S&P Capital IQ

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Arch Capital Group Ltd. NasdaqGS:ACGL

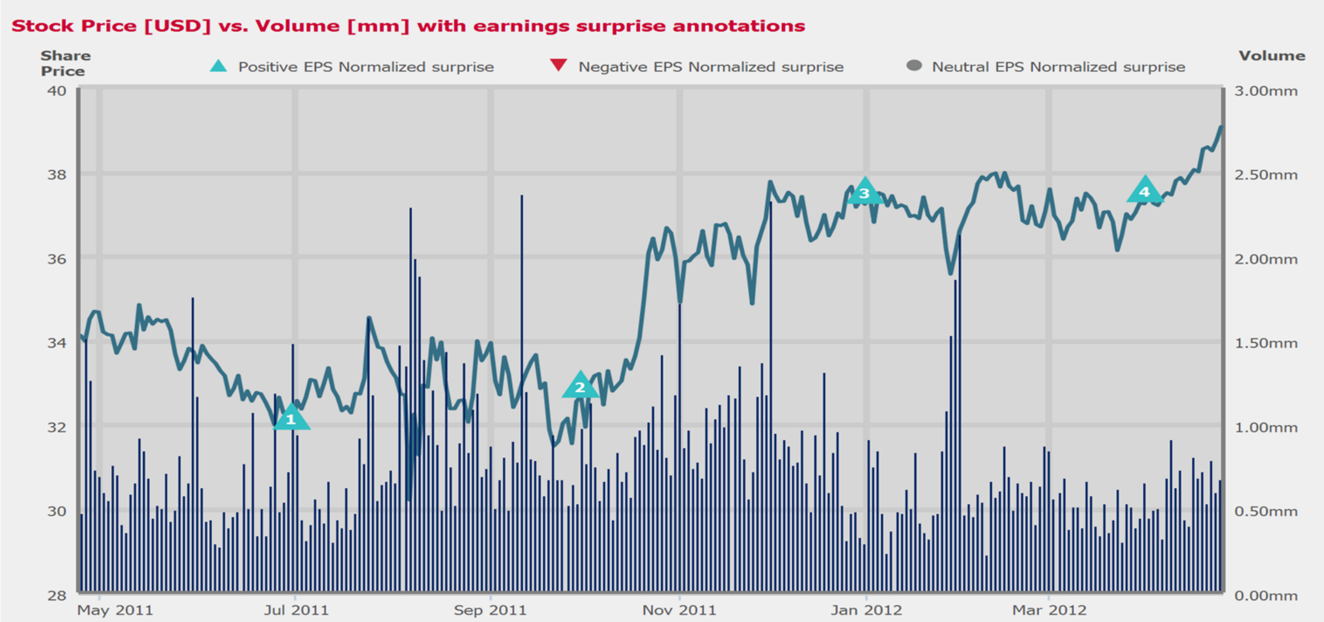
FQ2 2012 Earnings Call Transcripts

Thursday, July 26, 2012 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2012-			-FQ3 2012-	-FY 2012-	-FY 2013-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.80	1.02	▲27.50	0.63	3.24	2.88
Revenue (mm)	746.74	820.23	▲9.84	741.91	2954.65	3097.97

Currency: USD
Consensus as of Jul-26-2012 12:42 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2011	0.21	0.45	▲1 114.29 %
FQ3 2011	0.64	0.78	▲2 21.88 %
FQ4 2011	0.63	0.92	▲3 46.03 %
FQ1 2012	0.72	0.82	▲4 13.89 %

Call Participants

EXECUTIVES

Constantine P. Iordanou
Chairman and Chief Executive Officer

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

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

ANALYSTS

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Jay H. Gelb
Barclays PLC, Research Division

Joshua David Shanker
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Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Michael Zaremski
Crédit Suisse AG, Research Division

Ryan Byrnes

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Evercore ISI, Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Second Quarter 2012 Arch Capital Group Earnings Conference Call. My name is Dave, and I'll be your operator for today. [Operator Instructions] As a reminder, this call 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 be than 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 reports on Form 8-K furnished to the SEC yesterday, which contains the company's earnings press release and is available on the company's website.

I would like to turn the call over now to your hosts, Mr. Dinos Iordanou and Mr. John Hele. Please proceed.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you, David, and good morning, everyone, and thank you for joining us today. We had a terrific second quarter. But before I get into the details, I would like to address the management changes we have announced at Arch.

Joining me on the call today are both John Hele and Mark Lyons. This will be John's last call as Arch's CFO as he's leaving to join another financial services firm. I would like to take this opportunity to thank John for his contributions to Arch over the past 3 years, and we wish him the best in his new endeavors.

I'm not going to re-welcome Mark Lyons since he has been my partner for the past 30 years as we have worked together first as insurance rookies at AIG then onto Berkshire Hathaway, Zurich and now, of course, with Arch. Mark calls it both a blessing and a curse that he has been with me for such a long time, but it has been a great 30 years, at lease from my perspective. And in his new role as our CFO, the curse part will take precedence as he will be sitting right next to my office in Bermuda.

We are also pleased that David McElroy will be replacing Mark as the Chief Executive Officer of our Insurance group and that Michael Murphy will become President of our U.S. underwriting operations and will also be our Chief Underwriting Officer for the Worldwide Insurance Group.

