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Arch Capital Group Ltd. NasdaqGS:ACGL

FQ4 2013 Earnings Call Transcripts

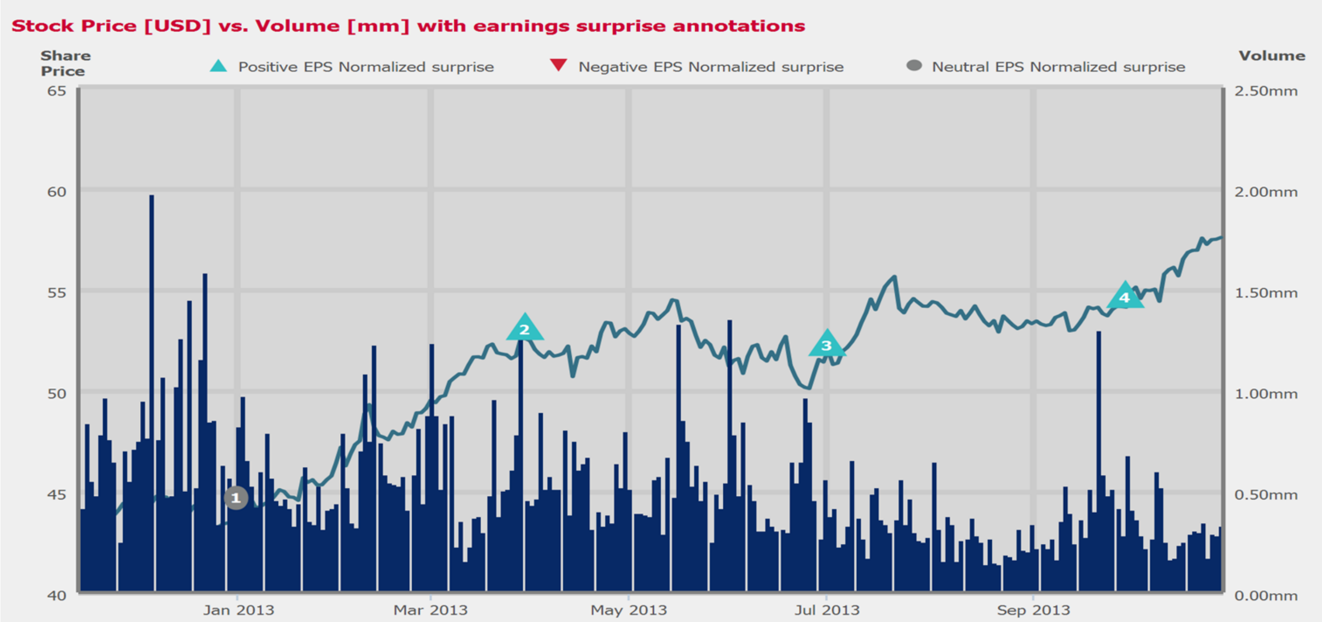
Wednesday, February 12, 2014 4:00 PM GMT

S&P Capital IQ Estimates

	-FQ4 2013-			-FQ1 2014-	-FY 2013-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.96	1.12	▲16.67	0.98	4.22	4.39
Revenue (mm)	669.89	748.92	▲11.80	1047.51	3395.89	3351.37

Currency: USD

Consensus as of Feb-12-2014 1:04 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ4 2012	(0.53)	(0.18)	NM
FQ1 2013	0.96	1.17	▲1 21.88 %
FQ2 2013	0.82	0.99	▲2 20.73 %
FQ3 2013	0.91	1.10	▲3 20.88 %

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Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Fourth Quarter 2013 Arch Capital Group Earnings Conference Call. My name is Dominique, and I'll be your operator for today. [Operator Instructions]

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 assumptions 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 historic facts are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The company intends the forward-looking statements in the call to be subject to the Safe Harbor created thereby.

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

I would now like to hand the call over to Mr. Dinos Iordanou and Mr. Mark Lyons. Please proceed.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thanks, Dominique. Good morning, everyone, and thank you for joining us today. We had an excellent fourth quarter, which capped off a very good year. And also, we were very pleased that 2 weeks ago, we finally closed on the CMG and PMI transactions. I will comment further on these acquisitions shortly, but first, let me share a few observations on our fourth quarter.

Earnings were solid and were driven by excellent reported underwriting results. On a consolidated basis, our premium revenue grew by approximately 17% on a gross written basis and 22% on a net written basis. Although there were a few noteworthy items that I will get to in a few minutes.

On an operating basis, we earned $1.12 per share for the quarter, which produced an annualized return of equity of 11.7% for the fourth quarter. For the entire year, operating income was $4.39 per share, which also represented an 11.7% return on equity.

On a net income basis, Arch earned $5.07 per share, which corresponds to a 13.5% return on equity, which is excellent in a year where investment returns on our fixed income assets were challenged.

Our reported underwriting results in the fourth quarter were excellent as reflected by a combined ratio of 85.3% and were aided by better-than-expected performance on catastrophe business, favorable loss reserve development and improved accident year performance in our Insurance Group operations, primarily due to rate increases that we have seen over the last 8 quarters and we are earning now. The underwriting returns for the entire year were also excellent at 85.9% combined ratio.

Net investment income per share on a sequential basis was flat for the quarter at $0.49 per share. Our operating cash flow for the quarter was $224 million, a $34 million increase from the same period a year ago.

The total return of the investment portfolio was 97 basis points for the quarter and 128 basis points for the full year 2013, inclusive of fluctuations in foreign exchange rates.

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Our book value per common share at December 31, 2013 rose to $39.82, increasing by 3.9% sequentially and 10% relative to December 31, 2013.

In the primary markets, which our insurance operations participate, we continue to obtain rate increases above loss trend. Although, I have to say, in the fourth quarter, they moderated somewhat relative to the third quarter.

