatives before we decide as to what type of alternatives we're going to do and what the expectation? A lot of what we do in alternative investments, we have an expectation of double-digit returns. So we're looking for 10% returns or better when we make these investments. That, of course -- there is -- you can be a fool if you're investing on something with expectation of 10%. You're taking a lot more risk, and we understand that. But it will supplement the less risky stuff we do that we're getting 2% return.

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

And there's already been a couple of quarters of -- exactly what Dinos just said about the performance and the extended performance of some of these alternatives as an ameliorating factor.

**Operator**

And our next question comes from the line of Ron Bobman from Capital Returns.

**Ronald David Bobman**
*Capital Returns Management, LLC*

Ian Gutterman asked my question.

**Operator**

And our next question comes from the line of Jay Gelb from Barclays.

**Jay H. Gelb**
*Barclays PLC, Research Division*

It will be a quick one. The mortgage insurance opportunity, when you look 3 years out, when that could be accretive, what type of combined ratio assumption do you think is reasonable?

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

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

**Jay H. Gelb**
*Barclays PLC, Research Division*

So does that mean midteens?

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

Yes.

**Operator**

There are no further questions.

**Constantine P. Iordanou**
*Chairman and Chief Executive Officer*

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

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