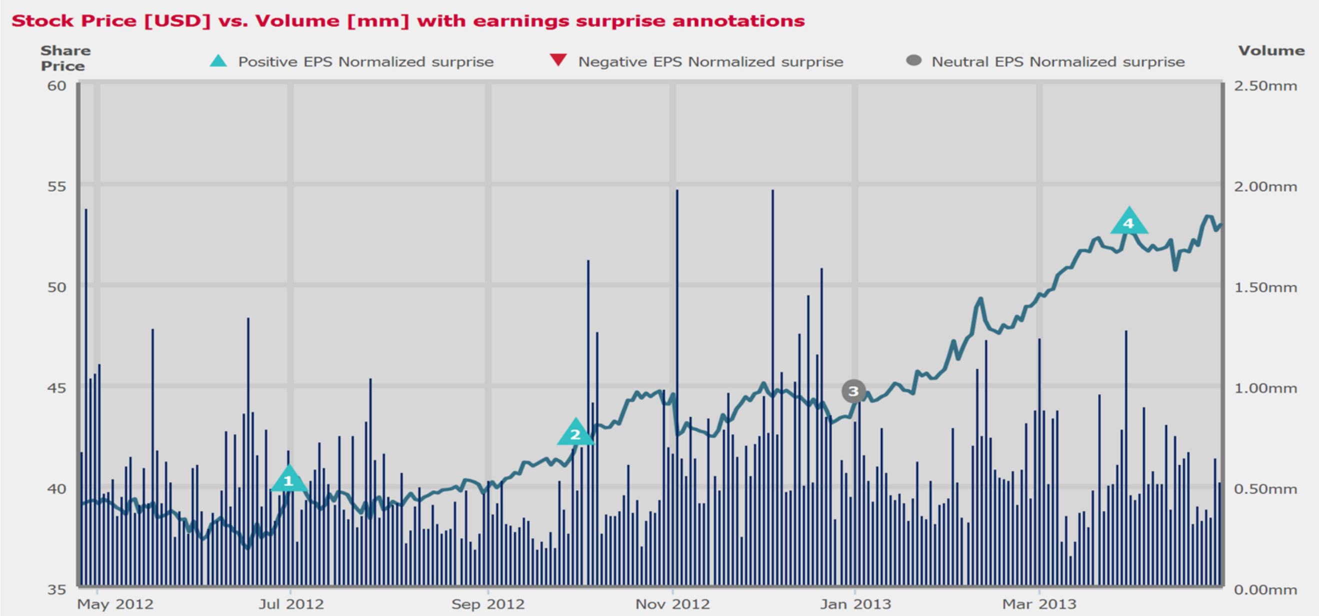
Arch Capital Group Ltd. NasdaqGS:ACGL

FQ2 2013 Earnings Call Transcripts
Friday, July 26, 2013 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2013-			-FQ3 2013-	-FY 2013-	-FY 2014-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.82	0.99	20.73	0.61	3.53	3.31
Revenue (mm)	879.13	810.54	(7.80 %)	818.72	3197.89	3469.54

Currency: USD
Consensus as of Jul-26-2013 1:30 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2012	0.80	1.02	1 27.50 %
FQ3 2012	0.76	0.87	2 14.47 %
FQ4 2012	(0.53)	(0.18)	NM
FQ1 2013	0.96	1.17	3 21.88 %

Call Participants

EXECUTIVES

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

ANALYSTS

Amit Kumar
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Jay Adam Cohen
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Crédit Suisse AG, Research Division

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Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Second Quarter 2013 Arch Capital Group Earnings Conference Call. My name is Glen, and I will be your operator for today. [Operator Instructions] As a reminder, today's conference is being recorded for replay purposes.

Before the company gets started with its update, management wants to first remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the federal securities laws.

These statements are based upon management's current assessments and assumptions and are subject to a number of risks and uncertainties.

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

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

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

I'd like to turn the call over to your host for today, Mr. Dinos Iordanou and Mr. Mark Lyons. Please proceed, gentlemen.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you, Glen, and good morning, everyone, and thank you for joining us today.

We had a good second quarter from just about every perspective, with the exception of unrealized losses in our investment portfolio due to the rising investment yields.

Earnings was solid, and our cat claim activity was modest relative to the significant level of industry losses experienced this quarter.

Across the group, our premium revenue was essentially flat in the quarter, although there was a lot of movement in the pieces that I will get to in a few minutes.

On an operating basis, we earned $0.99, which produced an annualized return on equity of 10.9% for the quarter.

On a net income basis, we earned $1.26 per share, which corresponds to a 13.8% annualized return on equity.

For reasons that I mentioned on our last call, which I won't repeat again, ROE based on net income was again significantly better than ROE on an operating income basis.

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

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

Our investment performance suffered this quarter due to a significant rise in rates and widening of credit spreads. Of course, in the last 2 weeks, credit spreads have come back, but as of the end of the quarter, we did suffer a bit.

