S&P Capital IQ

CONTENTS

Arch Capital Group Ltd. NasdaqGS:ACGL

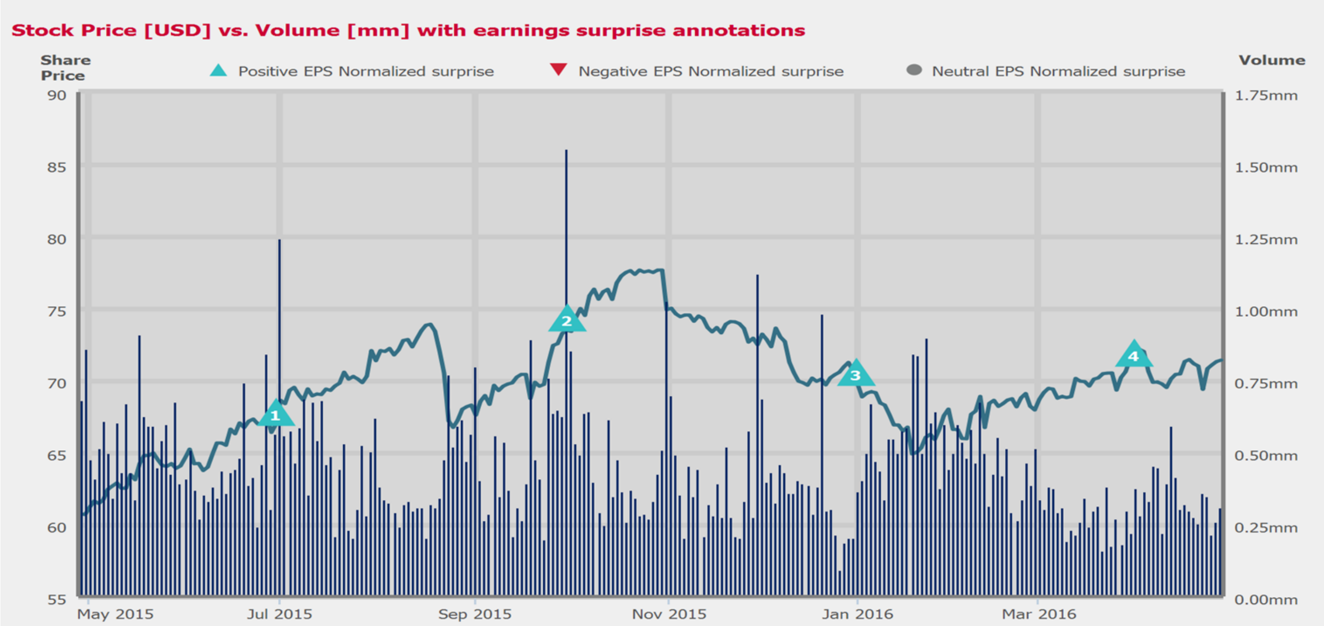
FQ2 2016 Earnings Call Transcripts

Thursday, July 28, 2016 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2016-			-FQ3 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.97	1.13	▲16.49	0.94	4.29	4.32
Revenue (mm)	971.29	1023.56	▲5.38	990.11	3950.88	4153.04

Currency: USD
Consensus as of Jul-28-2016 12:37 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2015	1.07	1.16	▲1 8.41 %
FQ3 2015	0.96	1.01	▲2 5.21 %
FQ4 2015	1.06	1.15	▲3 8.49 %
FQ1 2016	1.10	1.17	▲4 6.36 %

Call Participants

EXECUTIVES

Constantine P. Iordanou
Chairman and Chief Executive Officer

Marc Grandisson
President and Chief Operating Officer

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

ANALYSTS

Amit Kumar
Macquarie Research

Brian Robert Meredith
UBS Investment Bank, Research Division

Ian Gutterman
Balyasny Asset Management L.P.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Jay H. Gelb
Barclays PLC, Research Division

Joshua David Shanker
Deutsche Bank AG, Research Division

Kai Pan
Morgan Stanley, Research Division

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Quentin John McMillan
Keefe, Bruyette, & Woods, Inc., Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Arch Capital Group Second Quarter 2016 Earnings Conference Call. [Operator Instructions] As a reminder, this conference call is being recorded.

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thanks, Abigail. Good morning, everyone, and thank you for joining us today for our second quarter earnings call. We had a good quarter on a relative basis, and I might say it was very acceptable quarter also on an absolute basis. In today's market, we are emphasizing to our group's underlying discipline, execution and risk management in order to preserve capital and maintain balance sheet integrity. We continue to believe that our strategies of diversifying revenue streams and actively managing the allocation of capital will allow us to better navigate in this environment, which is challenging for all of us.

As reinsurance returns have narrowed, and as you can see in our second quarter financial statements, we're fortunate to have our other business segments, the primary property casualty segment and the mortgage segment, contribute more meaningfully to our operating results. Our reported combined ratio moved to a bit under 90% for the second quarter as catastrophe losses added 4.1 points to our combined ratio.

Loss reserve development remains favorable in each of our segments, which, in the aggregate, reduced our combined ratio by nearly 9 points. There were no noticeable changes in the property casualty operating environment from last quarter. There are some signs that reinsurance terms, especially ceding commissions, may have bottomed up.

In our insurance segment, we saw a slight deterioration in rates across some sectors, particularly in the excess of capacity layers and short-tailed areas. But rates were generally stable is most other lines, while the mortgage insurance environment remains very, very healthy. Marc Grandisson will give you more details on the segments in a few minutes.

On an operating basis, we produced an annualized return on equity of 9%, while on a net income basis, we earned an annualized return on equity of 13.2 for the quarter and a 7.9 on a trailing 12-month basis, which is a better measure to see our long-term profitability. Remember that net income movements can be more volatile on a quarterly basis as these earnings are influenced by changes in foreign exchange rates and realized gains and losses in our investment portfolio.

Net investment income per share for the quarter was $0.57 per share, flat sequentially from the first quarter of 2016. Despite volatility in the investment and foreign exchange markets in the second quarter of 2016, on a local currency basis, total return on our investment portfolio was a positive 163 basis points. Once we include the effects of foreign exchange, total return was 127 basis points in the quarter, in dollar terms.

Our operating cash flow was $153 million in the second quarter as compared to $232 million in the second quarter over a year ago. Mark Lyons will discuss the cash flow and other financial details in a few minutes.

Our book value per common share as of June 30, 2016, was $52.04 per share, a 4.4% increase from the first quarter of 2016. While some segments of our business have become more competitive, we believe that group-wide and on an expected basis, the present value ROE on the business written in the 2016 underwriting year should continue to produce ROEs in the range of 10% to 12% on allocated capital.

Before I turn the call over to Marc Grandisson, I would like to discuss our PMLs, which is essentially unchanged from April 1. As usual, I would like to point out to you 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 reflect a net for all reinsurance and retrocessions.

As of July 1, 2016, our largest 250-year PML for a single event remains in the northeast at $495 million or about 8% of common shareholders' equity. Our Gulf of Mexico PML at $434 million, and our Florida Tri-County PML increased very slightly to $392 million.

I kept my promise to be brief. And I will now turn it over to Marc Grandisson to comment on market conditions before Mark Lyons discusses our financial results. Marc?

