S&P Capital IQ

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Arch Capital Group Ltd. NasdaqGS:ACGL

FQ2 2014 Earnings Call Transcripts

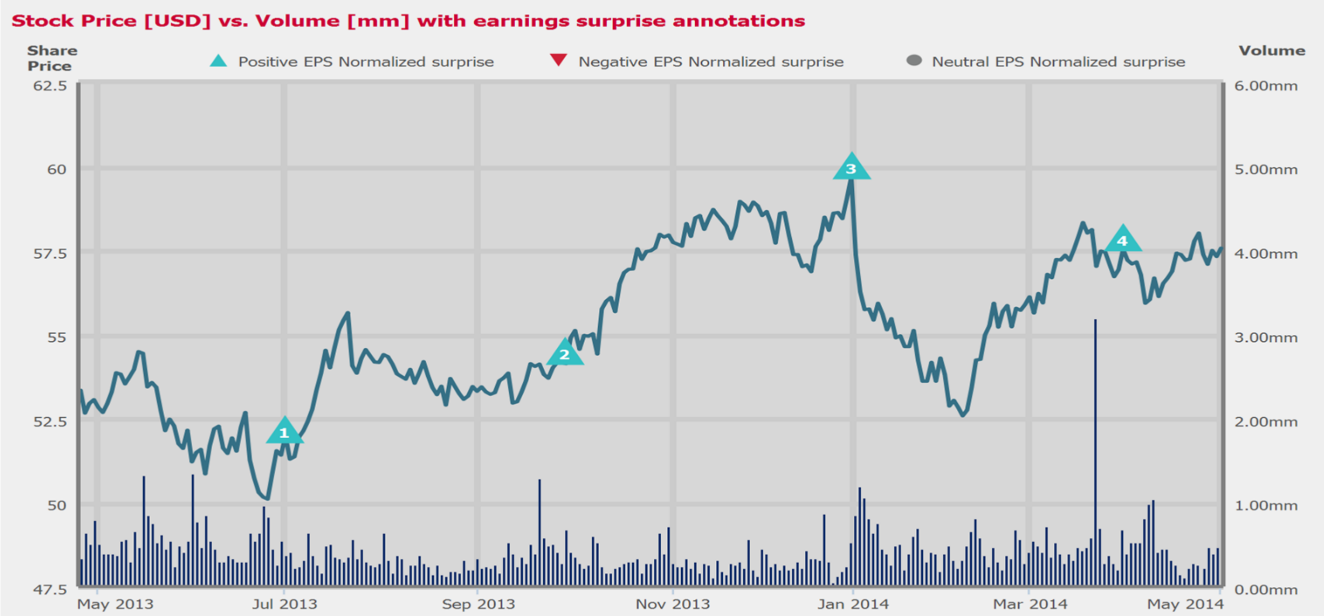
Friday, August 01, 2014 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2014-			-FQ3 2014-	-FY 2014-	-FY 2015-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.98	1.17	▲19.39	0.71	3.85	3.66
Revenue (mm)	932.04	971.93	▲4.28	911.16	3807.61	4054.82

Currency: USD

Consensus as of Aug-01-2014 11:09 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2013	0.82	0.99	▲1 20.73 %
FQ3 2013	0.91	1.10	▲2 20.88 %
FQ4 2013	0.96	1.12	▲3 16.67 %
FQ1 2014	1.06	1.20	▲4 13.21 %

Call Participants

EXECUTIVES

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

ANALYSTS

Amit Kumar
Macquarie Research

Ian Gutterman
Balyasny Asset Management L.P.

Jay H. Gelb
Barclays PLC, Research Division

Joshua David Shanker
Deutsche Bank AG, Research Division

Kai Pan
Morgan Stanley, Research Division

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

Ryan J. Byrnes
Janney Montgomery Scott LLC, Research Division

Vinay Gerard Misquith
Evercore ISI, Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Second Quarter 2014 Arch Capital Group Earnings Conference Call. My name is Towanda, and I will be your coordinator for today. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes.