As a result, our book value per common share decreased by 2.3% to $36.80, while it increased by 6.8% relative to the second quarter of a year ago.

The insurance market continues on its path of recovery with rates continuing to rise at roughly the same level as in the first quarter.

In our insurance operations, which gives us a good indication because we have more granular data, we experienced rate increases in the quarter that based on our estimations, provided approximately 150 basis points of expected margin improvement. This is on an underwriting year basis.

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

The movement of business from the admitted market back to the E&S market continues. Last quarter, we mentioned our expansion into the binding authority insurance business that caters to smaller E&S accounts written through the wholesale distribution channels. The group -- this particular group is off to a great start. They are producing an increasing level of business and have begun to leverage Arch's distribution platform to access more opportunities.

We expect them to contribute more meaningfully to our operations going forward.

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

With regards to new versus renewal pricing based on our monitoring systems, we saw no change on a relative basis from the indications that we shared with you in our last conference call a quarter ago.

On the reinsurance side of the business, terms and conditions are generally stable, although as the profitability of the primary insurers and our customers has improved, clients have, at times, pressed successfully for additional ceding commissions. Generally, 1 to 2 points is the additional ceding commission that they gained on code of share transactions.

On a consolidated basis, in the second quarter of 2013, gross written premiums were down 1.1% and net written premiums were down 1.2% year-over-year.

Net written premiums of the Reinsurance segment were reduced by 13.1% while the Insurance segment grew their net written premiums by 8%.

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

The Insurance segment had a net written premium growth predominantly emanating from their U.S. operations, which represented approximately -- which represents approximately 75% of the worldwide volume this quarter. The U.S. operations grew net written premium by nearly 18%, partially offsetting strategic reductions elsewhere in the world.

The U.S. growth came predominantly from program business, national accounts and new contract binding business, as well as construction and continued reduction in casualty lines, even though they're getting closer to meeting our return characteristics.

Construction and National Account businesses have continued rate increases, very strong renewal retentions, strong new business generation, and we experienced ratable exposure growth in those sectors.

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

Before I turn it over to Mark, let me update you on the status of our previously announced agreement to purchase certain assets of PMI and CMG.

On June 20, the Arizona receivership court approved the transaction. We're now working to obtain the necessary regulatory and other approvals required to complete the transaction.

As part of the process, we're continuing our discussions with the GSEs in order to obtain their approval of Arch as an eligible mortgage insurance carrier. If those approvals are obtained, it is estimated that the transaction will close during the end of this year.

It is worth noting that our cat PML aggregates reflect business bound through July 1, while the premium numbers included in our financial statements are through June 30. So when you make the comparison, you have to bear that in mind.

As of July 1, 2013, our largest 250 year PMLs for a single event declined moderately to $858 million in the Northeast and it represents approximately 17.5% of common shareholders' equity and $746 million in the Gulf, where our Florida Tri-County PML now stands at $606 million.

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

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

Great. Thank you, Dinos, and good morning, all.

Consolidated combined ratio for this quarter was 87.4%, with 4.8 points of current accident year cat-related events, net reinsurance and reinstatement premiums, compared to the 2012 second quarter combined ratio of 87.2%, which reflected only 1 point of cat-related events.

Losses from 2013 second quarter catastrophic event net of reinsurance recoverables and reinstatement premiums totaled $36.3 million, primarily emanating from Moore, Oklahoma tornadoes and flooding events in Europe and Canada.

The 2013 second quarter consolidated combined ratio also reflected 9.1 points of prior year net favorable development, net of reinsurance and related acquisition expenses, compared to 8.6 points of prior period favorable development on the same basis in the 2012 second quarter.

This results in a 91.7% current accident quarter combined ratio, excluding cats, for the second quarter of 2013, compared to a 94.7% accident quarter combined ratio on a like basis in the second quarter of 2012.

The 2013 accident quarter combined ratio excluding cats for the Reinsurance segment was 81.2% compared to 81.5% in the 2012 second quarter.

In the Insurance segment, the 2013 accident quarter combined ratio excluding cats was 98.6% compared to an accident quarter combined ratio of 103% even a year ago.

The corresponding 2012 Insurance segment accident quarter combined ratio, however, reflected a higher level of large attritional loss activity of roughly 2.5 combined ratio points.

Approximately 80% of the net favorable development in the 2013 second quarter was from the Reinsurance segment, with approximately 43% of that due to net favorable development on short-tailed lines concentrated in more recent underwriting years.

Furthermore, roughly 6% of the Reinsurance segment's net favorable development was attributable to medium-tailed lines spaced throughout many underwriting years and about 51% due to net favorable development on longer-tailed lines primarily from the 2002 through 2006 underwriting years.

The remaining 20% of net favorable development in this quarter was attributable to the Insurance segment and was primarily driven by short-tailed lines in the more recent accident years and medium-tailed lines across various accident years.