In our U.S. insurance operations, we achieved rate increases in the quarter that provides 80 basis points of expected margin improvements, which was approximately half of what we experienced in 2013 third quarter. Our U.S. insurance operations represent approximately 80% of our premium volume in that sector.

We continue to see our best opportunities in some sectors of the E&S market, and in our binding authority and program business, which are predominantly small accounts. In these areas, we have seen steady improvement in pricing and a steady gain in exposure units, which contributed to our solid growth in the fourth quarter in the Insurance Group.

On the reinsurance side of the business, we have seen a continuation of softening in terms and conditions that we noted in prior quarters.

First, the property cat area is under pressure, primarily due to the alternative capacity that has entered the market. For January 1 business, we experienced approximately a 15% reduction in rates on a gross basis.

Also, as we reported on last quarter's call, cedents are aggressively requesting additional ceding commissions on quota share contracts and reinsurance buyers continue to shift business to excess of loss treaties, in combination with request for further rate reductions. These conditions create an environment of increased risk to reinsurance for potential negative arbitrage.

Since we're both an insurance and reinsurance enterprise, should we experience some pain in our reinsurance segment, we stand to benefit from the improvement in terms on our insurance operations, there we're significant buyer of reinsurance.

From a production point of view, net written premiums in the reinsurance segment grew by 36%. The increase in the reinsurance segment stems primarily from two 2 significant treaties, including a large and premium transfer, along with premium growth in the mortgage space, which, in this quarter, is included in the reinsurance segment results. The insurance segment grew premium by 11.5% on a gross written basis and 14% on a net written basis.

Growth in the U.S. operations offset a strategic reduction in professional indemnity contracts in our international operations. Most of the business we write in national accounts and the construction segment are on a loss-deductible loss-sensitive basis. The guarantee cost large account capacity market continues to be unattractive to us.

Groupwide, on an expected basis, we continue to believe the ROE on the business we underwrote this year will produce an underwriting year ROE in the range of 11% to 13%, with a slight improvement in the Insurance Group results, offset by a slight deterioration in the reinsurance group due to lower cat rates.

As I indicated in my opening remarks, we're very pleased that we have entered the U.S. mortgage insurance market through the purchase of CMG and PMI. As you may know, CMG has been in the business of providing mortgage insurance on a continuous basis since 1994 with approximately $100 million of annual premium volume, catering exclusively to the credit union marketplace. The access to these marketplace is done through CUNA Mutual employees, who under a 7-year service agreement with us, will continue to mortgage insurance products to these clients on our behalf.

Our objective is to expand our penetration in this sector, and we believe that this operation will benefit from the financial strength of Arch, which should further enhance our ability to better serve these clients.

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As to the lenders channels previously serviced by the PMI operations, we have nearly concluded the build-out of our national sales management infrastructure with 75% of our national sales managers already on staff and working hard.

This team will focus their sales and activity on the top 40 mortgage originators and will complement our regional and area sales management teams that would cater to regional and smaller banks.

This hiring activity took place over the past couple of quarters and was an advanced investment by us in important personnel.

These proactive steps should enable us to accelerate our sales activity by at least one quarter. Of course, some of the costs related to these actions were already reflected in our 2013 operating results.

Beginning with the 2014 first quarter, we will be reporting the mortgage segment as a third business segment and for prior-year comparisons, we will also give you the quarterly performance of our mortgage activities going back to 2013.

Before I turn it over to Mark, I would like to also discuss our PMLs. As usual, I would like to point out that our cat PML aggregates reflect business bound through January 1, while the premium numbers included in our financial statements are through December 31 and, that the PMLs are reflected net of all reinsurance and retro sessions.

As of January 1, 2014, our largest 250-year PML for a single event decreased slightly to $801 million in the Northeast, representing approximately 15% of common equity shareholders, while the Gulf PMLs also decreased to $670 million and our Florida Tri-County PML now stands at $566 million.

With that, I will turn it over to Mark, to comment further on our financial results. And then after Mark, we will entertain your questions. Mark?

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

Great. Thank you, Dinos, and good morning, everyone. I have a bit of a cold, so hopefully, you guys, will bear with me.

The consolidated combined ratio for this quarter was 85.3%, with 2 points of current accident year cat-related events, net of reinsurance and reinstatement premiums, compared to the 2012 fourth quarter combined ratio of 112.4%, which reflected 25.8 points of cat-related events.

Cat losses occurring in the 2013 fourth quarter represented $16.8 million net of reinsurance recoverables and reinstatement premiums, mostly due to the Illinois tornado and other smaller events.

The 2013 fourth quarter consolidated combined ratio also reflected 7.9 points of prior year net favorable development, compared to 7 points of prior period favorable development in the 2012 fourth quarter.

Over 90% of this net favorable development in the quarter was from the reinsurance segment, with approximately 60% of that due to net favorable development on longer-tailed lines spread relatively evenly over many underwriting years, but particularly in the 2003 to 2007 underwriting years.

The remaining 40% of the reinsurance segment's net favorable development was attributable to shorter-tailed lines associated with the more recent underwriting years.

The remaining aggregate 10% of favorable development in the quarter was emanated from the insurance segment and was mainly driven by shorter-tailed lines, predominantly from the more recent accident years.

Similar to prior periods, approximately 69% of our total net reserves were losses and loss adjustment expense of $7.1 billion are IBNR or additional case reserves, which is a fairly consistent ratio across both the reinsurance and insurance segments over time.

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The insurance segment accounts for 63% of the total loss and LAE reserves as of year end 2013. Therefore, reflecting those, the current accident year -- accident quarter consolidated combined ratio excluding cats for the fourth quarter was 91.2% compared to 93.6% in the fourth quarter of 2012.

On a year-to-date consolidated basis, the 2013 calendar year produced the 85.9% combined ratio on a reported basis, compared to 95.4% for 2012, resulting in a $309 million improvement in underwriting income, and primarily reflecting the lower level of catastrophic activity compared to 2012.