Marc Grandisson
President and Chief Operating Officer

Thank you, Dinos. Good morning to all. The insurance industry returned to an average level of cash losses in the second quarter, with insured claims estimated in the $13 billion to $15 billion range worldwide. As you know, Arch underwrites globally, and we will pay a portion of these losses. However, previous underwriting actions taken in both our reinsurance and insurance segments helped minimized Arch's exposure to these events.

You may have heard us discuss cycle management in previous calls, but I feel it's worth repeating today that our appetite for assuming risks is directly related to our ability to earn an appropriate margin. In our view, it's not prudent to grow lines of business, where the expected margins are not adequate relative to the risk assumed. The insurance industry continues to face dual headwinds from low investment returns available in the market and underwriting margin compression as rates fail to keep up with loss trends in many lines of business.

Our focus remains on deploying capital judiciously and carefully in the P&C space, but we are continuing to redeploy aggressively in our mortgage or MI segment, where returns are very attractive and above our long-term goals. We remain bullish on the sector and believe that returns will remain above our hurdle rates for the next several years.

Within the U.S. mortgage MI sector, we estimate that our market share of the primary new insurance written, or NIW, in the U.S. was in the 9% to 10% range in the second quarter, up from 6.4% in Q1 as Arch MI continues to gain traction in the bank channel. The acceptance of RateStar, our risk-based pricing module, is the primary driver of the growth, and we believe that it will allow us to earn better risk-adjusted returns.

In addition, we continued our market leadership in underwriting new U.S. GSE risk-sharing transaction and continued to see good volume from our Australian primary insurance relationships. Our U.S. MI operation increased its NIW to $6.4 billion during the second quarter of '16, of which approximately 76% came through the bank channel. Over 80% of our bank channel borrower paid MI commitments by the end of the second quarter were obtained through RateStar. Our current return expectation across our MI segment is in excess of our long-term ROE target of 15%.

Let me turn now to our primary P&C insurance operations in the United States. Overall, we saw rate changes of negative 180 basis points this quarter versus the positive 20 basis points last quarter. We believe that we have mitigated some of that rate erosion after consideration of our ceded reinsurance coverage.

Most of our controlled or low volatility segments had rate change in a 0 to positive territory, while our cycle-managed segments experienced single to double-digit rate decreases. As I noted -- as we note, frequently, our cycle-managed segments are more heavily reinsured. Our U.K. operation is still pressured from a rate-level perspective with an overall rate decrease across all our product lines of 4.6% this quarter.

Our cycle management culture is a key factor in our strategy, and we are reacting accordingly to market conditions. Our net written premium was essentially flat, but we continue to realign the portfolio towards the more attractive opportunities in the U.K. Globally, our insurance group continues to adjust its mix of business on a gross basis and also on a net basis as we are able to buy reinsurance on favorable terms.

Ceded premiums increased 5% in our insurance group this quarter over the same period last year. Areas of opportunity for growth in the insurance sector in the second quarter were in our construction, national accounts, travel and alternative market lines. The vast majority of our growth came as a result of our ability to take advantage of the current dislocation in areas where major players are challenged. In contrast, our executive assurance, excess property and programs businesses are areas where rate levels lead us to a more defensive strategy.

Turning to our reinsurance group, which continues its strong performance. Our teams are increasingly more selective, given conditions in their markets. Underwriting year returns in many of the traditional reinsurance lines are in the low single digits and some are even negative on an expected basis. Adjusting for one large loss portfolio transfer and the impact of the Gulf reacquisition last year, our reinsurance net premium written declined by 2% for the second quarter of 2016 versus '15.

And with that, I'll hand it over to Mark to cover the detailed financial results.

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

Thank you, Marc, and good morning all. As getting into the financial information, I guess I'll be the most verbose out of the 3 of us. So as was true on my previous calls, that are the comments that follow on a pure Arch basis, which excludes the other segment, that being Watford Re, unless otherwise noted. I will continue to use the term core to denote results without Watford Re and the term consolidated when discussing results including Watford Re.

However, due to an all industries clarification issued recently by the SEC regarding non-GAAP measures, our earnings release now emphasizes GAAP measures as some previous tables and commentary that used to be in the earnings release have been shifted into the financial supplement. So please read them together.

Various examples are on Page 7 of the earnings release. We now show the reconciliation from net income to after-tax operating income, where previously it was reverse. The point being that you start with the GAAP measure, not the non-GAAP measure. We also, on Page 1 of the earnings release, now present consolidated underwriting results that includes Watford Re rather than the core underwriting results that previously had excluded them.

Lastly, the schedule showing prior period development and cat losses by segment along with the schedule displaying the components of net investment income and investment total return are now on Pages 21 and 23 of the financial supplement, respectively. So hopefully that provides a little bit of a roadmap.

Okay. With that said, the core combined ratio for this quarter was 89.9%. It was 4.1 points of current year cat-related events, which are net of reinsurance or reinstatement premiums, compared to the 2015 second quarter combined ratio of 87.9%, which reflected only 1.9 points of cat-related events.

Losses recorded in the second quarter from 2016 catastrophic events, net of reinsurance recoverables and reinstatement premiums, totaled $36.3 million versus $15.9 million in the corresponding quarter last year, primarily emanating from U.S. Texas hailstorms and floods, Fort McMurray, Canada, wildfires and earthquake events in Japan and Ecuador.

This was a quarter that experienced the high frequency of cat events, yet the largest of these had less than an $8 million net impact to Arch. This result evidences our continued emphasis on proper line setting and the overall focus towards reducing our cat PML exposure, given that, in our view, current pricing does not adequately compensate for the exposure assumed in many cases.

The 2016 second quarter core combined ratio reflected 8.9 points of prior year net favorable development, net of reinsurance-related acquisition expenses compared to the nearly identical 9.2 points of prior period development on the same basis in the second quarter of last year. This results in a core -- a quarter combined ratio, excluding cats, for the second quarter of 94.7% compared to 95.2% in the corresponding quarter last year.

This quarter, the reinsurance segment had 2 unique transactions that impacted the financial statement in different ways, both related to loss portfolio transfers. The first reflects the commutation of a preexisting contract that resulted in recognizing $19.1 million of other underwriting income. However, this contract had been accreting approximately $1.5 million of gain a quarter. So the incremental impact is approximately $17.5 million for the quarter. This contract had been receiving deposit accounting treatment since inception since it did not pass risk transfer under GAAP. Since this gain shows up in other underwriting income, it is outside of the combined ratio.

The second transaction involves a newly bound loss portfolio transfer with a long-term client, where we have familiarity with the underlying exposures. This contract has sufficient risk transfer under GAAP and, therefore, receives insurance accounting treatment. As a result, we booked this contract at approximately 100% combined ratio, and its impact is felt directly in the combined ratio. Furthermore, it covers the cedent's net after all inuring reinsurances, thereby making this a frequency contract.

That said, the reported calendar quarter reinsurance segment combined ratio of 82.1% would actually be 79.4% without the impact of this new loss portfolio transfer. In addition, it results in a 7.7-point increase in the calendar quarter loss ratio with a 5-point benefit to the expense ratio, therefore totaling a 2.7-point worsening of the calendar quarter combined ratio over what it would have otherwise been.