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

On a consolidated basis, the second quarter of 2013 expense ratio was identical to the prior year's comparative quarter, with a marginally lower net acquisition ratio offset by a marginally higher operating expense ratio.

The marginal increase in the operating expense ratio reflects incremental expense due to certain platform expansions in both our reinsurance and insurance businesses and higher equity expense charges than in the second quarter of 2012.

Our U.S. insurance operations achieved a positive 4.2% effective rate increase this quarter, which translates, as Dinos noted, to a margin expansion of 150 basis points over the second quarter of 2012.

This average range from having margin contraction in some units, such as health care and professional liability, up to a positive 890 basis points improvement in our energy casualty operation.

Other areas of note in margin expansion were the executive assurance middle market, E&S casualty and program businesses.

These figures represent the excess of written effective rate increases over estimated loss trends and provide continuing evidence of improving market conditions.

Property lines experienced a low single-digit rate increase this quarter and therefore, did not experience additional margin expansion.

It's also important to understand that many insurance segment lines of business have experienced effective rate increases over an impressive amount of serial quarters.

For example, although it's likely no surprise that wholesale and retail insurance property lines have seen 8 to 9 consecutive quarters of rate increases, it may not be apparent that other lines of business have experienced comparable results.

Our specialty casualty, national account, workers' compensation businesses have experienced 9 successive quarters of rate increases, whereas our executive assurance middle market and alternative asset protection books, along with our retail constructions units have experienced 8 consecutive quarters of rate increases.

Lastly, our excess workers' compensation and umbrella books have enjoyed 7 consecutive quarters of increases.

As always, we make capital allocation decisions based on our view of the absolute returns and not relative improvement to loan.

For example, although our Insurance Property businesses did not experience margin expansion this quarter, we continue to estimate healthy returns for this line.

The ratio of net premium to gross premium in the quarter on a consolidated basis was 77.9% versus 78% even a year ago. In the Reinsurance segment, the net-to-gross ratio was 91.5% in 2013 second quarter compared to 94.3% a year ago, reflecting more retro purchases protecting their property book.

The Insurance segment had a 71.3% net-to-gross ratio compared with 68.7% a year ago as a result of their ongoing strategy to grow the less volatile, smaller account businesses and reduce exposure in higher severity businesses.

The total return on our investment portfolio was a reported negative 159 bps in the 2013 second quarter, primarily reflecting mark-to-market adjustment on fixed income securities.

Excluding foreign exchange, total return was a negative 156 bps in this quarter.

This quarter, unrealized losses of approximately $260 million overshadowed realized gains of $4.7 million, so the following commentary will focus on the unrealized.

This quarter's unrealized loss of approximately $260 million is almost entirely due to changes in fixed income security valuations, driven by the rising interest rate environment and widening credit spreads, particularly in corporates and mortgages.

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

It's worth noting that equities and alternative investments now account for 14.9% of investable assets as of June 30, 2013 versus 12.9% a quarter ago and 9.6% a year ago as of June 30, 2012.

This allocation on a portfolio basis has the potential to ameliorate future impacts on fixed income securities from rising interest rates and widening credit spreads.

Our embedded pretax book yield before expenses was 2.43% as of June 30, compared to 2.45% at March 31, 2013, while the duration of the portfolio lengthened slightly to 3.04 years, which continues to reflect our conservative position on duration in the current yield environment.

Our exposure to Eurozone countries is listed in the supplement, with continued minimal exposure to countries undergoing severe economic hardship.

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

Our effective tax rate on pretax operating income for the second quarter of 2013 was an expense of 3.3% compared to a benefit of 0.3% in the second quarter of last year.

Approximately 90 basis points or $1.3 million of the second quarter tax expense is associated with catch-up of the first quarter to this higher effective rate.

Fluctuations in the effective tax rate can result from variability in the relative mix of income or loss reported by jurisdiction, along with forecast variances for the last 6 months of the 2013 year.

Our total capital was $5.63 billion at the end of this quarter, down 1.8% relative to March 31 and up 1.1% relative to year end 2012.

During this quarter, we repurchased 15.5 million of our common stock at an average 1.33x multiple to March 31, 2013 book value, which had a $0.03 impact on book value per share.

Our debt-to-capital ratio remains low at 7.1%, and debt plus hybrids represent only 12.9% of our total capital structure which continues to give us significant financial flexibility.

We also continue to estimate having excess capital in excess of our targeted capital position.

Our book value per share was $36.80 at June 30, as Dinos noted, which still represents a 6.8% increase relative to 1 year ago, at June 30, 2012.

This change in book value this quarter primarily reflects the company's continued strong underwriting results, offset by the negative impact of rising interest rates and widening credit spreads on fixed income securities.

With this introductory comments, we're now pleased to take your questions.

Constantine P. Iordanou
Chairman and Chief Executive Officer
Glen, we're ready for questions.