I have tremendous confidence in these individuals and our entire senior management team in both our Insurance and Reinsurance group. Accordingly, we are well positioned at Arch to move our business forward based on the improvement we see in the market opportunities and market conditions.

All of these appointments, once again, demonstrate the deep bench we have built at Arch and our ability to promote first from within and to give all of our people the ability to grow professionally over time.

Now let me turn back to our quarterly results. On an operating basis, we earned $1.2 per share, which on an annualized basis represents a 12.3% return on equity. Our reported underwriting performance was excellent, with a combined ratio of 87.2, while our investment performance for the quarter, including the effects of foreign exchange, was satisfactory, with a total return of 63 basis points for the quarter.

Cash flow was $252 million, an increase of $30 million over a year ago and $100 million over the past quarter. Our book value per common share was $34.45, a 3.4% increase from March 31, 2012, and a 12.2% increase from a year ago.

We also had very strong revenue increases for the quarter, which I will comment on in a few minutes.

The market environment continues to show improvement across the board in our U.S. Insurance business, where we have the strongest statistics both by volume and granularity. Rates increased on a weighted average by approximately 4%, which is 1% better than last quarter and slightly above our weighted averages loss trends.

Two other trends of note are emerging in the U.S. Insurance group. In our specialty lines, we achieved an average rate increase of 6%, so our specialty business is a bit stronger than standard. And our E&S submission activity increased year-over-year, another sign that standard lines underwriters are returning more business to the E&S market, where it belongs in the first place. To us, these are indications that the market is moving into new territory of gradual improvement, although we cannot call it a trend as of yet. Even with a better rate environment, given the level of investment yields currently available and our view of rate adequacy on an absolute basis, we believe that longer-tail lines still require substantial additional rate improvement to become attractive, at least to us.

In our Reinsurance segment, rates on a risk-adjusted basis continued to improve significantly in many areas of the world in the property and property cat lines, while all other lines remained basically unchanged, although our Reinsurance business benefits from the underlying rate improvements of carrying on the primary basis.

For the recent Florida renewals, we achieved mid-single digit rate increases, and were able to deploy additional capacity.

From a premium point of view, in our Insurance group, we are seeing some benefit from the improving rate environment as more accounts meet our underwriting standards. In the Reinsurance sector, on the other hand, our new initiatives are bearing fruit and most of our growth is emerging from those initiatives. On a consolidated basis, our gross written premium was up 15.3% and our net written premiums increased by 16.1%.

Looking at growth by segment. The Insurance group's premium rose by approximately 6.5% on a gross basis and 6% on a net basis, with slightly over 1/2 of the increase due to increased rates.

The Reinsurance group premium volume was up 35.7% on gross and 32.6% on net. These increases primarily resulted from new opportunities in U.K. motor and mortgage insurance that we spoke about last quarter and from the global property and property cat lines of business.

Groupwide, on an expected basis, the ROE on the business, we wrote in the second quarter of this year, will produce an underwriting year ROE in the range of 9% to 11%. The rate improvement that I mentioned earlier will not affect the expected ROE as the improvements in premium rates have been offset by reduction in expected investment yield.

During the quarter, we did not repurchase any of our shares, and as you may know, it is customary for us not to report our shares during the hurricane season unless there is a significant opportunity because of stock market factors unrelated to Arch. Having said that, there is a reasonable likelihood that we will reinstitute our share repurchase activity in the fourth quarter of this year.

Before I turn it over to John for more commentary on our financial results, let me update you on our cat PML aggregates. As of July 1, 2012, our largest 1-in-250-year PMLs for a single event were $878 million in the Gulf, or 19% of common shareholders' equity, and $846 million in the Northeast. Our Florida Tri-County PML now stands at $645 million, just slightly above what we reported in the last quarter.

With that, let me turn it over to John. And John, again, thank you for your contributions.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Thank you, Dinos, and good morning. On a consolidated basis, the ratio of net premium to gross premium in the quarter was 78%, essentially unchanged from the 77.5% a year ago. In the Reinsurance segment, the net to gross ratio was 94% in the 2012 second quarter compared to 97% a year ago. This difference in the Reinsurance segment was due to a fully funded quota share retro property cat treaty executed in the 2012 second quarter.

Our overall operating results for the quarter included a combined ratio of 87.2% with 1.0 point, or $7 million, of current accident year cat-related events, net of reinsurance and reinstatement premiums, compared to the 2011 second quarter, which included a combined ratio of 100%, reflecting 14.8 points, or $95 million, of cat related events, also net of reinsurance and reinstatement premiums. The 2012 second quarter amount reflected second quarter U.S. storm activity, which primarily impacted the Reinsurance segment, partially offset by reductions in estimates on 2012 first quarter cat events in the Insurance segment.

The 2012 second quarter also reflected favorable development on the 2011 and prior cat events, primarily in the Insurance segment. The 2012 second quarter combined ratio also reflected 8.6 points or, $63 million, of estimated prior year net favorable development, compared to $58 million or, 8.9 points, in the 2011 second quarter. Approximately 70% of the net favorable development in the 2012 second quarter was from the Reinsurance segment, with approximately 60% of that due to favorable development on short-tail lines from more recent underwriting years and 40% due to medium and longer-tail lines from earlier underwriting years. The remaining 30% of net favorable development was from the Insurance segment in the 2012 second quarter and was driven from short-tail and medium-tail lines mainly from more recent accident years.