The 2013 full year expense ratio increased by 50 basis points, which is driven by a 60-bp increase in the acquisition expense ratio, offset by a 10-point improvement in the operating expense ratio, relative to full calendar year 2012.

The 2012 year, as you may recall, already had its operating expense ratio improved by 50 basis points over the prior year 2011.

The full accident year 2013 combined ratio, excluding cats, was 91.3% compared to the accident year 2012's full year combined ratio, excluding cats of 94%, which represents a 270-basis-point improvement.

Overall, on a consolidated basis, the full 2013 year saw $327 million of gross written premium growth or 8.5% and roughly $300 million or almost 10% on a net basis.

The insurance segment grew net written premiums by nearly 7% and the reinsurance segment by 14% for the full year of 2013.

Also, on a consolidated basis, the ratio of net premium to gross premium in the 2013 fourth quarter was 78.4%, compared to 75.3% a year ago.

In the reinsurance segment, the net-to-gross ratio was 96.2% in the quarter compared to 92.3% a year ago, primarily due to change in mix of business on a written basis.

The insurance segment has 69.2% net-to-gross ratio, compared to 67.7% a year ago, predominantly as a result of that ongoing strategy to grow lesser volatile, smaller account businesses and reduce our exposure in the higher severity businesses.

In the reinsurance segment, the 2013 accident quarter combined ratio, excluding cats, was 84.0% compared to 83.9% in the corresponding quarter a year ago.

The reinsurance segment's result this quarter reflects changes in the mix of business on a net-written basis, with a higher contribution from casualty and other specialty at a lower relative contribution from property cat marine and aviation than the fourth quarter of 2012.

The casualty growth primarily reflects one large professional lines treaty, which Dinos has mentioned, which included an underwritten premium transfer, that is reflected as a onetime written premium increase in addition to ongoing subject new and rental business.

The full 12-month accident year combined ratio, excluding cats for the reinsurance segment, was 82.2%, compared to 83.3% for the full 2012 accident year, which represents 110-basis-point improvement.

In the insurance segment, the 2013 accident quarter combined ratio, excluding cats, was 96.4%, compared to 100.4% a year ago. The fourth quarter of 2013 showed a 60-bp reduction in the expense ratio with the acquisition expense ratio increasing by 50 bps, which was more than offset by 110-basis-point reduction in the operating expense ratio.

The full 12-month 2013 accident year combined ratio, excluding cats for the insurance segment, was 97.4% compared to 107 -- 100.7% combined ratio for the full 2012 accident year, a 330-basis-point improvement.

As a respect to pricing levels, the U.S. insurance operations achieved a 3.8% weighted average effective rate increase on a gross-written basis for the fourth quarter, which produced an additional margin expansion of 80 basis points over the fourth quarter of 2012. These figures represent the excess of written

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effective rate increases over estimated loss trends and provide continuing evidence of additional margin expansion, although the degree of expansion is shrinking.

Margin expansion continued in our program: casualty, excess workers' compensation and A&H businesses, while contracting marginally in health care surety and some executive assurance units.

It's important to note that these are gross effective rate changes. And with the recent softening in the reinsurance marketplace, the net economics have improved more so than the gross economics in various areas.

As one example, the U.S. Insurance Group, CNS property division, which was able to secure significant improvements in their cat treaty had a minus 1.5% effective rate decrease for the fourth quarter on a gross basis. But after reflecting the impacts of the improved cat treaty, the net estimated rate change was plus 6% or 650-basis-point swing to the good.

Just one division net impact was enough to increase the U.S. -- the total aggregate effective rate change by 30 basis points from 3.8% to 4.1% and provides a better measure of true underlying margin expansion of roughly 110 basis points.

Specialty casualty, workers comp and national account businesses have now experienced 11 consecutive quarters of rate increases, whereas, our executive insurance middle market and alternative asset protection books, along with our retail construction division, have each experienced 10 consecutive quarters of increases.

Furthermore, the excess work comp unit has now enjoyed 9 consecutive quarters of rate increases.

Reported net investment income in 2013 fourth quarter was $0.49 per share, substantially unchanged from the 2013 third quarter, but less than the $0.53 per share in the corresponding quarter of 2012.

The difference from the fourth quarter of 2012 is attributable to a reduction of investment income from fixed income securities and an increase in investment expenses on a year-over-year basis.

However, this quarter's investment expense are consistent with the first 9 months of 2013.

Our embedded pretax book yield before expenses was 2.38% as of December 31, 2013, compared to 2.41% at September 30.

The duration of the portfolio shortened slightly this quarter to 2.62 years from 2.83 years as of September 30.

As Dinos has mentioned, the total return on the portfolio was 97 bps in the 2013 fourth quarter, with equities in a high-yield corporate bonds augmenting the returns on our core investment-grade fixed-income portfolio. Excluding foreign exchange, total return was 85 basis points in the quarter.

The full year 2013 total return on the portfolio was 1.28% including the effects of foreign exchange, compared to 5.88% for the full 2012 year.

Excluding foreign exchange, the full 2012 year total return was 1.13%, compared to 5.59% for the full 2012 year.

Our effective tax rate on pretax and operating income for the fourth quarter of 2013 was an expense of 8.3% and the full year 2013 was an expense of 4.8%, versus a benefit of 3.8% for the full year 2012.

As always, fluctuation in the effective tax rate can result from variability in the relative mix of income or loss reported by jurisdiction. The increase in the 4 quarters tax rate on a pretax operating income was predominantly driven by a valuation allowance, that was established against our Canadian operations deferred tax asset. This valuation allowance stems from operating losses coincident with structural change effective 1/1/2013 that altered our Canadian operation for being a branch of a U.S. entity to a full Canadian domestic company.

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Our total capital was $6.55 billion at the end of the 2013 fourth quarter, compared to $5.84 billion at the end of the 2013 third quarter, and $5.77 billion at year end 2012.