Question and Answer

Operator

[Operator Instructions] And your first question comes from the line of Amit Kumar, Macquarie.

Amit Kumar
Macquarie Research

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, the exposure is customer by customer. Some customers, their business is showing -- starting to show some growth and we've seen some improvements, but it's not across the board. There is still a lot of customers that, from an exposure point of view, and where the economy is, they're suffering, were not seeing increased payrolls or increased sales, et cetera. So we -- but when we do our rate calculations, they're all exposure-based rate calculations and comparisons. But if your question is where the economy is going and if there's a lot more buying of our products, the answer is no. It's incrementally better than a year ago, but this economy is not moving at a high degree of new exposures. And the customers, we haven't -- sometimes, you can get them to purchase either additional layers or additional limits, and we don't see that either. They're pretty conservative in their purchasing.

Amit Kumar
Macquarie Research

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, from a rate point of view, the more business that you get close to adequacy, to maintain the same ROE performance, then from that point on, you don't need extraordinary rate increases. You need rate increases that will cover loss cost escalations. So as long as we're covering trend or we're ahead of trend, then we're very happy to write the business and continue to renew it. So -- and in prior calls, we talked about we have green lights, yellow lights and red lights, depending on the products that we put in the marketplace. We're seeing very few reds and more getting into yellow, that means write it with caution and more getting into green, which will allow our divisions to grow their business. Mark, do you want to add anything?

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

Yes. Thank you, Dinos. Just a potential clarification. In the insurance group, in the U.S., it's 75% of the insurance group where we have all the deep detail. You kind of think of the aggregate rate versus premium growth this way in the U.S. Rate was roughly 4.5%. It might be, to Dinos' point, marginal increase in exposure on same-store account, maybe 4% to 5% of that growth is new business, which is new aggregate exposure, but not growth in exposure within the existing accounts. And then the balance, because you're looking at net written premium, you have to take into account the change in the net-to-gross, which bumps up the increase in the change in net written.

Constantine P. Iordanou
Chairman and Chief Executive Officer

And then you've got to deduct the business that you have lost to get to your aggregate exposures.

Amit Kumar
Macquarie Research

Yes, you did answer my question. Sorry, I didn't phrase it properly. The only other question I had was your discussion on excess capital. On another call earlier today, we were talking about third party capital, new capital, whatever you want to call it. Perhaps looking at other avenues including casualty reinsurance risk versus traditional prop cat, I'm curious, a, what's your view on that, and b, would Arch be interested in something like that potentially down the road?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, first, my view is that capital formation will take different kinds of forms. It's more difficult from a biased perspective -- customer perspective to create those structures on the casualty line because in casualty lines, due to their long nature of the tail, it requires more of a permanent capital. It's not capital that you can put in towards a period of time that is in need and then withdraw it when there is other ample capacity. So my view is eventually, some of the structures even in casualty, they will be created, but it will have more permanency to the capital. And don't forget, in the casualty area, you need to have significant underwriting capability for the model to work. So as a company, we're interested in those structures. We had, over the years, many different discussions with different parties, and if we find the right structure that benefits our shareholders, we'll do it. But that's basically where we are.

Operator

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

Michael Zaremski
Crédit Suisse AG, Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes.

Michael Zaremski
Crédit Suisse AG, Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

That's also correct.

Michael Zaremski
Crédit Suisse AG, Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

No. I think, as Mark said, and I'll turn it over to him, you're not going to get consecutive -- you're not going to get rate increases escalating by 8%, 10% forever. So at some point in time, you will see that the market works in peculiar ways, when certain lines of business, they get to rate adequacy. To us, rate adequacy is to produce 15% ROE. Once you get there, as I said, the only thing you need is you try to make sure that you're getting enough rate to cover the loss trend, because loss trend will escalate. And as long as you're above it, you have an improved environment. So there is, I think, in the aggregate, Mark, you know the numbers better than I do, we probably lost on average about 1 point. If we aggregate all of our business, the rate increases we got in the first quarter versus the rate increases we got in the second quarter, they might have been 1 percentage point less in the second quarter, but it's still an improvement because it's on top of what we got a year ago and 2 years ago. And when you look at it from that perspective, the ROE on an underwriting year basis on that business we write today will be a little bit better, and that's what we try to estimate that 150 basis points. Mark?

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

That's a great point. One of the reasons I talked about the serial changes for like 8 or 9 quarters is at the right quarter, you're now approaching your third increase, which is why you're going to start to get some of these adequacy. But a lot of this still comes down to mix from one quarter to next -- to a different quarter. We would have had more insurance property, which flattened out a little bit more this quarter. But if for example we felt that more of the E&S casualty business had gone over the goal line to 15%, that unit experienced 9.5% rate increase in the last quarter, that didn't open the floodgate yet, but as Dinos said, it's starting to approach that. We start contributing some of that businesses, as it goes over the goal line, you're going to see the effective rate changes increase because of the weighting impact of that unit.