Now getting back to our results for the quarter. The reinsurance segment 2016 active quarter combined ratio, excluding cats, was 98.4% compared to 94% even in the 2015 second quarter. This quarter's combined ratio reflects the impact of the loss portfolio transfer we just discussed that contributed approximately $40 million of net written and net earned premiums as well as the impact of a large marine attritional loss that had no equivalent in the second quarter of last year. Without the impact of these items, the accident quarter loss ratio was nearly flat over last year's quarter.

In the insurance segment, the 2016 accident quarter combined ratio, exuding cats, was 96.3% compared to an accident quarter combined ratio of 97.6% a year ago. This 130-basis-point decrease was driven by a 100 bps in the loss ratio and 30 bps in the expense ratio, with the loss ratio decrease reflecting a lack of the large attritional losses that we experienced during the second quarter of 2015. When one adjusts for this, the noncat nonlarge attritional loss ratio was essentially flat quarter-over-quarter.

The mortgage segment 2016 accident quarter combined ratio was 66.1% compared to 77.4% in the second quarter of last year. This decrease is predominantly driven by the continued expense ratio improvement in our U.S. primary MI book, due mostly to growth, along with beneficial mix changes towards GSE transactions receiving insurance accounting treatments in lieu of derivative accounting treatment.

Regarding prior period reserve development, the insurance segment accounted for roughly 6% of the total net favorable development in the quarter and this was primarily driven by shorter-tailed lines from the 2012 through 2014 accident years, with some contribution from longer-tailed lines spread primarily across accident years 2003 through 2012 and partially offset by large energy casualty claim from the 2015 accident year [indiscernible] insurance operation.

The reinsurance segment accounted for approximately 81% of the total net favorable development in the quarter with approximately 70% of that due to net favorable development on short-tailed lines, concentrated in the more recent underwriting years and the balance due to net favorable development of longer-tailed lines, primarily from the 2002 through 2013 underwriting years.

The mortgage segment contributed to the balance or 13% of the total net favorable development in the quarter, which translated to a near 17-point beneficial impact to the mortgage segment loss ratio, primarily resulting from continued lower-than-expected claim rates from our U.S. primary mortgage insurance operation and from the quota share treaty covering the 2009 and 2011 book years as part of the original PMI and CMG purchase transaction.

As discussed in previous quarters, almost all of this favorable development benefit is offset by the contingent consideration earn-out mechanism negotiated within the purchase agreement. This contingent consideration impact, however, is reflected in realized gains and losses and not within underwriting income. This quarter, the nominal payout cap within the contingent consideration mechanism was reached, which is 150% of the transaction closing book value.

FX will still be felt in future quarters though, as we continue to accrete to the contractual payment dates and a discount rate employed to account for increased certainty decreases over time. The overall core expense ratio improved by 180 basis points, but this was affected by the loss portfolio transfer referenced earlier. Controlling for this transaction, the core expense ratio improved by 20 basis points, driven by the continued improvement in the mortgage segment, expense ratio and continued marginal improvement in the insurance segment expense ratio.

On a written basis, ceding commissions achieved within the insurance segment quota share sessions improved 210 basis points over the second quarter of 2015. As stated last quarter, the growth in alternative markets business reduces this benefit somewhat due to the associated captive sessions.

Core cash flow from operations was $153 million, as Dinos mentioned, in the quarter versus $231 million in the second quarter of 2015. This reduction was caused primarily by higher losses paid, net of recoveries, and the timing of outflows associated with ceding more premium this quarter versus a year ago.

Core interest expense for the quarter was $12.4 million compared to $12.6 million in the first quarter and $4 million in the prior year's quarter. The prior year quarter amount included a favorable adjustment for a deposit accounting transaction, which resulted in an $8.4 million reduction in interest expense in that quarter. As mentioned earlier, this deposit contract was commuted during the quarter.

Our effective tax rate on pretax operating income available to our shareholders for the second quarter of 2016 was an expense of 5.9% compared to an expense of 3.9% in the second quarter of last year. This quarter's 5.9% effective tax rate includes approximately 20 basis points or $250,000 related to a true-up of the prior year's tax provision to the estimated annual effective rate as of June 30. As always, 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 $7.6 billion at the end of this quarter, up 4% relative to March 30 -- March 31. Our debt-to-capital ratio this quarter remains low at 11.7% and debt plus hybrids represent only 16% of our total capital, which continues to give us ongoing financial flexibility.

We continue to estimate having capital in excess of our targeted position. We did not purchase any shares this quarter under our authorized share buyback program, and the remaining authorization is approximately $446 million as of June 30.

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

Constantine P. Iordanou

Chairman and Chief Executive Officer
Abigail, we're ready for questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Kai Pan with Morgan Stanley.

Kai Pan
Morgan Stanley, Research Division

First point -- these 2 loss portfolio transfer transaction, can you give a bit more details about it? For the one, your commute was the reason for that, and for the one you just booked. And so how do -- what attractive to yield, what do things for you? And do you see other opportunities, similar opportunities?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, the first one we commuted, we always try to keep very good relationships with our clients. It was a client request they wanted. And we felt that terms of commutation, they were attractive to us. So we accepted it. The second is in the normal course of business, we always look for transactions, and this was a transaction presented to us. We like the economics. So we did it. Marc, do you want to add to it?

Marc Grandisson
President and Chief Operating Officer

Yes, the only thing I would add on the second one, it was really as a result of being intimately very familiar with the book of business. It's a client that we have known for many years. And the years under which that LPT is -- the year it is covering, we actually had underwriting risk alongside with that party as well. And that came as a result of a -- again, a request by the client who seek an improved capital ratios, and that's really -- that's what it's driven by.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, it's a capital relief situation here.

Kai Pan
Morgan Stanley, Research Division

Do you see more similar opportunities?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, we see activity in that sector as a matter of fact. But we don't make predictions as to are we going to do any or not because I have the faintest idea, if they're going to happen. The instruction to our guys is you look at them, you like the economics, we do them, we got the capital. If you don't like the economics, we pass.

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

And Kai, it's always tough. There's a long runway on those. Hit ratios are low, but we continue to see them and entertain them.

Kai Pan
Morgan Stanley, Research Division

Okay. That's good. On the MI side, the Australian reinsurance transaction, is that considered like a one-off? Or is it continual relationship if that could recur?

Constantine P. Iordanou

Chairman and Chief Executive Officer

This is an actual ongoing relationship. It's a quota share of a primary reinsurance book of business. And it will continue until it gets canceled.

Marc Grandisson
President and Chief Operating Officer

Until we both cancel, the both parties agree to.

Kai Pan
Morgan Stanley, Research Division

Okay. Their additional is sort of like gross opportunity with that client?

Marc Grandisson
President and Chief Operating Officer

At this point we don't perceive it. We have a very significant portion of their portfolio, and we're sort of happy, very comfortable with that position.