This represents a $704 million increase in capital from the third quarter end and a $979 million increase in capital relative to year end 2012.

This full year 2013 increase in capital is primarily driven by $688 million of net income available to common shareholders, partially offset by approximately $209 million of unrealized losses, share repurchases and foreign translation adjustments, along with the $500 million of senior notes we issued this quarter.

This new debt has a 30-year tenure with a fixed rate 5.144% coupon and was issued at par. This coupon represents 130-basis-point spread over the referenced 30-year treasury, in effect on the date of execution, which was December 30, 2013. These notes were issued by Arch Capital Group (U.S.) Inc. and are unconditionally guaranteed by the company.

The proceeds were used to fund the acquisition of the CMG and PMI mortgage insurance operations discussed already by Dinos and also available for other general corporate purposes.

As a result, our capital structure at year end 2013 is comprised of 13.7% debt, to 5% preferred and 81.3% common equity.

At the end of 2013, we continue to estimate having capital in excess of our targeted capital position.

As Dinos has also mentioned, book value per share increased nearly 4% in the fourth quarter to $39.82, and up 10% from year end 2012 book value of $36.19, again, driven by the company's continued strong underwriting results.
So with these introductory comments, we're now pleased to take your questions.

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Question and Answer

Operator

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

Amit Kumar
Macquarie Research

Just a few follow-up on the MI piece, because, I guess, that's the most exciting piece right now. First of all, would you help us in terms of framing out what you believe the market opportunity is in terms of how you are thinking about the total mortgage originations and what share would private MIs have of that?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, you have multiple part question, but it's -- I'll try to frame it in broad terms, and then maybe Mark can get more specific to it. But first and foremost, the CMG has no change in the marketplace. CMG has been operating since 1994, so in essence, us acquiring that entity will transfer that $100 million-or-so of volume over to us. While PMI has stopped underwriting as of '11, and therefore, all that production will be new to us. Now to size the market, there is only 7, 8 competitors in the market and the FHA, the FHA, who roughly has about half the market today, is continuing to depopulate that as more and more private capital is assuming the risks. So we believe there is quite a bit of room in us expanding in that area. And the third point I will make, also both Fannie and Freddie through the stacker and Connecticut Avenue Security transactions, they are putting more of the credit risk to the private markets, especially for mortgages that fall below the -- have a higher than 20% down payment that did not require by law to purchase direct mortgage insurance. But in protecting their books, Fannie and Freddie purchased that on a book basis. So I don't know how best to describe the market to you, but we believe is a good opportunity and a strongly capitalized company like Arch Mortgage will be a welcome addition to the marketplace with enough room for us to grow.

Amit Kumar
Macquarie Research

Got it. I don't know if Mark has anything to add to that?

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

Well, not too much. I mean, as you know, we just split this thing by channel, how we look at it, the credit union space, we would have, now that the acquisitions is closed, a 45% market share perhaps that could go a little North. We'd like to protect that, perhaps, marginally increase it over to short term. And over the longer term, on the lender bank channel, we certainly hope to get to a double-digit market share 3 years down the line or so.

Amit Kumar
Macquarie Research

Got it. And the lender channel is through PMI, right?

Constantine P. Iordanou
Chairman and Chief Executive Officer

That's correct. Well, the old PMI. There's no PMI, it will be a...

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

CMG paper.

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Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes.

Amit Kumar
Macquarie Research

Got it. Because I'm looking at some statistics and it shows CMG at least is having currently a 3% market share, but that's on a traditional private MI business.

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

That's right, that's 3% of the total. Well, I was quoting of the channel itself, 45% of the credit union channel.

Amit Kumar
Macquarie Research

How much would that equate to -- in terms of the overall market? What would the 3% look like?

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

That's what...

Constantine P. Iordanou
Chairman and Chief Executive Officer

That's what -- that's the inverse of what you just said.

Amit Kumar
Macquarie Research

Got it. Sorry, go ahead.

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

The 45% of the broker -- sorry, of the credit union channel is 3%, 3.5% of the aggregate channel.

Amit Kumar
Macquarie Research

Got it. I guess, the only other question I have is, and I'll stop is, [indiscernible] in the past, you talked about sort of a mid teens return on this, has that thought process changed, and what would be sort of, I don't know if capital charge is the right word, how should we think about capital versus MI versus capital deployment and other avenues?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, our prospect of ROE have not changed. We still believe that is high mid-teen ROE type of business. On -- value of risk of capital is about 18 to 1. Probably, over time, that will get further down, depending what the regulators will do to probably 15 to 1. But for the time being, it's 18 to 1. And we do like that business. Of course, it will take some time for us to get to steady-state, probably 3 years, as Mark said. And then the real accretion to our ROE will start happening at that point in time.

Amit Kumar
Macquarie Research

Got it. And 3 years accounting, until 2016 is the first year, right?

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Constantine P. Iordanou
Chairman and Chief Executive Officer

No, mid-2014 is kind of the first year. Because the sales force is just about now, we won't be writing a lot on the old PMI platform until probably third quarter of this year. It takes time to get the bulk policies in place and then you start receiving the flow from the originators. In the small banks and regional business, a little faster. On the national mortgage originators, a little longer because they have to go through the vendor management routines and it takes a bit of time. We tried to accelerate that in anticipation of the close and we had people working on it in the fourth quarter, and of course, in this first quarter. But our success is mostly now with the smaller and regional banks because the process is a little easier and we gravitating to the large originators.

Operator

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

Jay H. Gelb
Barclays PLC, Research Division

Just want to touch base on the 11% to 13% accident year return on equity target. With primary commercial rates peaking and reinsurance rates softening, what do you feel to be able to continue to drive that over time?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Jay, it will depend what happens going forward. Don't forget, if everything remains steady, let's say, we just -- we barely -- if we say, the rate increases we achieve in the future, they're only good enough to cover loss core strength, then your ROE will -- unless you allow your capital to build up excessively, it will be -- it will remain constant in that range, right? So we haven't seen that change. As a matter of fact, even though rates have -- rate increases have moderated a bit, it's still above loss cost trend, not by as much as 150 or 170 basis points we saw maybe 2 quarters ago, but 80 basis points as we saw in the fourth quarter. So it will depend on that. But right now, we're very confident about the business we write it will generate that kind of return on equity.