Michael Zaremski
Crédit Suisse AG, Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

We didn't say all. As I said, we still have product lines in the yellow, which means you've got to be selective and do it with caution. To us, a green light is a product line or a division that we believe that the marketplace is allowing them to underwrite to 15%. Still quite a bit of what we do is in there. As I said, I gave that 11% to 15% ROE depending -- and the reason we give a range is because we don't know how the mix is going to come in. But that means there's still a lot of business that is in the high single-digit ROE and low double-digits in order to average 11% to 13%. We don't -- we have lines of business, they're in the green, but we do have some in the red still, and we still have more and more in the yellow.

Michael Zaremski
Crédit Suisse AG, Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Mark, you want to...

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

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. And we've been guarding against rising interest rates for a long time. We're keeping the portfolio short in duration and also high credit quality. So in essence, we might take the unrealized, but it will unwind itself within the duration of the portfolio pretty quickly. So if rates move up, it will be beneficial to us, and I guess, most of our competitors. It depends what happens to the underwriting side of the business. Will the underwriting then get adjusted because we're getting more yield, or people, they say, no, let's keep the same underwriting margin because -- and yield will be a margin improvement. So I don't know. I can't predict the future and I can't predict behavior. But I can tell you a rising interest rate environment even though it's negative early on, it gets very positive for us.

Michael Zaremski
Crédit Suisse AG, Research Division

Maybe I can just -- in more simple terms then. So if current interest rates stay where they are, and you talked about 50 basis points increase in new money yields, do you expect the portfolio to increase by 50 basis points?

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

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

And also the portfolio turn over, it's what's coming off from the prior years, what's maturing and what gets reinvested. But I can tell you, there is also a shift in our allocations, as Mark, to alternative investments and assets. So that's the reason I went through that whole explanation why our net income is different than our operating income. Because as we're increasing allocations into alternative investments including equities, et cetera, some of it is not going to come as investment income, it's going to come to us over time as realized capital gain. So it's not easy to answer your question with a simple answer and say, yes, it's going to improve by 50 bps. But looking at the fixed income portion of what we do and not taking into consideration how much is rolling off and coming and gets reinvested, anything that is new, and we're putting in fixed income has a 50 bps improvement, I don't know if that's a quarter of the portfolio, I haven't done those calculations.

Operator

Your next question comes from the line of Michael Nannizzi, Goldman Sachs.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Listen, there is nothing that we do because we move from one to the other because we're in an excess capital position. So basically, all of our units can have all the capital they want as long as they can deploy profitably. So let's start with that because I'm not stressed out that I have to take from Peter to pay Paul. If Peter and Paul can give me very good returns, they get all the capital they want. Now having said that, our market conditions will influence as to how much we do on the reinsurance sector, independent if it's U.S. cat or international cat or whatever, we look at transaction after transaction. And we see what we believe their profitability is and do we like it, and then we write that business. As you can see, we're at 17.5% of common equity as the highest 250 year peak zone, so we have plenty of room. We're authorized by the board to go all the way up to 25%. So from a capital point of view, from a capacity point of view, we have more, it's only the market will allow us to do more or less. Now you're asking me to predict how the market is going to behave. I don't know. It depends on that behavior and would tell you that if rates continue to go down, we'll adjust accordingly and if the rates go up, we will adjust. Also, sometimes we're sellers and sometimes we're buyers. And we did buy more this quarter. It gives us more protection. It smooths out the volatility within our book of business, and we felt we were getting good deals. I'm sure the people who sold it to us, they also think they're good deals, but people can have difference on opinion on that.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it. One question I had, I saw recently the New York MTA floated an insurance bond which it sold to the capital market. Is that -- it seems to me, and I could be wrong, but I think it's one of the first insurance market transactions that are just specifically outside of property cat reinsurance. Is that important as a development? I mean, again, I realize it's very small, or is that something that do you think sort of will happen from time to time?

Constantine P. Iordanou
Chairman and Chief Executive Officer

They will happen from time to time. It's not significant. Even in the cat market today, which they've been at it since after Katrina, which is 7, 8 years, it's not a significant part of the capital formation. Still, traditional capital and those type of transactions, they're preferred by most customers. The -- some of the specialized companies, they're unrated, they're fully collateralized vehicles, they're reissuing similar coverage as the rest of us, and that is capacity that you have to worry about. The cat bonds, they've been around for a long time but they're not a significant part of the business.

Operator

Your next question comes from the line of Jay Gelb, Barclays Capital.