Kai Pan
Morgan Stanley, Research Division

Okay. Lastly, it's on the -- your REIT commentary in the insurance sector. It seems like it's down, like decelerates internal pricing decline. Could you give a little bit more color on the pricing dynamics there? And in this environment, how do you sort of manage your portfolio? It looks like your core combined ratio actually improved in the insurance segment you said mostly due to mix change. Will that be enough to keep that -- the margin?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it's a complicated question. Let me give it a shot at. We don't give you the granular performance on each one of the sectors, for obvious reasons. You listen but do so our competitors, et cetera. So we're not going to tell them everything that we do. But it's true in our comments that the aggregate rate reduction across the entire renewable book was about 1.8%. That's 180 bps. And then you factor in some loss claims trend. That means that's not a good market to operate. Now having said that, we have sectors that we're very defensive because that's where we're seeing the significant rate reductions. I mentioned in my remarks property lines and excess both in D&O professional and liability lines which the capacity players -- and at the end there is no -- it's pure supply and demand. There is no differentiation in the product, et cetera, and it's under pricing pressure. We try to manage those down, and we try to put more emphasis on our small to medium-size business that we have more control on the rating and also the quality of the risk, et cetera. Now I'm going to turn it over to Marc Grandisson because he runs the insurance group now, he runs all of our operations, and he's more granularly involved with these decisions as he does the reviews with the property centers, et cetera, to give you a little more flavor.

Marc Grandisson
President and Chief Operating Officer

Yes. The flavor was actually given in the remarks. I did mention specifically the controlled and low volatility business, which is a small to medium-size what we have, more intimate and more influence over what's happening in the form and pricing. We are getting flat to single-digit rate increases in many instances. The ones that are more cycle managed, more open market or more competitive or a lot more commoditized, this one had the single digit 5% to 7% rate decrease. So -- and as I mentioned also in my comments, the cycle managed one is the one where we are a little bit more willing and then working harder to buy reinsurance to actually mitigate those rate decreases.

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

And I would just add on top because Marc nailed it is the additionally layer that we've talked about the ceding commissions. So on the commoditized product lines, you manage your mix through increased reinsurance. In this environment you're getting continuing those thick overrides that drop the bottom line and really help with net income.

Operator

Our next question comes from Jay Gelb with Barclays.

Jay H. Gelb
Barclays PLC, Research Division

We've heard some other reinsurers and perhaps even some of the brokers say that they view the reinsurance market as bottoming. Would you agree with that?

Constantine P. Iordanou
Chairman and Chief Executive Officer

In general, I do. Marc, do you agree?

Marc Grandisson
President and Chief Operating Officer

Yes. My comment on this is -- I will be careful because we don't know, again, the future. There are certainly signs that reinsurance markets are pushing back on markets like property cat, for instance. There is some layer that had to be repriced in the second quarter because there were some -- too much aggressiveness in trying to get the price down. So there's some pushback. It's still going down, but not to the same level. In addition, we have -- we also have pushbacks on the market on getting increased ceding commission. We are successful in getting a couple of points, which Marc and Dinos mentioned before, but this is landing around 1% to 2% increase, but there's a lot of push to get more than that. So there's still a lot of push back on market at this point in time. What I tell our troops is, again, we're going to react to whatever we see in the marketplace. It could be a bottom. It could be a plateau before more damage being done. It's really too early to tell.

Constantine P. Iordanou
Chairman and Chief Executive Officer

But you see shortfalls. That's an indication that there is a pushback. If you cancel the placement and you got to go back with filling a shortfall. So there are signs that we're hitting the bottom. Listen, where interest rates are, where investment income is, you better make it on the underwriting. And if you're not making it on the underwriting, you better pack it in and go and open a Greek diner. You make more money doing that.

Jay H. Gelb
Barclays PLC, Research Division

Okay. The next topic I want to touch on is the mortgage insurance business. And based on our model, it looks like the underwriting profits from that could double this year compared to 2015, driven by the strong topline growth and improving margins. How big of a business can you envision this being over time?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, first, you got 2 questions there. One is you're projecting earnings. I don't think your comment is actually totally correct. You got to understand that in our MI book, we have U.S. MI. We have the Australian MI, which is more steady. We got GSEs, which is more steady. And then we have some early transactions. We had a couple of reinsurance transactions that they're declining because they're maturing. They were vintage 2012, and the duration is 6, 7 years. So we're towards the end of those. So I would say, yes, the contribution of earnings is going to grow, but it's not going to be exponential the way you put it. Having said that, the second part of your question is do we like the sector? Yes, we do, and we're willing to contribute more of our capital. But we don't want it to be totally the dominant exposure that we have. And the way we think about it, we want to have a balance over time between reinsurance, insurance and mortgage. Having said that, in different parts of cycles, depending which segment is the most attractive, the earnings might be in -- coming heavier in one area and lighter in another area. But that's the beauty of allowing us to navigate and allocate capital into our 3 businesses. At the end of the day, we'll not be 100% mortgage company. We won't be 100% reinsurance company, and we won't be 100% P&C company. But the market will determine which sector is a little bigger or a little smaller for us because at the end, we're only facing margins. And if you're chasing earnings, you got to go where the earnings are.

Jay H. Gelb
Barclays PLC, Research Division

Of course. On the mortgage insurance front, do you envision it being organic growth that drives this going forward? Or is our attention in acquisitions in that space?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We're interested in everything. I mean, we'll like a sector. But our history's been let's make sure that we have the right strategies that we can always grow organically and depend on that because acquisitions, sometimes they happen, sometimes they don't. And at the end of the day, you don't have -- we don't have a strategy that is focusing on acquisitions for growth. Our strategy is focusing on, let's see if we can build it organically. But we're not excluding anything that it might be thrown our way and is attractive to us. Marc, do you agree?

Marc Grandisson
President and Chief Operating Officer

I agree with you. Yes.

Operator

Our next question comes from Michael Nannizzi with Goldman Sachs.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

One question, Mark, just on the reinsurance business or the LPT specifically is, it seems like all of that was earned in the second quarter. Should we assume that there really isn't a durable impact for the remainder of the year, either in terms of top line or losses, first of all? And then secondly, does this -- should we assume that it renews again in the second quarter next year and we should see that lift in premiums again, when that happens?

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

Good question. To both of those, you should view that as a unique special event, not recurrent and really not earnings that was fully -- virtually fully earned right away. So consider it a quarterly outlier.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Okay, so no -- not expected to return again?

Constantine P. Iordanou
Chairman and Chief Executive Officer

There's no underwriting gain or loss. There's no underwriting gain or loss. We booked it at 100 combined, and at the end of -- yes, that small increment on the flow that is going to run, it's going to be there. But there is -- for all intents and purpose and for your model, ignore both of them.

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

I mean Michael, it's possible a year from today, we reevaluate the ultimate as favorable or what have you, sure. But don't think of it is as a quarter by quarter impact.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it, okay. And then it looks like Watford premiums were down year-over-year. So I was just curious because it looks like sessions in this segments were up. So does that just mean that your ceding business to more non-Watford entities? Or how should we think about that?

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

Well, I think you've got -- as Marc already talked about, if you're looking at overall sessions, you have the insurance group continuing to cede a little bit more. I think in totality, it's roughly the same net to growth at an ACGL level, but the mixture between -- you still got the reinsurance guys doing some retrocessions. But I think it's mostly leveraging reinsurance in the -- from the insurance sector side.