Jay H. Gelb
Barclays PLC, Research Division

If market conditions were to deteriorate worse than expected next year, can you talk about Arch's ability to pull back on volume?

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

Well, before you go there, your question along as some of Dinos' answer. Remember, we're quoting you this margin expansion numbers on a written basis, so a lot of it is baked into 2014 already, because of what was done in the 4 quarters of 2013. So even if you have the assumption of 2014 being a 0 margin expansion, you can pretty much figure out the -- borrowing unusual cat, things of that nature. You could arithmetically write pretty much get to a strong insurance result.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, the earned premium comes later on than the written premium. So the '14 is baked, if you have a change, it will affect '15 and beyond. But I can't predict the future if it's going to have a change. The math is pretty easy, depends how many, if you're gaining margin expansion or you're losing it. Our ability, which is your second question, to navigate through these markets, all you got to do is look our history. Even in today's market that predominantly we like on the Insurance Group, we have -- in our European operations, we have reduced significant volumes in the professional indemnity space because we just don't like the -- what's happening in that particular -- too much competition, too many players and we're not

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getting rate increases above trend. So in essence, that will deteriorate and we don't like to be playing in spaces that economics get worse.

Jay H. Gelb
Barclays PLC, Research Division

Right, okay. And then can you just update us on your thoughts around share buyback, given the growth opportunities in areas like mortgage insurance? You said in the past that you shouldn't look for much noise in your buybacks. Just wanted to confirm that, that was still your current thinking.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, our current thinking hasn't changed. We will maintain a bit of excess capital as cushioned, that's always been our philosophy. And we continue to look for opportunities to deploy capital in our business. But absent of good opportunities, we probably will go back to share buybacks if we are accumulating excess capital at a faster pace than we need to have.

Operator

Your next question comes from the line of Michael Zaremski of Crédit Suisse.

Crystal Lu

This is Crystal in for Mike today. My first question is, can you elaborate on the Watford Re fund? If you can't comment on the potential size of the fund and the impact to the financials, perhaps you can discuss the strategy, which appears to be casualty line focused, whereas most third-party funds in the marketplace are property focused.

Constantine P. Iordanou
Chairman and Chief Executive Officer

You have a nicer voice than Michael, you tell him that. But what we have announced in January is we have agreed in principle to act as the reinsurance manager, reinsurance underwriter for Watford Re, which is going to be a new multi-line Bermuda reinsurer fully rated. And Highbridge Principal Strategies will act as the investment manager of the Watford Re. The venture is not yet finalized so we're limited as to what we can say about it. But they're in the middle of capital raising so we can't comment on that. On the conceptual thing, think of this as a kind of a semi-virtual company, it will have its own management, a CEO, a CFO, a Chief Risk Officer, underwriters to do underwriting, reviews per se on our activities. And then the bulk of the underwriting activity, it will be done by the Arch employees and the Arch underwriting system, and the investment operations will be done by Highbridge Principal Strategies. And both of us, Highbridge and Arch is bound contractually for a long time to provide those kind of services. So that's the principal concept of the facility.

Operator

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

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Maybe, Dinos, maybe -- you talk about how much capital right now is at the -- is in the MI?

Constantine P. Iordanou
Chairman and Chief Executive Officer

In the MI space?

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

No, no, no. That you have pushed down into CMG in order to write business?

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Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, we haven't -- CMG is capitalized. We just bought the entity. Our financial strength will, as a matter of fact, they're under review by the rating agencies to -- they were on a -- they're a triple minus with positive outlook, BBB- with a positive outlook based on waiting for the closing of the transaction. So we expect a significant bounce on the credit rating of that facility, but we're going to be adding capital to it to maintain adequate capital ratios. And depending on their production, we will continue maintaining adequate capital. Mark, you want to...

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

Yes. To the extent that if your real question, Michael, is emanating from consideration at closing, which is a little different than ongoing capital base.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

No, no, no. I guess, my question is like, as we're thinking about the earnings power here, how should we think about insurance in force, how should we think about whether or not you feel like you need to contribute capital related to potential changes to the GSE standards or anything of the like. I'm just trying to figure out how much is in there, how much business do you think you're going to write so we can start to think about what sort of ROEs this business is going to be able to generate, and when?

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

I understand that, the underlying premise in your question, but we don't know to what extent we're going to be penetrating that lender market. As Dinos said, that's not going to get any traction until the mid year and then get the monthly streams behind it. But it's clear that we're going to be -- whatever the capital standards are that come out. As Dinos said, it's approximately 18:1 now and gets stiffened over time, that's what we're going to need to do. But that will be a function of the actual rate on which we put on these exposures, so...

Constantine P. Iordanou
Chairman and Chief Executive Officer

And you've got to understand, Michael, that based in our agreements with Fannie and Freddie, at the beginning, we'll probably a bit over capitalized because we have contributed in our MI operations approximately $350 million to $400 million. That doesn't limit what we do in the U.S. Also, this is part of the things that we do overseas. You're going to get a lot more clarity on this on the first quarter when we're going to start reporting the segments individually, and then you can build your models after that.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it. Okay, so -- I mean would it be possible to get like insurance in force, just the kind of ballpark at this point or you want it in both?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, right now, I think the risk of capital ratio is closer to 10:1. So it's not going to -- this is what it looks like now to us, and that will start going up as we produce more business. But it will take probably a couple of years, maybe 3 years, before we get to the point that we have enough production and then we need to add additional capital in order to support the profit capital ratio.