In the Reinsurance segment, the 2012 accident year combined ratio, excluding cats, was 81.5% compared to 80.2% in the 2011 second quarter. The Reinsurance segment's results in 2012 reflect changes in the mix of business with a higher contribution from U.K. motor business and some specific opportunities in medium and longer-tail lines.

In the Insurance segment, the 2012 accident year combined ratio, excluding cats, was 103% compared to 102% a year ago. The Insurance segment's results in the 2012 second quarter reflects slightly higher attritional losses in medium-tail lines. The 2012 second quarter results include the effects of the April 2012 acquisition of the international credit and surety operations of Ariel Re based in Zurich, Switzerland. The acquisition, which is not material to tangible equity, included $83.1 million of net unearned premiums along with other insurance balances and was accounted under purchase accounting rules. Under such rules, the unearned premium acquired is not included in premiums written but will be reflected in premiums earned. Net premiums earned for the 2012 second quarter included $17.3 million related to the unearned premium acquired, with the remainder primarily expected to be earned over a 2-year period.

Net investment income in the 2012 second quarter was $0.53 per share or, $74 million, compared to $0.54 per share or, $74 million, in the 2012 first quarter.

Our embedded pretax book yield before expenses was 2.76% in the 2012 second quarter, the same as in the 2012 first quarter. We lengthened the duration of the portfolio slightly to 3.01 from 2.75 in the 2012 first quarter.

The total return on the portfolio was 63 basis points in the 2012 second quarter compared to 187 basis points in the 2012 first quarter. Excluding foreign exchange, it was 104 basis points in the 2012 second quarter compared to 160 basis points in the first quarter. Our exposure to eurozone countries is listed in the supplement, with minimal exposure to the current countries of interest.

Foreign exchange gains were $32 million in the 2012 second quarter. However, when compared to the net 41 basis points loss on the investment portfolio from investments held in foreign currencies, which works out to be $50 million, recorded direct to the shareholders equity, the proximate combined net impact of foreign exchange was a negative $18 million or a $0.13 per share to book value. This net negative impact is due to the strengthening of the U.S. dollar against almost all major currencies.

Our effective tax rate or pre-tax income in the 2012 second quarter was an expense of 0.3% compared to a benefit of 2.4% in the 2011 second quarter. 2011 second quarter benefit reflected a tax effect of the second quarter cat losses as well as a re-estimation of the full year tax rate. Book value per share increased 3.4% to $34.45 in the 2012 second quarter due to operating earnings and total return investments. Book value per share has increased by 8.5% in 2012.

As I mentioned in our last call in April, we issued $325 million of Series C preferred shares for the 5-year non-call period. We also announced the call of our $325 million of Series A and B preferred shares at par. The net savings in coupon cost is 120 basis points per year or $3.9 million. As previously announced, taking account all cost reissuance over the 5-year non-call period, we expect to save a net 63 basis points in annual cost in the next 5 years.

In the second quarter, preferred dividends were higher than normal as we paid an overlap of dividends on the Series A and B classes and on the new Series C class for a short period.

Our total capital increased to $5.4 billion at the end of the 2012 second quarter, up from $5 billion at the end of 2011. Our debt plus hybrids represent only 13.4% of our total capital, giving us significant room towards additional capital in the future at our targeted rating.

At the end of the second quarter, we have excess capital over our targeted capital position. Today, after the market closed, the 2011 global loss triangles report will be published on our website.

As Dinos has mentioned, I'm leaving Arch to pursue another opportunity at a major financial institution. I have very much enjoyed my time at Arch. I thank Arch for all that they have done for me. And I wish to reassure everyone listening that in the future, I will switch your side of the call, being a very interested shareholder.

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

Constantine P. Iordanou
Chairman and Chief Executive Officer
David, we are ready for questions.

Question and Answer

Operator

[Operator Instructions] The first question comes from Mike Zaremski of Crédit Suisse.

Michael Zaremski
Crédit Suisse AG, Research Division

Dinos, it's maybe a naive question, but I'm going to ask it still.

Constantine P. Iordanou
Chairman and Chief Executive Officer

There is no naive questions. All questions are good and welcome.

Michael Zaremski
Crédit Suisse AG, Research Division

Good to hear. So do you feel the results in the primary Insurance segment are satisfactory given the current market environment? Or is there initiative to maybe prune out underperforming businesses? And I asked that because I'm looking at the accident year.

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's an excellent questions. First, we -- that's an ongoing process. A tree is never healthy unless it's pruned all the time. So in essence, we look at all of our profit centers. And where we need improvement, we execute a strategy for improvement. And where we have satisfactory results, we try to grow that business. Having said that, based on the existing market conditions, the activity in our Insurance group is acceptable to us. It's satisfactory. And in a lot of segments, we're looking to grow. The rate improvement is coming. Don't forget, we always look at our business on a policy year basis. And one quarter's accident year doesn't tell the story about who we are from a profitability point of view. One of the things that I have encouraged in past calls analysts to do is since 50% of our book of business is short tail, medium tail, that might have attritional volatility in one quarter. A better measure to see if there is a margin improvement or margin contraction is to do a trailing 12 months calculations. I guess it might be -- you guys, I know you're very busy and you might not be willing to do that, but it will give you a better indication. Specific to the Insurance group, this quarter accident year, it was influenced by one-time attritional losses. We have 2 losses in the surety sector. That might give you the wrong impression about the healthiness of the underlying book. But in answering the question, yes. Some divisions of ours were defensive. You can't totally exit the market, so you take defensive paths there. You write less business, you might move to smaller accounts, et cetera, and not allocate resources to grow that. And in some other sectors, we're looking to grow.