Constantine P. Iordanou
Chairman and Chief Executive Officer

There's not much change in this buying as well and the reinsurance side as well. It's very consistent.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Okay. But just the net like the dollar amount of sessions in the businesses was higher, whereas the net premiums in your other segment, which I assume is all Watford, were down. So I was just curious if your strategy in terms of how much business you're placing with Watford was changing? Or if that's -- there's some other distortion in there?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Let me take you back, and then I'll turn it over to Mark. At the end the of the day, independently we are shipping premium out to third-party reinsurance or to Watford. It's got to make economic sense. So we're not going to -- if I can get it cheaper in the open market, I'm not going to give it to Watford just to maintain volume. I'm going to go and buy it from where is the most attractive place for me. Having said that, I don't think we have changed anything strategically as to what we're to do with what. Our responsibility with Watford is to be the underwriting managers and underwrite business that at the end of the day, it's going to give them flow as close to 0, of course, as possible. And when we find those opportunities, we do it and we give it to them. And if that business produces returns that are acceptable to Arch, we won't sell it out. We'll keep it at Arch. So our philosophy and our strategy has not changed.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Okay, got it. And then just lastly, just back to mortgage for just a second, written premiums, both gross and net, have increased nicely. Guessing a lot of that is the GSE business -- I mean all the business but GSE seems to be growing more. Earned premium has lagged that growth. So I'm just -- I guess I'm just trying to figure out how -- yes?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I can answer some of that. But -- go ahead. Go ahead, Marc.

Marc Grandisson

President and Chief Operating Officer

The premium written, a lot of it -- half of the growth actually comes from Australia, and it's a result of being the product is a single premium upfront. So you get all the premium upfront and earnings pattern is extremely flat. It drags along. And also on the written premium for that -- for the rest of the units, there will be a lag in earnings. We have to write this business, and it takes a long time to write. And we have some singles as well on the Arch U.S. MI. So we did write some singles there. Not as much as the other guys in the world, but we did some. So there's definitely going to be a lag between the written by virtue of being single upfront, mostly from the Australian business front.

Constantine P. Iordanou
Chairman and Chief Executive Officer

The way you got to think about this is that first, the mortgage business has a 6 to 7 years earning pattern, right? The Australian market, a lot of it is single upfront, but it was still on over 6, 7 years. So we have lack in the earnings and lack on the income that is going to come over time. In the U.S., you see our numbers. We do about 20% singles, 80% is the monthlies. The monthlies, they booked and earned on a month by month. The singles, they're written upfront, but they run over 6, 7 years. So as long as you monitor those 2, it will give you a good ability to put both the earnings stream as it's going to come in and also the net income stream that is delayed. That's why some people try -- like to talk about embedded value in the mortgage sector, which some of you may have models predicting what's going to happen in the future.

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

And Michael, just because I think you're probably going to go back and you're thinking about how you're going to project this stuff on a go forward basis, I just want to clarify both Marc and Dinos, talked about Australia being a singles market. I just want to make sure you realize that the contract itself is not a big bullet single. It's a contract over a whole set of singles that they accept one month and one day after the other after the other. So it's a book of business that has singles and testing throughout its term, but not a big bullet single upfront.

Constantine P. Iordanou
Chairman and Chief Executive Officer

We're getting it every month, but we're not getting a little component month by month over 7 years. We get it all upfront, so all the more this is going to be one in one year. The premium is going to be booked in that particular year, but it's going to be booked month by month.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

I understood. So it's flow business, not bulk business. It just happens to be singles.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes.

Operator

Our next question comes from Quentin McMillan with KBW.

Quentin John McMillan
Keefe, Bruyette, & Woods, Inc., Research Division

Mark, you had a lot of information in there and thanks for walking us through everything with a little bit of more complicated quarter in a couple of those one-off things. But one thing that I wanted to understand just a little better is you mentioned the reserve development in the mortgage that had an offset in the contingent consideration reaching the nominal payout cap. Can you explain that a little bit better for us?

Sort of how the reserving works there and why you had this big -- relatively bigger $11 million reserve development, and it sounds like it's an offset somewhere else in the balance sheet, so it's not really a gain. Is that the right way to think about it?

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

Well, think of it more as an offset of income. You've got prior period development. In rough numbers, these were $10 million or $11 million, I think, in totality. So it's $10 million or $11 million on a realized loss, that's how it goes through. And then you've got the standard prior period development. So it has to be coming from the same stores, kind of like a profit commission sometime does. With the loss ratio increase, they might decrease the profit commission. Similarly here, you've got the subject years of what we purchased, so it was -- it's continuingly lower delinquency rates and claim rates associated with those that dictates and indicates the reduction. Because on the CMG transaction, we bought -- it was a provision, it was a stock purchase, so we initially paid 80% of book with an earn-out mechanism. And depending upon the actual performance, which is exactly what this is indicative of, we could pay out more up to 150% of the closing book value. We hit that nominally, not present value, but normally this quarter. But it's directly related. So as it continues to have good performance as mostly shown through improved loss reserve development, you get an increase in the contingent consideration.

Constantine P. Iordanou
Chairman and Chief Executive Officer

And from now on, anything that is positive, if it continues, it sticks to our ribs. They have ate all their meals. It's done.

Quentin John McMillan
Keefe, Bruyette, & Woods, Inc., Research Division

Okay, that's great. Very clear and really helpful. Secondly, on the MI side as well, you mentioned 80% of the 75% of the bank channel -- I'm sorry, 76% of the bank channel came through RateStar. Obviously, that's having great success for you guys. Can you just talk to us about what you're seeing the competitors now do in response to RateStar? Or maybe sort of what you expect the competitive environment to look like because of that.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I don't know what they're going to do. And as far as we're concerned we -- at the end of the day, RateStar is the proper way, in our view, to price mortgages. It's no different than in the auto sector when you introduce many different variables to price risk appropriately. And that's what we've been doing. We're pretty happy with not only the performance from a production point of view, but also when we go in back half, what RateStar gives us versus rate card. So we still have the rate card. Our clients -- some 20% of our business and 50% of our business in the credit union channel is coming through the rate card. But we test both and what we like a lot about RateStar is that, first and foremost, the ROE variability around the mean is very narrow, and we like that. It gives you stability and more predictable earnings, where the rate quarter has a much bigger variability. And now how competitors -- they're going to -- they'll respond. I don't know. I think the best way for them to respond is just -- and I don't want to give my competitors advice, is go to a risk-based pricing tool and make sure that they are pricing risk appropriately. I mean, that's the proper response. If they try to just cut rates on the rate card and all that, it's like somebody in a quicksand and they keep moving their feet.

Marc Grandisson
President and Chief Operating Officer

The one thing I will add to this is the only -- the other one that's a big competitor for us is the FHA, as you guys know. So that one is the government agency that's also even harder for us to even figure what they're going to do with the prices. So I just want to make sure I put it out there.

Quentin John McMillan
Keefe, Bruyette, & Woods, Inc., Research Division

So the government's tricky to figure out, that's unusual.

Marc Grandisson
President and Chief Operating Officer

Exactly.

Quentin John McMillan
Keefe, Bruyette, & Woods, Inc., Research Division

If I could just sneak one more in, I'm sorry. On the valuation of the stock, obviously, the very high-quality problem to have, it's been up there and above what your 3-year return threshold would be for buybacks. And I'm kind of assuming that's why buybacks were limited in the quarter. Just assuming that we stay in this sort of heightened valuation for the stock in the near term or over the long term, how do you guys sort of expect to deploy capital? Or what might you do?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I think you're reaching a conclusion that it might be right and it might not be. It wasn't as much the valuation of our stock, but it was more where we see opportunities in the marketplace. And let's face it, we've seen most of the opportunities on the MI space. So basically, we kept our powder dry for the reasons that we can deploy more capital in the MI space, and that was the main reason behind it.