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

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And one way to think about that, in rough terms, in round numbers, because -- now that it's closed, CMG has roughly $5 billion of risk in force. So if you use the 18:1 that Dinos just talked about, that translates to about $280 million -- $275 million of implied capital needs. That's arithmetically as opposed to GSE requirements. But that assumes that 100% of it is kept onshore as well, which likely is not the case. Anyway, I'm just giving you--

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

That's great, that's what I was looking for. And then the last one, the marginal tax rate on the MI business, will that be -- I imagine that will be different from your kind of your consolidated tax rate or do you expect it to be similar?

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

It should be marginally higher because there may be a difference in the quarter share percentage.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it. Great. And then last question, Mike just off of this topic, but I guess one question I have is obviously you're seeing a lot of flux on the reinsurance side and it seems like you're prepared to move capacity into the insurance market and particularly if there are some opportunities on the E&S side and as the buyer reinsurance, challenging or competitive reinsurance conditions are helpful. But at what point do you see or could we see others employ that same strategy of just kind of lifting the capital out of the reinsurance market, moving into the insurance market and kind of bringing that kind of situation with them? Is that something you think about or?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I can't talk about others because I don't know what they're going to do. First of all, if you have a structure like Arch, which you have businesses on both segments, you have the opportunity to do it. If you're a pure reinsurer, of course, you don't have the opportunity to do that because if you lack in insurance operations, you've got to stick with what you have. Having said that, it's the willingness of managements to decide as to where they're going to allocate capital and what segments. Even in the insurance segment, we don't have a lot of liking on the large accounts business where rates are today, especially if they're written on a guaranteed cost basis. If you eliminate law-sensitive type of transactions, it's less underwriting risk and more service-oriented type of business. Predominantly, we're focusing on very tiny binding authority business and small accounts across the board, not only in our program business or a binding authority business, but also in what we do throughout the world. And that is also a focus of our reinsurance operations as reinsurers of underlying businesses, they still look for the small, medium-sized type of accounts to reinsure.

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

And let me just add, Michael, that the -- don't view this as a panacea of moving capital from reinsurance to insurance. We just got done quoting that the full accident year was about 83 combined for the reinsurance group. And they worked hard to be well diversified, so although there's focus on cat, cat's not -- clearly, not the only game in town, so that's a 17% return on revenue right there, so it's not -- the sky isn't falling.

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's definitely clear that when things are getting more challenging, especially in the reinsurance business, talent will make a difference and discipline will make a difference. And I think our track record speaks for itself. We have terrific underwriting teams in our reinsurance group, and I think they are as disciplined as

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they come. I don't -- I do have a management tool that I got from my father, it's a Louisville Slugger, it's in there. But I only keep it in the corner of my office because I never have to use it. These guys are more disciplined than I am.

Operator

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

Joshua David Shanker
Deutsche Bank AG, Research Division

Dinos, what happens if there's an Andrew or a Katrina? And with all this collateralized paper, are there no second event covers out there, has the industry suddenly scrambled for a protection on day 2?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I mean, it depends what these facilities that have the collateralized paper will do, are they going to ante up additional capital so they can participate or -- I don't know the answer to it. You can have different scenarios as to what's going to happen. For example, if I'm the buyer of -- on a retro plan of collateralized capital and I have a major event, I'm not releasing that collateral until I know exactly that I get paid for my losses. So in essence, if they want to reload and participate, is up to them. But I don't know what their reaction is going to be at that point in time.

Joshua David Shanker
Deutsche Bank AG, Research Division

In terms of you're buying, are you buying protection at this point with collateralized paper more so than rated paper? Or how do you view the trade-off there?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We buy both, we buy both and is -- we model things out and we believe we can have a good purchase. We don't really care if it's traditional or fully collateralized.

Joshua David Shanker
Deutsche Bank AG, Research Division

And is there a reversal expected for this Canadian tax charge in 2014? Is this one time or does it get earned back through the other direction in the future?

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

Yes, that's -- it's a good a question, and you kind of answered it yourself. This is not a write-off, this is a valuation allowance against the deferred tax asset. So depending upon, let's say, revaluations periodically and performance is good in 2014, you start to see the unwinding of that.

Constantine P. Iordanou
Chairman and Chief Executive Officer

But not in '14, you'll see the unwinding of that in '15 and beyond.

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

We'll call it a reevaluation allowance.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes.

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Operator

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

Vinay Gerard Misquith
Evercore ISI, Research Division

So the first question is on the debt. I'm little surprised that you took on debt because I thought that you guys are sitting on a lot of excess capital. Could you help us understand that decision, please?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, we do, but don't forget, it was attractive terms, especially on a net basis. So we said all along that we kept a very conservative balance sheet to give us those kind of opportunities. We felt we can raise at attractive churns and in the right jurisdiction, so we chose that path. And maybe we have a bit of excess capital beyond what we had before, but we also have the opportunity to deploy it in other business and there is a few things that we are working on. And if that doesn't materialize, we can always return it to shareholders.

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

So to amplify that, Vinay, Dinos saying it's attractively priced, it's tax deductible. We tended to want to raise it in the jurisdictions where it's going to be deployed. And as general statement, we don't really like to track capital if we can get away with it.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay. The second question is on the mortgage insurance space, I believe you said that you don't want to get it more than about 20% of your capital. In the next 3 years, where do you think -- I mean, how much of capital do you think you'd be able to deploy right now?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Not enough to even get us close to 20%. We just said, we have put in about $400 million, we're about 10:1 right now. We have a lot of room to get to 18:1. If we're very successful, probably you're looking out 3 years out before we need. And don't forget, I can't even predict what my balance sheet is going to look 3 years out, but I can tell you, it will have a lot more than $560 billion of common equity. So the 20% will take quite a bit of time. We didn't say we want to be 20% tomorrow, we said, we'll work on the opportunities the market gives us and we're going to try to build it. But from a risk management point of view, we didn't want to deploy more than 20%. And of course, there are other ways to deploy capital as you've seen with our activity at Watford.