Michael Zaremski
Crédit Suisse AG, Research Division

Okay. That's helpful. And John, maybe I missed this in the prepared remarks. Can you just comment on the new money investment rate?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

No, I didn't mention that. It's essentially about the same as -- for we're looking at. I think it was about 2% to 2.5%. We're not buying German bonds or things like that with negative returns. We're looking for some nice -- we have some opportunities here and there that's getting us into that range, which is a big spread over U.S. treasuries, if you look at treasuries today. There's some call-protected mortgages we're looking at and a few other things. And we're also diversifying the book around the world with some other bank loan funds that we may get some investment income in. But it's still a challenging investment environment.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Unembedded yield hasn't moved. You saw it was 2.74 writing on the first quarter. And this quarter it's exactly at the same level.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

So we've been able to maintain it with through some of these other activities.

Operator

Your next question comes from the line of Matthew Heimermann of JPMorgan.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

I guess, one -- the first question I'd have is you put in one of the press releases last night the announcement of the executive management strategy committee. And I guess, I'd be curious just what the catalyst was for forming that group because to some extent, I would have thought there probably was a similar group that already existed. And also, whether or not we should be -- what the rationale was for disclosing the formation of the group. I don't know if there was some subtle message you were trying to send to all of us or potentially I'm over reading.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, there is only one message. You're correct in your assessment. Even though I get this bad reputation sometimes as CEO that I lean a little bit on the dictatorial side, I'm not. I'm very collaborative guy, and I try to get multiple people's opinion in the way we operate the company. And it's maybe my loud voice that gives me the bad reputation. But we did operate as a company on that basis for years. We -- and some of you and that's why it's no surprise to you, you knew that because you asked that question in other meetings, et cetera. The only nuance of us announcing it is usually in the past, it was kind of me and the Reinsurance guys if the issue is coming up, strategic or acquiring a team, it was falling into the Reinsurance sector, and me and the Insurance boys, if it was on the Insurance side. When I say me, it's me and Vollaro in the past and me and John Hele presently. And it will be John and Mark Lyons in the future -- me and Mark Lyons in the future. So Now I think because where the market is going and also reviewing the activity we had in the last year, we've seen more and more of these calls and these opportunities, and I said, "I think we'll benefit from the wisdom of putting both Insurance and Reinsurance and holding company personnel together in our discussions as to should we pursue this opportunity or not or should we." So internally, it's not going to be a big change. It's business as usual. But by putting it in an announcement, at least, I'm telling the world that's the way we're operating. So it's no surprise to anybody as to how we do things at Arch.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

And then is it fair to read from that comment then that it kind of reflects of what we've talked specifically about some of the opportunities this year -- credit, mortgage, reinsurance, what have you. That kind of out flow of things continues in a way that it necessitates those.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. It's usually -- and it goes even beyond the 6 individuals that I have. That's just to air and get a first opinion on a particular opportunity, and if we decide that we're going to pursue it, we'll probably --

usually we get a little deeper and we expand it, too. But our culture of managing by working around is not changing. I talk to the guys all the time; I'm on the phone. I'm not to their chagrin, I'm not what I would say a meetings-and-appointment guy. I hate meetings and I hate appointments. It's free flow of information, free flow of communication. We talk to each other and the conference room is anywhere from the coffee station all the way into the bathroom. So at the end of the day, anywhere I have the opportunity to talk to our guys, we are -- that's the way we operate. And we're going to be as simplistic as that.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

Fair enough. That's helpful. I guess, John, just on the mortgage reinsurance business, is -- I mean, we've talked kind of in generality about how to think about this business in past calls. But if we back out kind of the catch-up premium in the quarter, is that a reasonable kind of run rate to use for this business?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Yes. Because a lot of it is earned monthly, so it's pretty steady. It's not as lumpy certainly for the contract we have for this year.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

All right, that's helpful. And then just from a margin standpoint, just the combined ratio, I mean is that from a mixed standpoint? Is help or hurt kind of the way we would think -- the way we would have thought about margins in the past?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, the mortgage business has very good margins, if the question is when do you recognize it. And we like to be conservative on the recognition of the margin. At the end of the day, nobody ever puts his hands in my pocket and takes out my money. So by reserving conservatively, at the end of the day, you see how things go. And if things go better than you expected or as you expected, usually you have favorable development. But this is a new line for us. We're very careful about how we analyze transactions. And also we're very careful as to how we're booking these transactions for the simple reason we got to see how we will perform over years.