Jay H. Gelb
Barclays PLC, Research Division

I had a couple in terms of business volume trends. The first would be the pull back in reinsurance premiums. I understand that reflects, to some extent, market conditions. I'm trying to get a sense of whether you think you'll still see growth in premium volume for the year. So that's first for reinsurance. And then second, can you talk a little bit more about within the Insurance segment, the growth in the program business? And I have a follow-up.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. Let me start with reinsurance. Reinsurance is a lumpy business and it's hard to predict what's going to happen. Let me start. We had reductions in 3 sectors, right? One, it was mortgage, but that's kind of comparing apples to oranges. If you go back when we reported a quarter ago, a year ago for the second quarter, you will know that we had kind of an incoming portfolio because on the mortgage reinsurance, we had premiums from November, December, first quarter and second quarter that we booked. And now, the second part, it was the U.K. motor that we set. As long as we believe the business is profitable, we'll stick with it. If it's not, we'll let others do it. And as you can see, there is more competition in that line, so we have switched to write more excess of loss, not as much quota share, so that affects the premium production. But I don't know if that's a predictor as to what's going to happen into the future. By its nature, you can write 1 or 2 new contracts and you can change the trajectory. And the reason we don't give guidance and all that is because I can't predict the future. I mean, our whole principle is we're going to underwrite and we have a big appetite, but it's got to have profitability before we do it. So I'm not trying to avoid your question there, but I'm just telling you, Jay, how we operate. The second part, it was the Insurance group. We believe we have a great program division. You heard from some of our major competitors who write package business, and these are very good companies like the job or the travelers, et cetera, and they're getting good rate increases. And that's the sector that our program's administrators compete with. Because they write, even though they specialize covers for a certain kind of customers, they're in that market, and we have been experiencing very good rate increases, which, in essence, gives us more revenue, but also new exposures, winning additional customers. And that business, it's been behaving extremely well for us for all the last 10, 11 years. So we're glad that, that is growing. And our binding authority business, which is the level below that, which is -- these are average 5,000 per policy premiums, the small E&S accounts, and that business is going through market improvement from a rate point of view and through the teams that we have and also the very broad distribution capability that we have for other relationships that Arch has with wholesalers is really going very well. That unit, I think, is up to about $1 million a week in production, which is ahead of our projections.

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

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, it's small limits. We keep it 100% net, and it all sticks to the ribs.

Jay H. Gelb
Barclays PLC, Research Division

Okay. And then switching gears to capital management, the pace of buybacks has been pretty modest so far this year. Should we expect anything before 4Q?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No. Third quarter, we don't like to buy because of the cat exposure that we have. That will be an issue on the fourth quarter.

Operator

Your next question comes from the line of Vinay Misquith, Evercore.

Vinay Gerard Misquith
Evercore ISI, Research Division

This is Vinay Misquith. A few questions here. First is just a numbers question on the mortgage reinsurance and the U.K. motor. So I presume those lower premiums had also negatively impacted third and fourth quarter. Do you have a sense for how much is going to negatively impact third and fourth quarter for those 2?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, the mortgage is a comparison issue. You were comparing a fat quarter a year ago to -- on a written, not on a number basis. So basically, I don't think that has an effect as we move to the third, fourth, first quarter from a year-to-year comparison, right? The motor is -- will be coming down about proportionately on the same basis for the third and fourth quarter because we have cut back our capacity in that line.

Vinay Gerard Misquith
Evercore ISI, Research Division

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

Constantine P. Iordanou

Chairman and Chief Executive Officer

I don't have all the treaties in front of me calculating numbers, but...

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay. The second thing is actually more of a philosophical question. I think your company, and I think you, Dinos, has taken the stance that we'll wait for the market to turn, and on the event it's sufficiently turned, will sort of go after growth. And you've hinted the fact that more is green now versus red, and that's interesting. But there's recent discussion out there that maybe we're reaching the end of the rate increases. So just a philosophical question. Do you think that you can actually now grow or take advantage of the opportunities or do you think that now that pricing is reaching sort of adequacy, that there'll be more competition?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I can't -- like you're asking me first a philosophical question. Let me answer that first and then get to the predictions, which I don't like to make predictions. But on a philosophical point of view, this is the same playbook we have been running Arch for the last 12 years. Business is in the red, you better justify everything that you do. If it's in the yellow, you'll be very careful. If it's in the green, write as much as you can get to. As I said, there is more in the yellow and there is some moving into the green, and that's why you see growth especially -- and that is more of a phenomenon in the United States. I don't think the European markets have moved yet. So the price corrections, they're mostly in North America, U.S. and a bit in Canada. But having said that, once you get to rate adequacy in our view and you're getting enough rate increases, maybe smaller than before but it's ahead of trend, you'd be stupid if you're not trying to write as much as you can, so we're going to have that approach. We're going to try to write as much as we can. Having said that, I don't know how the competitors are going to react. They might -- because rates go up and down depending on what I do versus somebody looking at the same account from a competitor's point of view. So if rates start going down, then you're going to see us pulling back again. Because our whole mentality is let's look at treaty by treaty on the reinsurance side, account by account on the insurance side, does it meet our return characteristics and then -- we're not governed by volume. We're not a volume-driven company. I have no production goals for any one of my divisions, they don't get compensated on production. They only get compensated on return on equity. And it's my problem to make sure that our capital gets utilized properly. So if they can write a lot, I gave them the capital, if they can't write as much, then I have to deal with capital, excess capital issue at the holding company.