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

And as Dinos alluded to though, it's a combination of things. We never have a price line, as you know, on that. It's more of a guidance. And for most of the quarter, we traded, I'd say, a little south of 1 4 to book value. So it's got to be a little clearer than that given the combination of things.

Operator

Our next question comes from Josh Shanker with Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

I want to look at the favorable development in the mortgage insurance segment and understand -- I mean, I realize that this is a very low loss content business, but if you were only ringing a short period of time, it almost took at all losses out for the quarter. I mean, what's going on there? Is that one-time in nature? Is the business so good that it's not showing any losses, sort of...?

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

Josh, the -- it's been a continual march downwards on the delinquency rates and the associated claim rates as they come out of that. Remember, this is really 2011 and prior, so there's vintage of seasoning associated with this. So it's not like the PC. And it's really -- you got to think of it as more of a report year review of the triangle. So...

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, this is CMG mostly, which is the credit union business. And we bought that company and we bought the reserves and we bought all the assets and the liabilities that come along with it. And we had that pricing mechanism, the adjustment we talked about. And -- but at the end of the day, you got to report their performance and the performance, it was better than we even expected ourselves. Otherwise, I am the dumbest guy on 2 legs because what I negotiated didn't work for me. It worked for them because

I'm paying a lot more for that company than if I would have taken 100% at book value at that time. In retrospect, if I know what I know today, I would have negotiated better.

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

You can't see us nodding here, Josh.

Joshua David Shanker
Deutsche Bank AG, Research Division

So if I look at the mortgage loss reserve, what percentage of it in broad terms is legacy business versus Arch MI business?

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

I don't have that at my fingertips, but I would say the -- substantially.

Constantine P. Iordanou
Chairman and Chief Executive Officer

The vast majority. It was all the stuff.

Joshua David Shanker
Deutsche Bank AG, Research Division

Okay. So the fact that you're not favorable development to negate your current -- your losses, comparing apples and oranges, you have a huge back reserve and a small current -- and small sort of newco reserve.

Constantine P. Iordanou
Chairman and Chief Executive Officer

That's correct.

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

That's right. And remember, Josh, because we kind of alluded to it, I think in the prepared remarks, that part of the original transaction was a quarter share on the 2009 to 2011, I'll call it back book. And so that is also experiencing some of the same aspect, but that wasn't CMG, though. That was CMI.

Joshua David Shanker
Deutsche Bank AG, Research Division

And you have any reasons to believe that business that you can detect RateStar underwritten business as a better loss ratio than rate card business?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, we price the RateStar and rate cards to give us the same ROE. So we have the same target. Now as we back testing both, because every month I ask the guys and we back test based on the volume that comes in and we underwrite, the only difference between the 2, it's not on expected return on equity. I think both of them on an expected basis, they're about the same. And we did price both at about 15% ROE. The difference is that the RateStar produced business is very narrow -- narrower around -- it's 3 to 4 ROE points up and down the mean where rate card is much wider. To give you an example, if you had a -- just use credit score as one variable that you're going to test for. If you're testing the 7 50s in the rate card versus RateStar, the rate card, even though the mean might be 15, it might be some business all the way up to 20%, 22% and some all the way to 7% or 8%, where with RateStar, it's more like 12% to 13% all the way up to 17%, 18%. Well, you were right on your write-up, except you couldn't predict our one-off transactions and when you're ready to predict that one-off transactions, I want you to call me because you and I, we're going to go to Vegas together.

Operator

Our next question comes from Amit Kumar with Macquarie.

Amit Kumar
Macquarie Research

I'll try to ask some intelligent questions now. This is a big thing for me. So very quickly, these are more -- most of my questions have been answered, but sort of big picture question. One is sort of tying in the comments in response to other question. If returns are stable in reinsurance and insurance, and if your MI business is growing rapidly, should we expect a slow trend up in the AY ROE? And if that is the case, does your book value grow at a faster clip than the industry, all as being kept equal?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, because your assumptions -- I don't think you were totally listening to us correctly. We said that reinsurance is deteriorating. I mean, still there's the results, don't get me wrong. But it's under pressure, so we're losing ground there and we're losing lesser ground on the insurance side. But both those sectors, we're losing ground. So in essence, from a profitability point of view, they're not going have the same ROEs as before. And the reason I didn't change the 10 to 12 on an underwriting basis is because I'm offsetting what I'm losing on those 2 sectors by what I'm gaining through mix change on the MI sector, and that's the way you got to think about it.

Amit Kumar
Macquarie Research

Yes, that's a fair comment. I'm sure Ian is already disappointed in me. The next question I have is again on MI. With the Baron story coming out on Sunday, there's been a lot of focus -- a lot of sort of new investor feedback as well as from traditional investors. The one question which I was getting, and this is sort of interesting, is the traditional P&C investors were asking, if things go south, wouldn't ours be locked in? Unlike traditional P&C where you can cut back underwritings, pull back on the capital and then wait for the cycle to turn. It seemed that there was some fear on that thought process where if Arch becomes bigger and bigger than MI, maybe a different class of investors cycle in and the traditional investors cycle out. What would you say to that in terms of -- if the cycle does turn, how easily can you sort of pull back or pull out or change your strategy?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, let me -- it's a very complicated question, but it's a very, very good question. Because it talks about what do you need to do from a risk management point of view, from capital allocation and also what the history has taught us in this particular sector. Let me start by pointing out to you that the performance on the bank channel versus the credit union channel was even -- the worst fear for the credit union channel through the financial crisis was 152 loss ratio. Nothing to write home about, but not catastrophic, right? And what I'm sharing with you is information we have through the PMI transaction, right? On the bank channel, you got in excess of 300, 2x. When we examine that and we've done a lot of analysis on it, most of it, it wasn't just economic conditions. Yes, economic conditions will have an influence and that's the caravan that you have to plan for and make sure that from an aggregation point of view, you're comfortable with how much risk you take in. It also tells you that if you don't violate your underwriting guidelines, your performance, even in down economic conditions, unemployment going to 15% and prices coming down by 25%, you can withstand all that as long as you're disciplined on your underwriting side. Because most of the delinquencies, they came from fraudulent loans, loans that there was very little verification, the underwriting information was very suspect, and on top of it, very, very loose underwriting. People are writing risk that they shouldn't be taking that risk. Having said that, it's no different when you write long tail liability lines on the P&C work. If you're pricing your workers comp at 20% or 30% below.

And depending if you stop writing tomorrow, you're going to have that tail that is going to continue hitting you with that risk loss development year after year after year because the duration of those liabilities is probably even longer than the duration that you have on the MI space. The key to this business, in my view and in our -- all of our underwriters, is to maintain discipline in accepting risk. The beauty of it is that even when you stop underwrite, let's say your pricing is at -- and with risk space pricing, maybe the market will reject your pricing and they're going to find it cheaper from a set of competitors, you continue to have streams of revenue coming from what you underwrote properly in the prior year. And then the only thing you need to worry about is the broad economic downturn, the increase in unemployment and price reduction in the housing market, et cetera. And we test for that and we have cap load. And also that determines as to what size we want MI to be as part of the overall Arch family. So that's what we are. Mark?