Operator

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

Joshua David Shanker
Deutsche Bank AG, Research Division

In looking at your investment portfolio, you guys took the lumps early on, I think. I look at your competitors. You might have one of the lowest investment yields of any of your competitors out there. And when I look at some of your competitors, even those located stateside, they're earning 3.5%, 4% yield and they have tax-preferred securities. When you're thinking about strategy, when are they going to feel the pinch? Because they have been earnings those yields for now 3 or 4 years, and it seems like nothing gets those yields down. What's your strategizing when they're going to have you raise prices and you might see some business coming your way because you've already made those adjustments?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Listen. I don't know, Josh. How do I know? I don't go and spend my time analyzing somebody else's balance sheet and see what kind of investments they make. You know that if you're going to have a much higher yield, you're taking investment risks. At the end of the day, I don't have to tell you. I mean, you know that better than I do. We are conservative in our approach to investments on the basis that I think the people, our shareholders who buy our shares, they're not doing it because they think we're going to take undue risk in the investment side of the balance sheet to stretch earnings. They're buying our shares because they think we're prudent variants of capital and good underwriters in the insurance business. And I think that's the kind of investor that we want: people will have confidence in our abilities to analyze risk, price it appropriately and writing prudently.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Josh, you also have to factor in thinking about our mix of business now being more short tail, our duration, we've been a little shorter and we've been cautious on it as well. If you look at other competitors, you have to think what business do they have. Are they longer tail or are they...

Constantine P. Iordanou
Chairman and Chief Executive Officer

What would be a duration of their businesses are.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Yes, yes, that's right. So as we shifted to more short tail, it's natural that our duration would be shorter, and therefore we're going to have a slightly lower investment yield.

Joshua David Shanker
Deutsche Bank AG, Research Division

Yes, of course. And then anything thing about 2013 propensity to deploy capital in non-fixed income, will there be change in your appetite?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, yes. Yes, I think we are allocating more into alternative investments. But it's not a significant amount of money. I would put in the range of maybe $0.5 billion out of $12.5 billion in order for us to find other opportunities. And recently I was in the Far East with our Chief Investment Officer, looking for different funds that maybe we'll present us opportunities for better return and we're going to allocate a little more of that. But it will be done the Arch way, conservatively done.

Joshua David Shanker
Deutsche Bank AG, Research Division

So we won't feel it as investors?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Not immediately. We don't -- I hate boiling water. So when I put my toe, I put it to make sure that maybe the edge of my skin gets burned, but nothing more.

Operator

The next question is from Jay Cohen of Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

A couple of questions. One, numbers question, one bigger picture question. On the number side, John, can you talk about the amount of your fixed income portfolio that is maturing in dollars next year?

John C. R. Hele

Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

I don't have the exact number handy. Our duration is about 3, and it's fairly evenly -- it's not barbell-ed in how we do that. So you just have to just take an approximation on that.

Constantine P. Iordanou
Chairman and Chief Executive Officer

But we can do some work and then we can -- if that number is very important to you, we can -- call John or Mark and we'll figure it out.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Yes. But it's fairly straightforward.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Yes, a follow-up. That would be great. And then the second question for whoever wants to opine. It does feel as if the capital markets have played a pretty significant role in the reinsurance, specifically in the cat side. This year it seems to be growing. How much of a threat do you see this being going forward?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it depends on their return characteristics. At the end of the day, the cat business, it's a model business. Usually you see a significant expansion of capacity with the sidecars and capital markets jumping in when they think there is really good returns, and that thing disappears pretty quickly when they believe the returns are inadequate. Now depending what -- where these new opportunities come -- hedge funds, pension funds, et cetera -- and what the expectations for normalized returns in that business is, it might or might not affect us to what the opportunities are for us and the rest of the cat writers. Looking at what we -- and you saw our volume. Our volume expanded, so we wrote more in that and we wrote more at the same time that prices went up. Maybe they didn't need everybody's projections, but in the line that is on an expected basis, having good returns, getting another 5% or 7%, it improves the environment for us.

Having said that, I can't predict the future. I mean, if a lot of cat bonds get created with low return characteristics, et cetera, they might take a slice of what we do away from us. But I haven't seen it yet. It's not in the billions and billions of dollars of PML capacity that the cat business requires. Even all these peripheries, they're not a significant part of the cat business. Mark, you want to add something? This is Mark Lyons, by the way.

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

From the perspective of a provider, one of the perspective Dinos just said, I think it makes a lot of sense. From the perspective of a purchaser, which has really been our history in the Insurance group, we've been very focused towards having indemnity covers, and we've looked from time to time at the capital markets. We certainly don't want to take this risk, but beyond us, I'm speaking on behalf of the purchasing side the industry, you really have to evaluate what's basic risk. You have to evaluate cost up top. And I think to a large extent, it's going be increasing the model driven. And so it's going to be -- and the behavior of the purchaser can be just as important as the cost coming out from the provider.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

That's a good point, Mark. And this is one quick one. I assume in your Reinsurance group, you don't write much related to agriculture.

Constantine P. Iordanou

Chairman and Chief Executive Officer

We write a little bit. I think -- what is our total payment? $3 million or $4 million.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Yes, $3 million.

Constantine P. Iordanou
Chairman and Chief Executive Officer

We have some XOL on core -- but it's not a big line for us, it's not a big line for us. We're not a big reinsurer of the agribusiness. Of course, we have a team in -- we're starting to write international crop business out of our team in Zürich, Switzerland, but that's non-U.S. exposures.

Operator

The next question comes from the line of Meyer Shields with Stifel, Nicolaus.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

I don't know if I'm reading too much into this, but I noticed in both the Insurance and the Reinsurance side, you're having decent growth in casualty. And, Dinos, you commented earlier that overall rates for longer-tail lines don't look good. So I was wondering if you could maybe talk about that a little bit.