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

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

Additionally, certain statements contained in the call that are not based on historical facts are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The company intends the forward-looking statements in the call to be subject to the Safe Harbor created thereby. Management 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 turn the conference over to your host for today, Mr. Dinos Iordanou and Mark Lyons. Please proceed.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you, Towanda, and good morning everybody, and thank you for joining us today. We had an excellent second quarter and first half of 2014 from both an underwriting and investment perspective. We believe that our diversified approach and the construction of our book of business over the past 12 years has functioned well in many various market environments.

This balanced approach has been a hallmark of Arch from inception, and is designed to allow us to achieve appropriate returns in many market environments.

Earnings was solid and were driven by excellent reported underwriting results and our premium revenue grew by approximately 13.5% on a net basis, driven by our insurance and mortgage segments.

On an operating basis, we earned $1.17 per share for the quarter, which produced an annualized return on equity of 11% for the 2014 second quarter, which was slightly higher than the ROE reported in the same quarter last year.

On a net income basis, Arch earned $1.48 per share this quarter, which corresponds to an annualized 14% return on equity.

Our reported underwriting results in the second quarter were excellent as reflected by a combined ratio of 86% and were aided by a low level of catastrophe losses and favorable loss reserve development.

We also benefited from an improved accident year performance in our U.S. Insurance Group, which was offset by an increase in the accident year combined ratio of the reinsurance group.

As we discussed last quarter, we expected the reinsurance combine ratio to rise on a year-over-year basis as a result of changing its mix of business. The rise in the combined ratio reflects the fact that the reinsurance group is writing less property and property cat business, which has a lower expected loss ratio than liability business.

And secondly, as we have found additional pockets of casualty and professional liability business that meet our return requirements.

Because of the long duration of this business, we believe it will produce good economic returns over time even in today's low interest rate environment.

Net investment income per share on a sequential basis increased 10% in the quarter to $0.53 per share, primarily as a result of a fund distribution, which Mark Lyons will get into in more depth in a minute.

Our operating cash flow for the quarter was $254 million compared to $183 million in the same period last year. The total return of the investment portfolio was 180 basis points for the quarter, inclusive of fluctuations in foreign exchange rates.

Our book value per common share at June 30, 2014, rose to $43.73 per share, increasing by 5.3% sequentially and 18.8% relative to the second quarter of 2013.

The insurance segment's net written premium grew by approximately 15% on a net basis with alternative markets, E&S casualty and travel accident lines generating most of the increase.

The alternative markets growth came predominantly from a renewal rights transaction. Most of our organic growth is coming from small accounts with low limits, which should have lower volatility, as well as from our loss-sensitive E&O [ph] businesses.

On the other hand, competitive conditions in the property reinsurance sector have negatively affected primary property rates. And our property growth has been flat.

In the primary markets, in which our Insurance Group participate, we continue to obtain rate increases above loss trend, albeit slightly below the levels that we observed last quarter.

We continue to see our best opportunities in some sectors of the E&S market and in our binding authority and program business. In these areas, we have seen improved pricing and a gain in exposure units.

On the reinsurance side of the business, we have seen a continuation of softening in terms and conditions that we noted in prior quarters. As you may have heard on other calls, the property cat area remains under pressure, primarily due to the alternative capacity that has entered that market.

From a production point of view, net written premium was essentially flat in the quarter for the reinsurance group over the same period of 2013.

Although on a gross basis, the reinsurance segment grew by nearly 10%. Almost all of the growth in the segment was from business produced for Watford Re.

Our mortgage segment includes primary mortgage insurance written through Arch MI in the U.S. and other MI internationally. Reinsurance treaties covering mortgage risk, which is written globally, as well as other risk-sharing and structure mortgage businesses.