Marc Grandisson
President and Chief Operating Officer

One difference I will say with casualty, and I totally agree with the analogy, is that we have a lot of tools at our disposal that we can use to really assess and evaluate the origination at any given time. So if we know exactly what's been originated at any one point in time, we can assess what the risk is in that portfolio. And I would argue that an MI book of business is a lot more homogeneous than a casualty book of business across all lines of business. More homogeneous, much more stable, a lot more predictive in terms of what you bring to the table by virtue of the various -- variable you use to price. So it's always a factor. Things could change after you've underwritten it. But certainly, when you underwrite it, you have a very good sense for the quality of what you've underwritten.

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

Yes, and then I'll just add one more thing. Your premise is that all PC business can be decisions on an annual basis. If the market softens, you get an increased proportion of multi-year contracts and this is -- and that's an industry statement. And this is a differentiator between carriers. It's the difference between having multi-years with legitimate reunderwriting abilities versus ones where you're locked in. And that's becoming increasingly common and as that grows in proportion, it's not quite as a stark difference it should be.

Operator

Our next question comes from Jay Cohen of Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Question on mortgage insurance. Shocking. When I look at the results for the quarter and I take out the favorable development, and I come to this kind of accident year of loss ratio, first of all, is that a reasonable concept in mortgage insurance? It's not?

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

No. Sorry to interrupt you halfway through, Jay. But you got to think of it as a -- it's a report year closer to a claims made view of business than in the current view. So accident year and claims made business really is report year and this is really the same thing.

Constantine P. Iordanou
Chairman and Chief Executive Officer

You can't reserve unless you have a delinquency. And that's -- we don't like the accounting model. We talked about it in other calls. But at the end of the day, I'm not setting up the rules. I just play by the rules.

Jay Adam Cohen

BofA Merrill Lynch, Research Division

The trend I've seen in this ratio, which has kind of steadily come down, that's not necessarily is kind of the thing to look at going forward.

Constantine P. Iordanou
Chairman and Chief Executive Officer

The delinquency rate or...

Jay Adam Cohen
BofA Merrill Lynch, Research Division

The loss ratio excluding -- whatever you want to call, the loss ratio you're reporting excluding the prior year development, which has gone from kind of 30 down to 17, makes it hard for us to forecast that number. Is the more recent year -- more recent quarters that are reasonable number to use?

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

It's really -- there's more mix here going on here than you think. Marc and Dinos talked about before about the glide path difference on some of the old reinsurance contracts that are now running out. The insurance accounting treatment on a lot of the GSEs have a different loss expectation than does some of the primary U.S. So I hate to say it, but it does come down to a lot of mixture.

Constantine P. Iordanou
Chairman and Chief Executive Officer

And if you -- if we were pure primary MI, it would be easier for you because then you will see what the average claim cost is, which doesn't move very much. It's in the mid-40,000 range. And then you will look at the delinquency and that is improving so bit by bit. But because we have -- we've got the Australian business, we have the GSE business and those, it depends what blocks we get, it gets a little more complicated.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Got it. A bit of a modeling challenge for us certainly.

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's all right. I mean, listen, you got to have some challenges.

Marc Grandisson
President and Chief Operating Officer

Jay, at a high level to help you, I think the way we think about it on the run rate basis, the expense is about 25 to 30 in a run rate, I mean, when I think this is us for ourselves but it's globally in the industry a mature book of business. And currently, the loss ratio is anywhere -- you see them reported 20 to 30. That sort of gives you a range. I mean, it's kind of hard to -- it could be -- obviously, if nothing happens significantly below this, but trying to get you a long-term average.

Constantine P. Iordanou
Chairman and Chief Executive Officer

That's the way we think out ultimate.

Marc Grandisson
President and Chief Operating Officer

Yes, look at the long-term average value.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Got it. That's helpful. The second question was on the -- this contingent consideration. Mark, what was the cap that, that railway was it up to? Was it like $150 million, you said?

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

No, no, no. 150% of the stated value at closing.

Constantine P. Iordanou
Chairman and Chief Executive Officer

But it was on [indiscernible] provision. Basically, we will continue to be recalculating the book value based on the actual performance of the loan portfolio from the date of closing and prior.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

So up until now, that basically has kind of helped your operating earnings and it was offset in the kind of the net income to some extent.

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

Yes, you have net income versus the realized. So it doesn't -- it's operating versus net income.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

But going forward, it sounds like that offset on the unrealized loss -- or realized loss won't be there to the same degree anyway. And therefore, it starts to flow through more right to net income.

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

You will, as I commented, because you -- the financial statements reflect more the present value of it, so it accretes over time like any interest unwinding, especially now as we cap down nominally, will accrete towards the payment date, plus we're required through GAAP accounting to -- as it becomes more certain we have to drop the discount rate used in that present value cap to get both forces causing additional effects in feature calendar quarters.

Constantine P. Iordanou
Chairman and Chief Executive Officer

But they're going to be small, so don't get too overexcited.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

No. But that makes sense. And then lastly just on the political environment. You're a fairly global company and it seems both parties have some issues with free trade. Are you, one, concerned about this? Two, are you doing anything to prepare for maybe a change in the trade environment?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Not specifically because at the end of the day -- listen, free trade will affect the global GDP and global GDP will affect the revenue for the insurance sector. But having said that, because we're a highly regulated business, a lot of what we do is global, but it's local from a regulation point of view. You operate and you need local licenses, and you participate in that local market, et cetera. So I don't see significant change in the way the insurance business is done. If there is barriers that they put up, at the end of the day though, if GDP growth is very low, it will affect our ability to get revenue. And it's been always like that. You can track the growth on the P&C where reinsurance and insurance is with GDP, and there is a very, very good correlation there.

Operator

Our next question comes from Brian Meredith with UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

So just back on the MI business, I'm just curious. Does the Australian reinsurance business have better economics than the U.S. MI business? As that kind of comes in, is that contributing to maybe the improved loss ratios and stuff we're seeing? And then as an addendum to that, any other opportunities that you're seeing in the Australian market?

Marc Grandisson
President and Chief Operating Officer

So on the Australian market, right now, the Australian transaction that we have is really like an insurance flow business that we've done with that partner of ours down under. That has not gotten a lot of earned premiums. So I wouldn't ascribe a lot of pickup from that, really. We've done, in the past, some reinsurance transactions that we -- to go back your point about -- the second question about opportunities, there were opportunities in the past. That's also what got us to really focus more intently on Australia. We had quarter share reinsurance transactions with a couple of players down there. But those -- but since we have struck this significant, we believe, relationship with that bank, we don't need -- we don't feel that we have the need to do anything more in this segment.

Brian Robert Meredith
UBS Investment Bank, Research Division

So you're tapped out in Australia. You wouldn't do anything else?

Marc Grandisson
President and Chief Operating Officer

For now, the answer is we're comfortable with where we are right now.

Brian Robert Meredith
UBS Investment Bank, Research Division

Great. That's helpful. And then I'm just curious, on the LPT transaction, just trying to understand it, what kind of interest rate your return assumptions are you using when you're doing transactions like that to get returns that you need?

Marc Grandisson
President and Chief Operating Officer

Right now, our units are doing pricing transactions or portfolios using a treasury fee rate, by and large. That's what we're using. That's how they're compensated on, when they calculate the ROEs.

Brian Robert Meredith
UBS Investment Bank, Research Division

So if you do get 100 combined ratio, that means that there's like virtually 0 capital sign put.