Vinay Gerard Misquith
Evercore ISI, Research Division

Sure. But just looking in terms of the capital that you're looking at deploying...

Constantine P. Iordanou
Chairman and Chief Executive Officer

Within the Arch balance sheet, yes.

Vinay Gerard Misquith
Evercore ISI, Research Division

All right. So do you think that the mortgage insurance operation, you could maybe do about $1 billion in terms of capital deployed the next 2 to 5 years?

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Constantine P. Iordanou
Chairman and Chief Executive Officer

Maybe 5 years out, but not in the 2 to 3 years.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, all right. And then last question is on the ROE. Looking at the 11% to 13% sort of underwriting your ROE, I'm trying to translate that into GAAP ROE, I know that there are various ins and outs, because you've got excess capital. Could you help us understand this sort of difference?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I don't understand the difference. I mean, what you've got to look, Vinay, is our performance. This year, we did 11.7% on an operating basis for the year, and we've done 13.5% on a net basis and it was not a stellar year from an investment point of view because of what happened to the fixed income securities. So 11% to 13% without significant -- don't forget, there is no significant deterioration in the underwriting conditions globally. Insurance group is improving, reinsurance group is slightly losing some ground. On balance, when I look at it, I think nothing has changed for us. I view '14 to be as good as '13 and maybe slightly better. So at the end of the day, I mean, we do an in depth then I'll turn it over to Mark, calculations on these things, but they're projections and we feel comfortable with it, that's why we put it in our commentary. Mark, anything more you want to say?

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

No, I think you nailed it. I've got nothing to add.

Vinay Gerard Misquith
Evercore ISI, Research Division

Sure. Though -- so wasn't '13 a very low year for cats and '14 should be more normal year for cats?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, the cat business for us is, I would say, on an expected basis, the low cat might give you another $100 million, $150 million of excess profit. And on a bad cat year, you take it off, right? Because you cannot assume 0 cats and then our cat load is like $250 million a year. So basically, yes, that will have a fluctuation. If you do the math, right? So is a few points of ROE that it can swing, kind of 2 to 3 up or 2 to 3 down depending on heavy or no cat activity. And that's what you saw. The other event that happened this year is that the fixed income market didn't really help very much, with the ROE on a net income basis and/or the growth in book value. So you can do your own math, but when we look at the business we underwrite, we allocate 2 notches above our rating, cap it off through the S&P bond model, and we run everything through to see. I'm not saying everything we underwrite today produces that kind of ROE. We've got business there in the mid-single digit, but we're still in it because we like the future of that business and we have business that have 15% ROE. In the aggregate, when you put that on in the hamper, we come with that range. That's why I gave you a range, I don't give you a bullet point because I'm not that smart to know exactly which segments we're going to be successful to grow versus the other, and mix will make a difference. But 11% to 13%, we're very comfortable with.

Operator

Your next question comes from the line of Ryan Byrnes of Janney Capital.

Ryan J. Byrnes
Janney Montgomery Scott LLC, Research Division

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Just wanted to get your thoughts on why you're making a bet on your professional lines and D&O on the reinsurance side rather than the insurance side?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it's the -- don't forget, we're doing it on both, on insurance side and on the reinsurance side, but you've got to go by geographies. We're not making a big bet in Europe and other parts of the world because we don't see the uplift on the rate. The bet we're making in the U.S. is we view that as a unique situation. A good underwriting team with a very good track record and having a significant amount of business in the primary D&O space, which have experienced more stickiness and also that better rate improvement than anything we've seen in that D&O world in the last 3 to 4 years. So we're backing, I think, a good team. We like the management from the top down all the way through. And at the end of the day, we were willing to do that. Having said that, it doesn't mean our insurance operations in the D&O space in the U.S., they're not trying actively where they see opportunities to grow. Where we don't see opportunities, also, we don't have any misguided misconceptions, we will cut that back.

Ryan J. Byrnes
Janney Montgomery Scott LLC, Research Division

Okay, great. And then just quickly, last question is could you refresh us maybe on your M&A pipeline or some one-off-type deals, I guess, the use of capital going forward.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, we don't comment on future activity because -- but in general terms, we've seen, as we reported on the Ethniki transaction, opportunities sometimes do special deals in reinsurance because people they're looking for capital relief. And sometimes you've got to have the excess capital available and ready to deploy it immediately. If we see those type of opportunities drying up, then we've got to rethink about what do you do with excess capital. But right now, I'm still in a wait-and-see pattern looking at all these opportunities that we're discussing.

Operator

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

John Arthur Hall
Wells Fargo Securities, LLC, Research Division

I was wondering on the mortgage insurance side, you sort of moved into that segment, first in reinsurance and now, with the closing of CMG. Do you think being a primary player is going to reduce your opportunities to continue to write reinsurance there?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I don't believe so. I mean, the opportunities might have went away anyway. I mean, a lot of the reinsurance transactions, they were out of necessity because some of the direct mortgage insurers, they were in need of capital. And we recognize that from the first day we did the first transaction, and that was the reason that we will always have an interest. Our interest to enter the primary mortgage insurance business didn't happen yesterday. We had that interest going back 4 years ago. We just have to find the right opportunity with the right facility, et cetera. As you know, technology plays a big role in that. You've got to have robust systems to be in that space, you've got to have good relationships with organizations like yours, which we expect to do a lot of business with. You're the largest originator. And you've got to have the interfaces and all that. So when we found that opportunity, we entered the market. Having said that, we always knew that our reinsurance opportunities, especially from the primary mortgage, it will purely depend on their capital needs. And now the capital markets have opened to some of the potential clients, some existing clients and potential clients. So I don't know what their needs are going to be in the future, but our intent is to be both in as a reinsurer and also primary in the U.S. and also overseas.