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

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

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, that's helpful. And just as a follow-up to that. Your primary insurance operation, you want to keep about 70% net. Do you think you're going to raise your retention on primary business now that it's improving?

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

Don't mislead yourself. That's a premium comparison, not a limit or exposure comparison. Remember, we chose to grow contract binding business, program businesses, lenders businesses, things that don't put out a lot of capacity, and therefore, we take as frequency basis and we're more comfortable taking that risk assumption in-house. The fact that D&O businesses and hospital professional businesses have capacity up to 25 million in the U.S. simply means we haven't deployed as much, but they may still be reinsured to the same level until we're comfortable of where the returns are.

Constantine P. Iordanou
Chairman and Chief Executive Officer

But if you've seen the trend for the last few quarters, our net-to-gross is increasing, so we're getting more net. Because what we're actually selling, what we're actually selling is more low limits, primary small accounts business, and that we keep 100% net. There's no reinsurance around behind that.

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

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

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, that's helpful. And just one last question if I may. From the ROE of 11% to 13%, what amount of that can we see sort of hit the bottom line as an operating item? Because you have excess capital and like you have for certainty, returns on the equity portfolio. So how should we translate that into really the bottom line operating ROE?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, if you don't know how much excess capital I have, you can't make that calculation because we take the S&P AA level capital, and that's what we allocate to the operating units. Everything else -- of course, we allocate some capital to the investment department, we expect alpha from the investment department for the capital we allocate. Don't forget, we do the ROE on the operating units on the risk rate of return when I allocate capital. So it's a combination of that. Our excess capital is not significant, it's not 20% of the book. It fluctuates. But it's been around 10% of our total capital. So you can do the calculation. It might affect it because the underwriting ROEs, we do allocate our capital to the operating units, and that's when -- and the underwriters, they get compensated on that ROE because I don't want to give them excess capital, bring down the ROE specifically to 1 division and affect their compensation negatively because I'm going to go out and try to find business to write and then that's business that I don't want on the books if they don't have the proper return. So we try to align their interests by giving them the right amount of capital, AA capital, let them operate and we hold them responsible to their performance to that. So it's an old formula, it works. It's like doing cheeseburgers on a Greek diner. I used to do that when I was in college.

Operator

Your next question comes from the line of Greg Locraft, Morgan Stanley.

Gregory Locraft
Morgan Stanley, Research Division

You guys released your global triangles in the quarter? Just wanted to see if there is anything in particular that you wish to call out. They looked pretty strong, continue to be strong and I don't know if there's any lines or anything that are worth mentioning?

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

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

I have nothing to add.

Operator

Your next question comes from the line of John Hall, Wells Fargo.

John Arthur Hall
Wells Fargo Securities, LLC, Research Division

In your commentary, you talked about the long-tail casualty meeting rate in some segments, but some hitting adequacy. I was just wondering if you'd share what some of those segments are?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, it's pretty simple. I think lead umbrella is still shy of adequacy. Don't forget, we still have ancient attachment points like auto attaching excess of $1 million and even long-haul trucking sometimes, they are attaching excess of $2 million, which is to me, you're in the buffer area, we're not in the lead umbrella area. And so -- but even if you get over $25 million or so, and the area that we see on -- small, medium-sized accounts and all that, that's the area that -- now that excess, it's still not the excess that goes to the global market, Bermuda, London, et cetera, that -- the Fortune 2000, per se. But Mid-America and those kind of accounts on the excess, they're starting to whet our appetite, where the lead umbrella is not yet where we want to be. And then we like some of the primary. It's sector by sector, it's different exposures, different customer groups. But those are the primary E&S, the first $1 million of exposure over either deductibles or SIRs. So we got the primary we like and we got kind of mid excess that we like, we don't like the umbrellas, lead umbrella, et cetera. But we're watching it and we're measuring it. And I'm not saying we're right, it's just one company's opinion, I mean that's what makes the marketplace. But I do pay a lot of guys a lot of money to make sure that they keep monitoring, monitoring, monitoring and making decisions. We're not going to make everything and be correct in every decision we make, but we try very hard.