Marc Grandisson
President and Chief Operating Officer

No, capital, no. There's no return. No return. The capital is allocated.

Constantine P. Iordanou
Chairman and Chief Executive Officer

No underwriting return. The duration of liabilities are of, let's say, 5 years. They will take that 5-year CBL and that's 1%, 5% pickup on the flow. Now when you look at the contract that we assign capital to it and you got to see what the upside, downside and how much capital it goes and you make those calculations. Don't forget, some of these transactions, they have a limited risk transfer. Some of them, they have more risk transfer. And that's when we got to go through a test, if it's going to be the deposit accounting or reinsurance accounting. This one has enough risk transfer, but we're happy with it because of our familiarity of the book of business and our participation on that book of business as the quota share participant in prior years. Having said that, don't misconstrue on how to combine that. That might be the expected value of the contract over time. At the end of the day, you reserve conservatively. And then if you're wrong, nobody is taking the money out of your pocket. You -- the shareholder will get it eventually.

Brian Robert Meredith
UBS Investment Bank, Research Division

Got you. And then last question. Is there any update on your ability to kind of take advantage of opportunities from AIG and some of the other companies that have been doing reunderwriting? I know we've talked about that in the past.

Constantine P. Iordanou
Chairman and Chief Executive Officer

We don't target specifically any company. I mean, there is reunderwriting to be done by many companies, including AIG and others. All I have to say is that we've seen some increased opportunities in sectors that we believe we have good underwriting expertise. And we're getting into the batter's box so to speak. We haven't been hitting a lot of doubles, triples or home runs, maybe a single here and there, which tells you that the market hasn't come up to our liking yet. But we have increased -- the opportunities that we see have increased noise.

Operator

Our next question comes from Ian Gutterman with Balyasny.

Ian Gutterman
Balyasny Asset Management L.P.

So I won't ask about anything MI. I want to stick to the other 2 legs of the stool, and probably a lot of these are numbers to the questions since it's late. In insurance, you talked about in the release some of the adverse development from an energy casualty claim. Any color on that?

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

Yes. It's -- should I name it? Sempra Energy. It's out of our Bermuda operation where when you have a claim down there given the towers and the attachments and where we play, they're Wall Street Journal front-page events. This was a gas leak explosion. The estimate is $660 million...

Constantine P. Iordanou
Chairman and Chief Executive Officer

Industry loss.

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

Industry loss all through. Where we're on 2 layers, the lowest of which is in excess of $265 million. And then we're on a piece of another layer above it. So we fully reserved it on a net basis so it can't move any more than where it is.

Constantine P. Iordanou
Chairman and Chief Executive Officer

But it was a big loss for us. It's a man-made disaster cat, we call it that. That's why I think you saw cat losses in insurance.

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

That's what the Bermuda insurance market is. That's exactly the kind of complex risks that are tried.

Ian Gutterman
Balyasny Asset Management L.P.

That's what I was going to ask you. Is -- so did you -- I thought this was an adverse development. Was it a cat as well?

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

It was -- no, it's not a cat.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Not a cat. It was based on the accumulation of natural catastrophes for '16, but it was on the adverse development.

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

Right. It was from the 2015 year. And it just takes a while before those things are noticed, especially at attachment points like that.

Ian Gutterman
Balyasny Asset Management L.P.

Sure. And so my question on the cats in the insurance segment is I guess, that was higher than I thought. I just looked back. It's I think the first time in a long time that a cat's insurance have been greater than reinsurance. I guess, I just was curious if there is anything unusual that would cause that.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Nothing unusual. But listen, on the insurance side, you get on 2 buildings and you got $5 million or $10 million in each, and then all of a sudden you can have $15 million. And we got an operation up in Canada, so I do know exactly the specific account. But it wasn't a significant number of claims. It was a few claims. And don't forget, we don't write personal lines, so for us to get hit, we got hit on apartment buildings or school or something of that sort and it's very easy to get caught with $5 million on a couple of them. And all of a sudden -- we're not reporting tens of millions of dollars. I mean, at the end of the day, yes, it was slightly higher than reinsurance, but it was nothing unusual for us.

Marc Grandisson
President and Chief Operating Officer

Yes, but those losses, Ian, that we had in the second quarter were mostly insurance losses, so it was heavily -- some of the reinsurance in Canada, but a lot of it outside was insurance more than reinsurance. And I will echo what Dinos said. Having a small loss of cat load of about $10 million on our insurance group, it's not -- having a variability of about $10 million is not a big deal for us within the variability.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, it can happen. It was -- if you're in the wrong hospital or in the wrong apartment building, in the wrong -- and you put $10 million up, you're going to get hit, you get hit.

Ian Gutterman
Balyasny Asset Management L.P.

And just to relate to that, just overall for the combined insurance to reinsurance business, just looking at the cats for the quarter. Was that basically in line with the cat load you've talked about? I think even a hair below. A lot of the calls people talking about is being an active cat quarter making it seem like this is much above average. Is that your view that this was an above-average quarter and you came in average? Or is this just an average quarter and people are kind of talking about making it seem like a bigger issue than it really was?

Constantine P. Iordanou
Chairman and Chief Executive Officer

When you have $13 billion to $15 billion worldwide, I would say slightly above average. I don't want -- If you were a 10 [ph] and you say, $40 billion annual cat load worldwide is maybe that's the expected number. But I haven't spent a lot of time. Maybe Mark, you have. I know there's a lot of statistics and we look at that, but I would characterize it as slightly above average. But not -- this is not something that is not going to happen again

Marc Grandisson
President and Chief Operating Officer

It's definitely slightly in -- above average in the U.S. If you look at the PCS numbers, they're not totally outsized. The one thing I'll tell you that in Canada is really, really outside of the norm. That's really what's surprised most of our guys and it's not really reflected in the cat load of anything that people write in general around the world.

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

Ian, I would offer that the perspective varies depending on whether your results are 2x or 3x your cat load versus inside your cat load.

Ian Gutterman
Balyasny Asset Management L.P.

That's kind of what I was getting at a little bit. Okay. So my last one is just, Mark, if you could help me on the LPT math. I just want to make sure I'm doing this right. So the 2.7% you talked about was on the overall combined, but on the accident year, because the accident year is higher than the calendar year, the accident year I was getting maybe 30 bps or so, so it was not that much of an impact. Is that right?

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

I'll see. We did it on a calendar year basis.

Ian Gutterman
Balyasny Asset Management L.P.

But your accident year was in 98 something, so 100 versus a 98 doesn't really change it too much.

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

Yes, that's correct.

Ian Gutterman
Balyasny Asset Management L.P.

So the question is, so when I get the accident year, when I pull it out, it was still pretty close to a 98, maybe high 97s, that was up about 3, 4 points from where you've been running. Kind of curious what happened there. I know you mentioned some large losses, but was it just that or anything? Is there something...

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

I mean, when you take there was a -- we had a Marine loss with a vessel that -- it does -- yes, we believe a loss. So you take that large attritional. That was pushing 300 bps, I believe. So -- and there's couple other noise, but that really accounts for it.

Operator

I'm showing no further questions. I'd like to turn the conference back over to Mr. Dinos Iordanou for closing remarks.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you all. Enjoy your lunch, and we'll talk to you next quarter.

Operator
Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program. You may all disconnect. Everyone, have a good day.