Constantine P. Iordanou
Chairman and Chief Executive Officer

You have to go back in our definitions. Let me remind you that the Reinsurance group puts all professional liability, D&O and what we would call liability business, either primary or excess liability, into the same group of casualty. So don't read into it. That is sectors that we don't like. We continue to not like primary liability, excess liability, umbrella liability, all of that. So anything that we have done in the Reinsurance group is more in the professional lines.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Okay. And I guess you're comfortable with that?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. Could you speak a little closer because you're barely coming through?

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

No, not a problem at all. Is that -- I'm trying to think what sort I'm asking. Are there rising rate improvement in the professional liability lines that you like?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It depends on the sector. The small accounts of professional liability sector is still attractive to us, both on the Insurance side and the Reinsurance side. The large accounts still require, in our view, significant rate. Mark runs the Insurance group, so I'll turn it over to him. He might give you.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Maybe I'd add on the Insurance, we also had some Canadian treaty business and casualty written in the quarter. There were some of that in the Reinsurance.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Right. Right. Mark?

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

Yes. On the professional liability side for the Insurance group, we've had an initiative started about 9 months ago out of the U.K. specifically focused on the SME business. That has grown to about -- it went from perfectly nothing 9 months ago to an annualized $20 million to $25 million, mostly because in the London market, business follows well-known acts of underwriters. And we have people with excellent track records who have fabulous distribution ties and know the business and match it appropriately and so forth. So to us, that's a good trade-off and it's a high net business because of its lesser volatility aspects.

Operator

Next question is from the line of Vinay Misquith with Evercore Partners.

Vinay Gerard Misquith
Evercore ISI, Research Division

The first question on the primary insurance operations. There seems to be a pickup in the loss ratio. And I think you talked about it. I'm sorry I jumped on late. How much was the surety impact on the loss ratio this quarter, please?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Mark, what was it?

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

Yes. Today, what we really have was -- surety is a little bit of an odd duck, number one, because we evaluate surety. I call our businesses on an underwriting year basis. So it really becomes a bond-effective base. So when you have a surety event, it actually affects multiple underwriting years across the times that the contractor was given a work program size from us. But the way the accounting works when the event occurred is considered discovered in that year. So we've had 2 events that were "discovered" in 2012...

Constantine P. Iordanou
Chairman and Chief Executive Officer

In the second quarter.

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

In the second quarter that really have bonds and underwriting decisions that have been scattered back over several underwriting years. So that being said, the 2 losses that we're talking about, net basis, accumulated to about $13 million, and what the -- it's where the actuarists went through, and the overwhelming amount of that was additive to the totals that was there. So as a result, taking that into account, I would say it's roughly $11 million of impact on -- so basically 2.5 loss ratio when you cut through all of the detail.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, that's helpful. And...

Constantine P. Iordanou
Chairman and Chief Executive Officer

That's why, Vinay, if you do trailing 12 months, it takes property losses and one-time events like that and it smoothes it out a little bit. It can you a better indication as to if you have margin contraction or margin expansion.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, fair enough. And then just look at the trailing 12 months, it just seems that the primary insurance operations is getting a combined ratio of around 103%, 104%. Do think that's appropriate at this stage or do you think that there's a scope for bringing that down?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It depends on the mix, and our mix is changing. And I think it's a little less than 103%, 104%. I don't know how you got those numbers. But at the end of the day in the Insurance group, we believe that our margins, they're probably at the lowest level of acceptability for us and because we've got a lot of segments that we were on a defensive mode. Having said that, we're starting to see some of the profit centers now gaining more traction because with the rate increases and not having reserve issues to deal with. It allows us to gain back to the acceptable profitability. Don't forget, I'm still in the 9 to 11 ROE range and that includes all of our business and we have significant sectors, both in Insurance and Reinsurance, that way north of that. So I can tell you, I have profit centers that they are barely keeping their head above water, probably earning 2%, 3%, 4%. And the tough question there is, should you continue to do that? Well, I play defense on those. I try not to grow them, but you don't want to aggravate because you exit, you might not have the opportunity to come back and reestablished market relationships, reestablish underwriting teams, et cetera. If long term, we believe that particular product is going to provide good profits for us, we look at that from a long-term perspective and we play defense in the tough times.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, fair enough. Just...

Constantine P. Iordanou
Chairman and Chief Executive Officer

And then that philosophy, I mean, I talked about it all the time. It hasn't changed and it's a balancing act. Yes, our Reinsurance group is performing extremely better than the Insurance group, but that's true with the entire marketplace. Mark, do you want to add anything to it?

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

Vinay, I know that Dinos tried to talk about this on many different quarterly calls. But let me tell you, we are very active cycle managers. We view this like you would view a portfolio of assets. So we have constant reallocation, we have different defensive strategies, offensive strategies. Take for example some of the numbers Dino has quoted in the specialty book in the U.S. getting 6%. This is our second consecutive quarter of having 100-plus basis points higher, at least, on loss inflation. You're not going to see that manifest itself into accident quarters or calendar quarters. That's an underwriting-quarter basis and it bleeds itself in. You'll start to see the benefit of that especially if the pricing continues at this level in future quarters. That's the first thing. The second thing is at some of the discussion of loss ratios and so forth, our evaluation as you would expect, is cash-flow based. Our return on capital is updated every quarter based upon what the actual achieved rates and other views takes anything into account. So we're looking at the expense ratio componentry. As we write more of the smaller accounts, they come with lower loss ratios but higher acquisition costs. And that is why we've been so meticulous on managing down the G&A piece of the expense ratio because we knew that those things would be lockstep. We're looking at all aspects of it, not just one element.