John Arthur Hall
Wells Fargo Securities, LLC, Research Division

Great. Understood. And I just want to ask about the mortgage insurance acquisition. I guess, when you first started doing all your work, the field was not very crowded and the incumbents were pretty beaten up. And by the time you closed at the end of the year and then frictional startup and the like, it's going to be pretty far out there when you really start ramping up in that business. I guess the question is, will the opportunity that you saw 6 or 12 months ago be there in another 12 or 18 months?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. I mean, we wouldn't have gotten into that, in the permanency of such, if we didn't think the runway is 7 to 10 years out. Don't forget, if I thought the market opportunity was temporary, I would have start just with reinsurance transactions so I can do them when they are needed 1 or 2 or 3 years, and then move on when they're not needed. We view that marketplace, the need for good capacity with -- and the field is not crowded. It's going to be 6 or 7 of us in a field that has potential to expand significantly, especially depending what our legislators do in Washington as they're trying to push more and more of the credit risk to the private market instead of government-sponsored enterprises, et cetera. FHA still is the predominant insurer with maybe, I don't know if they dropped below 60% of the market, but they still have 60% of the market. In normal conditions, it's supposed to be the insurer of last resort, kind of the assigned risk and they're in the 15% to 18% market share. So we got a long way to go, and we view the opportunity today as good as it was 6 months ago. And we wouldn't have moved towards that if we didn't think this as a 7 to 10-year horizon in front of it. A lot of things can happen and that might change, but that's our view for the present time.

Operator

Your next question comes from the line of Jay Cohen, Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

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

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

Well, broadly speaking, I mean, we quoted the embedded yield on fixed income, which as Dinos said, is a piece of the action, at 243 bps, which is pretty flat serially from the last quarter. The 50 bps improvement that we quoted is really about all I'm prepared to really comment on. But since we're a total return focused entity, and that's total return irrespective of the geography of where it's put and irrespective of the asset classes, it's hard for us to answer that question without the alternative investments side and everything else coming into play. So...

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Well, we can make our own assumptions on the alternative, but the fixed income is still a big portion of the portfolio, so that's why...

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

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

But if I count on the geography, it's more -- it's more as more treasuries and other things roll, it's going to be higher coupon. You guys tend to focus more on the income statement, NII, which is going to get some benefit from it. As Dinos said earlier, over the term of the duration of the portfolio, it's going to unwind itself. But geography basis, you're going to see some improvement because of the higher coupon.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Right, right. I guess, the second question is really a follow-up on the insurance pricing question where you suggested that the price increase decelerated a bit in the quarter. But pointing out that it's still good to get increases above claims inflation, which is clearly true, I guess the concern that the equity market had is that, this is a trend we will see for the next 2 or 3 quarters, and whatever cushion there is in pricing is going away pretty quickly. So my question to you is, while you did see the deceleration -- say that again?

Constantine P. Iordanou
Chairman and Chief Executive Officer

That premise is not what we've said. But go ahead, finish your question.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

That's definitely the question. I mean the question is the tone that you're seeing in the market, the behavior you're seeing, does it really represent -- do you see a big change in how your competitors have been behaving that would make you nervous that this slide, if you will, will continue?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No. We don't see aggressive behavior, so to speak, in the marketplace. I think, people, they are pushing for improved terms and pricing on the primary market. Also, we see the trend that we mentioned that the primary insurers don't want to share as much of that with the reinsurers. And they say, hey, you guys had pretty good numbers for a long time. We need the improvement so you got to stick to our ribs so pay us a little more ceding commission if you want our business and we see that. But this is an improving environment. And on account, even though you're not getting the same rate increase that you've got a year ago, it doesn't mean on an absolute basis is marginally better. And as long as that continues, that's a good thing. And I hear about the second term derivative BS and all that and at the end of the day, maybe those are trying to be predictors of what's going to happen into the future. I don't know what's going to happen into the future. But as long as we're getting, as an industry, and we are, we're getting price increases that are ahead of claim inflation, I think things are getting better, not worse, and there is no other way to interpret it. If people have a crystal ball and they say, this now is going to go into a dive and the rate increases are going to be below, claims inflation, you can get into a different conclusion. But there is no evidence in anything that we see or anything else that every competitor has reported that is pointing to that.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Great. That's helpful. If I could squeeze in one more question. The expense ratio in the reinsurance side, the G&A expense ratio, was up a little bit. And one of the things you mentioned in the release was some investments in that business. Can you talk more about that, exactly what those...

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's very simple. You guys read 8-K sometimes but you don't pay a lot of attention to it. We did a big retention run at year-end, so there is equity cost that is coming through and especially if you're familiar with accounting rules, and believe me, I've got so many accountants I take 3 Advils every time I meet with them. If a lot of our employees, they're retirement eligible, you got to take that cost in 1 year immediately, so you can't spread it over the 5-year cliff vesting and all that, that we have. And second, we had beefed up some of our teams, both on the starting to hire on the mortgage side and starting to hire in health -- the life reinsurance sector, a few individuals and, of course, on the insurance side, we brought a big team. We're just starting to produce already in the contract binding business. So the retention run, it was done for the right reasons. We have good employees, and we want to retain them, and we create another obstacle for competition to take them. And we are paying for it and we're happy about it. But that's the 2 explanations. There is nothing more into those numbers other than those 2 things.

Operator

There are no further questions at this time.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, thank you for giving us the time and the opportunity, and we're looking forward to seeing you and talking to you next quarter. Have a good afternoon.

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