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

And just to augment that a bit. Your question necessitates a scenario or 2, and how will the capital markets continue to view our mortgage churn space. As to the GSE capital requirement, let's hypothesize. Let's say they go from 18:1, and then you go to 16, then you go to 15. This could be increasingly difficult for some of the legacy players to come into compliance. To the extent that the capital markets get a little more cold shoulder towards it, reinsurance as a capital source becomes very attractive.

Operator

Your next question comes from the line of Meyer Shields of KBW.

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

Two quick questions, if I can. First, in that 40% of the reinsurance segment reserve releases that came from shorter tail lines, is there any way of breaking that down between sort of normal run rate losses and the major cats that have been incurred since 2011?

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

Most of it is non-cat. So there is, I'm estimating, but I believe it was closer -- it was North of 50% on non-cat.

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

Okay, great. And second, if we were to tease out the mortgage insurance results in 2013 from reinsurance, would the underwriting margin gone up or down?

Constantine P. Iordanou
Chairman and Chief Executive Officer

They'd probably go -- the margin will go down slightly though, because it will be negligible. This is taking out the MI out of...

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

Well, I think it's funny because we look at that ourselves. And if I do it in combined ratio perspective, it's probably the best way to do it. The calendar quarter for the reinsurance division would have been about 90 bps higher, which is marginal, and 40 bps higher in the full calendar year with the mortgage insurance removed.

Operator

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

Ronald David Bobman
Capital Returns Management, LLC

I had a question about Watford. Generally, is the third quarter of this year sort of the reasonable timeline for when Watford will begin binding business? I was wondering you could describe a little bit about some of the types of lines of business that you envision for Watford. And will it only write business that Arch Re is not writing or might there be deals where you both participate? And then finally -- I'm sorry, just to add one more related question, sorry, Dinos...

Constantine P. Iordanou
Chairman and Chief Executive Officer

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I'm writing them down.

Ronald David Bobman
Capital Returns Management, LLC

I guess, it would sink in a little bit more if my voice was a little bit sweeter. And then the professional liability reinsurance deal that you did with the large earned-premium reserve pickup in the fourth quarter, is there any tie between that and Watford, is the prospect of Watford starting soon in any way linked and will it participate at all on that treaty? And that's it for me.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Okay. Let me start with the fresher one, the last question. Now, it had nothing to do with Watford because Watford, even though the probability is very high, at the time we made that transaction we were making it for us. We want to maintain that. Now in the future, if we chose to put some in Watford or not, it will be up to us. Having said that, in your question about what business Watford will take, yes, they will take sometimes business that we ship out today to our other participants and they will participate with that. Sometimes, we're going to be side-by-side and sometimes there might be deals that they will do on their own. At the end of the day, the underwriting standards of Watford Re will be the same underwriting standards as we have at Arch. I'm not reprogramming the brains of our underwriters. What might be slightly different, than in my -- cause some business will go to Watford, it will depend on duration of liabilities and what kind of expected return we expect from the Highbridge principal strategy, it's the hedge fund who is going to be managing the assets. So yes, there might be situations that some accounts might not make the cut for Arch, but it will make the cut and produce the north of 15% ROE for Watford and then, we'll do those too. But I want to emphasize that our underwriting teams, when they're working on Arch accounts or Watford accounts, they're going to use the same basic tools and the same principles that we have established over the last 12 years.

Operator

Your next question comes from the line of Mark Dwelle of RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

One real quick question. On the CMG premiums you gave us, $100 million, is that a written or an earned?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's an annual written premium and since it is being steady-state, is annual earned too.

Operator

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

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Just a quick follow-up. So I guess I had a question on, I remember a while back, maybe Dinos it was you or Mark, you'd mentioned that the MI would not meaningfully impact earnings until '16. Did that contemplate the interest costs related to this debt raise or is that just on the underwriting side?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It contemplate everything.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

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Okay. It contemplate this period's, that risk. Got it. Okay. And I also just wanted to square the 11% to 13% comment. I guess, does that ROE comment on business that's written today, I'm guessing that contemplates the action at your loss ratio you initially booked is above your estimate of ultimate losses. Is that -- because otherwise, it doesn't look like, on an accident year basis, you would be there for '13?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I don't totally understood. Did you understand the question? I don't know.

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

No.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

So in other words, you had -- you booked a 13.7%, right, this -- or 13.5% this year, 11.7% operating.

Constantine P. Iordanou
Chairman and Chief Executive Officer

13.5 on a net basis, yes.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Yes. Right. 11.7% operating and then -- but you had some -- obviously, some favorable development in there, so taking that into consideration, you're -- that would be somewhere $250 million of development maybe you're in the 7% to 8% range. So if you're booking business on a 11% to 13% ROE basis, I'm guessing that assumes that the accident year results is not going to close that gap for '14 or '15, that there's some assumption that the reserves will continue their trend that we've seen in the last several years.

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

Well, some of it is. Remember, these comments Dinos make on the range are underwriting years, not accident years. In an improving market, accident year '13 will be worse than underwriting year '13. And underwriting year '14 will improve even more. So accident year is the starting point but you have to translate probably a material movement to convert that to an underwriting year and improve it.

Constantine P. Iordanou
Chairman and Chief Executive Officer

On your reserve question, we've be reserving conservatively all of our lives, we're not planning to change that. Usually, performance comes, as I say, the current accident year, it's a self-grading exam. Maybe 4, 5 years out it becomes an exam, but the professor will grade, and that philosophy hasn't changed with us. So I don't believe that our reserve philosophy will change. So in essence, based on historical averages, I would think the same kind of performance is going to emerge.

Operator

With no further questions in the queue, I would like to hand the call back to Mr. Iordanou for closing remarks.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, thank you, all, and we're looking forward to talking to you in the next quarter, which is going to be probably a little more exciting. The first time we're going to report the MI as a separate section of our 3

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businesses. And I'm sure you're going to have a ton of questions. With that, have a wonderful day. Thank you.

Operator
Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect, and have a wonderful day.

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