Constantine P. Iordanou
Chairman and Chief Executive Officer

And Vinay, let me remind you, go back in history, in '02, '03, they thought of us as the dumbest company on the face of the earth. And then we got real smart, I guess. It was the same guys, I don't know. Maybe I had a brain transplant somewhere in between, and in '05, '06, '07, we became a smart company. But we call it like we see it. We do a lot. We're technocrats. We do a lot of analysis, and if we believe there is profitability in a particular group. I'm not afraid to turn the guys loose to go and get the business.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, that's fair. And then one last, a numbers question. Just wondering, the premiums from the credit reinsurance team that you got from Ariel, have you guys record any written premium this quarter, not earned, written?

Constantine P. Iordanou
Chairman and Chief Executive Officer

John, do you want to go through that again or?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

No, it wasn't that much because they raised -- this is all mainly Jan. 1 type of business.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay. So we should not expect any premiums for the balance of this year but maybe Jan. 1 next year? Correct?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

In general. No, there'll be some written because the trade credit is written also throughout the year.

Constantine P. Iordanou
Chairman and Chief Executive Officer

And I don't know all the surety treaties is the rule -- international surety, it is all January 1. They might have. But it's not going to be significant, Vinay.

Operator

The next question next is from Ryan Byrnes at Langen McAlenney.

Ryan Byrnes

I want to give you a question. You mention that you're likely to resume your share repurchase in the fourth quarter. I just wanted to see if that's reflective of, I guess, fewer of the kind of the one-off underwriting opportunities that you guys have, I guess, announced recently.

Constantine P. Iordanou

Chairman and Chief Executive Officer

Well, we still have an eye for those, but also look at the capital position. It's growing. You're having good earnings quarters. It keeps adding. So like I said, I didn't say I'm doing it. I said there is a good likelihood. That was the words. So if nothing comes -- we don't do transactions for the sake of doing transactions. We don't acquire teams for the sake of acquiring teams. It's a balanced approach. If we find a great team that fits our underwriting mode, we're going to be them in. And we don't really care about what part of the cycle. We're not trying to time the cycle or anything of that sort. If you have good athletes, good things will happen to you. When we brought the people from -- into our executive assurance area, it wasn't the best of times to say, oh, I want to really expand and run as fast as I can in that sector. But when you get extremely good athletes, you want them on your team and. So that's been our approach, not knowing how many of those might or might not materialize. And we've got things in the hopper. I can't tell you as to what my capital position is. But if we have significant excess capital come the fourth quarter and there is nothing on the horizon, I'm going to invest on me.

Ryan Byrnes

Okay, great. And then, secondly, I think you guys mentioned that this quarter was kind of the inflection point. It was in your insurance operations where your rate increases were, I guess, outpacing your loss cost increases. I just wanted to get your thoughts as to when, I guess, on an earned premium timeframe where you think that inflection point will flow through.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Mark, go ahead. He's -- if you're running your own insurance group, he's an actuarist also. I'm surrounded by -- I'm drowned by actuarists.

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

So in spite of that deficit -- I'll get there. And answer the question. I think you should look at mostly it's probably first quarter 2013 on. First off, there's a lot of things you have to make assumptions of. To the extent that these things don't continue if this is a flattened out marketplace, you're not going to see them as readily. It if continues or the rate of increase in -- if prices escalate further, you're going to see it's going to compound itself. You're going to see it marginally in the next 2 quarters, and I say moderately into the first half of 2013.

Ryan Byrnes

Okay, great. And then can I actually ask that for the Reinsurance segment as well or is that harder to calculate for it?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. I mean, don't forget, a lot of what we do in Reinsurance, other than our excess of loss piece of the business, which is mostly in the cat area, it's quota shares. So any market improvement in the primary benefits, it follows our reinsurance. If you're not changing seating commissions of -- the betterment of the market by the seat, then it will reflect in your numbers as an reinsurer. And it would be pretty much the same now. For us, the excitement of a market turn is the ability of a lot of the opportunities we see both either individual accounts in Insurance and/or treaty opportunities in the Reinsurance is to make the cut because a lot of times, we put our terms and they're not accepted by the market. As the market improves, even though it's gradual the improvement, a little more makes the cut. Don't forget, the advantage of Arch is twofold. Number one, we have terrific people. So when the market interacts with us, they're talking to knowledgeable underwriters. And that's important. Number two, we have pristine balance sheet. A+ $5.4 billion of total capital. People like to transact with us. So we see a lot of the stuff that we want to see. The question is can we be competitive enough, maintain a real margin for us, be competitive in order for us to win some of these? And we see a little bit of that coming our way. Nothing that makes me jump up and down, but you can hear from my tone I think I'm a little more excited now than I was a year or 2 ago.

Operator

Our next question comes from the line of Jay Gelb with Barclays.

Jay H. Gelb
Barclays PLC, Research Division

So I just wanted to clean up on a couple of issues. Given the amount of business you're writing in the differentiated deals, the large deals, can you give us a sense of what you feel your excess capital position is currently?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

We're not going to be specific anymore on the exact amount, but it's not a bad margin above where we target. And we'll see how the earnings come out for the rest of the year. It's moving into cat season, so we never know. But I think we're in a comfortable a position.

Jay H. Gelb
Barclays PLC, Research Division

All right. And the target being?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

S&P AA. So 2 notches above our current rating.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. We're A+. We run it at AA.

Jay H. Gelb
Barclays PLC, Research Division

Got you. All right. And then on the I guess more of a numbers question. On the Reinsurance segment, if I'm looking at the $72 million of other specialty premiums that were in 2Q as well as the $26 million of other reinsurance, my sense of those are just -- that's where the new deals are showing up. Is that the right...

Constantine P. Iordanou
Chairman and Chief Executive Officer

I think yes.

Jay H. Gelb
Barclays PLC, Research Division

Is that the right run rate quarterly going forward in terms of net and premium volume?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Yes, for as long as we keep the U.K. and motor around. And that's where the -- and the crops that will be -- hopefully, those might be ticking up as the new crop guys and the international surety guys do some business from that. And U.K. motor, we keep it as long as it's going to be profitable.

Jay H. Gelb
Barclays PLC, Research Division

Okay. What's the earned premium look like on that? Is it ratable over 4 quarters or is it stretched out more?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, the motor is only 4 quarters. The mortgage is longer because you're earning it on a monthly basis and the trade credit is normal. It's like the motor.

Jay H. Gelb
Barclays PLC, Research Division

Okay. So the earned premium progression might be a little slower than that.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Right. But don't forget, on -- you know that we have a -- the one-time earned because of purchase accounting, that is not going to earn over '12, but it was over the 8 quarters. So you've got to make that adjustment, right? If you go back to the prepared remarks John had, the unearned premium, even though we took no written premium because of the accounting peculiarities, that unearned premium, which was only the $17 million for the second quarter, it has a patent that it goes out 8 quarters.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

And just to be clear for you, other specialty includes the U.K. motor and the crop business, whereas Other that season will have [indiscernible]. Other includes the mortgage insurance. So they're 2 different sections.

Jay H. Gelb
Barclays PLC, Research Division

Okay. That's helpful. Right. And on the U.K. motor, I mean, that's been a -- for the primary company, that's been somewhat of a challenging line. Do you have a stop-loss protection in place on your reinsurance contracts?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We have -- it's a sliding scale, that kind of a deal, but it gives us a lot of downside protection for upside profit commission we give to the season. So our deal is -- we're very, very comfortable with that deal.

Operator

And next question is from Matthew Heimermann of JPMorgan again.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

Just on -- this is just for my own edification, but just on surety, should -- with all the talk around municipal bankruptcies and cities potentially exercising that option strategically, does that have any blowback impact on surety? I guess what I'm saying I don't really knew where our contractor critical projects stand but...

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's mostly the healthiness or unhealthiness of a contractor and how good and collectible is your collateral. Because it's that combination. On surety, you have different situations. Sometimes you may have a contractor who runs into financial difficulty. He might be competent. He might be competent to complete the job, but he's having difficulty with payroll, et cetera. In that, you might extend in your claims process, you might extend credit to them and let them help them finish the project so you don't have purely a surety loss. And then you work out the based on how much collateral he has and you collect from him. Sometimes the contractor -- it's so weakened that he lost a lot of his personnel, et cetera, so you choose to throw them off the job and then you bring a new to complete it. It's a lot of different workouts in surety. But most of your losses usually come because a contractor is in trouble, not where the municipalities are in trouble.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

Yes, I understand that aspect. So I just -- I guess I was wondering with respect to how a contractor who's in process on something would stand from a creditor standpoint if a municipality that had sponsored the project actually went into bankruptcy.

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

Well, let me go a little and answer it a little bit differently. Besides the fact that we've reassessed our volume on that over time and not have as much, the thing you've got to think about over a whole book of business is the relationship to a local contractor with the regional banks. That's where they're really getting their extension of credit and other working capital base. So we spend a lot of time interacting with our D&O people who have more of a Side A approach, which is more of a bankruptcy credit risk perspective, and interacting with our surety people because they're underwriting the D&O on a lot of our local and regional banks. At least we have that experience. And we try to make sure we identify pockets around the country where that could be an exposure, and we've avoided them as a result.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Getting back to your concern, yes, there is a little bit of concern that if that contractor doesn't get paid, so he's doing a lot of work for a municipality and that municipality doesn't pay and he gets tied up in court, that means his cash flows get affected. And now you're making a determination, should you extend credit to him so he can complete the job? The bond is not in play, but you're waiting for that fight because he got to win against the municipality, collect his money before he can reimburse you. So financial difficulties, independent if they come from the municipality or the contractor itself, there are concern, and we do continue to monitor all of our contractors from that perspective. What are their outstanding balances? Who is paying? Where the contracts are? Is it for the government or is it the municipal government or is it the state government? Because a lot of these projects that they get bonded usually is for public work.

Operator

We currently have no further questions. So I'd now like to turn the call back over to Mr. Dinos Iordanou for closing remarks.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, thank you, all, for attending. John, again, all the best in your new endeavors, and we'll hopefully even find some opportunities to do business together.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Thank you very much.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Have a wonderful day. It's lunchtime so enjoy your lunch.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Good day.