As you may know, our mortgage insurance business in the U.S. serves 2 major markets: one, the credit union market; and two, banks and other mortgage lenders.

Net written premium in the second quarter of 2014 was approximately $50 million, of which $25 million was written by Arch MI U.S.

As we discussed on prior calls, Arch MI has a dominant position in the credit union sector and is in the process of building out its client base with the bank channel lenders.

As of June 30, 2014, we have approved 222 master policy applications from banks. Of these approvals, 20 represent national accounts and the balance are regional accounts. This represents an increase of 14 in national accounts and 175 in regional accounts as compared to Q1 2014. Of the top 25 originators, we have 11 approvals so far.

Of course, approvals are the first step in the process. It takes time to integrate systems, and then get into the banks rotations in order to receive new mortgage insurance policies.

Group wide, on an expected basis, we continue to believe the ROE on the business we underwrote this year will produce an underwriting year [ph] ROE in the range of 11% to 13%. As on a present value basis, improvement in the Insurance Group and the addition of the mortgage segment offsets lower expected returns in the reinsurance segment.

Before I turn it over to Mark, I would like to discuss our PMLs. As usual, I would like to point out that our cat PML aggregates reflect business bond through July 1, while the premium numbers included in our financial statements through June 30, and that the PMLs are reflected net of reinsurance and all retrocessions.

As of July 1, 2014, our largest 250-year PMLs for a single event decreased to $674 million in the Northeast or 11% of common shareholders' equity, where Gulf PMLs also decreased to $623 million.

Our Florida Tri-County PML now stands at $426 million, the lowest level in memory.

I will now turn it over to Mark to comment further on our financial results. Mark?

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

Great. Thank you, Dinos, and good morning.

Firstly, I'd like to reemphasize that last quarter we made some changes to our reporting format primarily by adding 2 new segments in addition to our 2 prior segments, which were insurance and reinsurance. The new segments are mortgage business and the Other segment.

The mortgage business, as Dinos has commented on, encompasses both insurance and reinsurance across U.S. and international operations, includes any risk-sharing transactions with the GSEs or banks, will also be reflected here.

Previous to last quarter, mortgage insurance, reinsurance and risk-sharing transactions were reported within the reinsurance segment, but that is no longer the case, and we have provided apples-to-apples comparatives, so you can properly reference prior periods.

The second new segment called Other continues to solely reflect Watford Re results at this time. Unlike our other segments, Watford Re operates through a management team that is independent from Arch. It also has a distinct and separate investment portfolio and investment strategy. Therefore, the Other segment presents Watford Re's results inclusive of its investment performance.

Also as a reminder, although Arch only holds an approximate 11% minority interest in the common shares of Watford Re, we have consolidated 100% of their results on a line-by-line basis and Arch's consolidated financial statements with a requisite offset reported as noncontrolling interest.

We have consolidated Watford not due to our percentage ownership but due to the GAAP accounting rules for variable interest, annuities or VIEs.

The financial supplement shows consolidated financial statements that include the Other segment, which is I said is Watford Re, as well as providing other financial information that excludes the other segment. And those are footnoted as such on each page of the supplement to help your ease on analysis.

Furthermore, within the segment information of the supplement, we have provided a subtotal of Arch's core segments without Watford Re and have also additionally provided Watford Re's results posted alongside to arrive at Arch's consolidated segment view.

These permit views within and without the influence of Watford Re. The investment information of the supplement, however, is completely shown excluding the other segment.

So my comments that follow today are on a pure Arch basis, which excludes the other segment, unless otherwise noted.

So beginning in that vein, the consolidated combined ratio for the quarter was 86.2% with 1.8 points of current accident year cat-related events net of reinsurance and reinstatement premiums, compared to the 2013 second quarter combined ratio of 87.4%, which reflected 4.8 points of cat-related events.

Losses from 2014 second quarter cat events net of those above items totaled $16.5 million, primarily emanating from Midwest tornadoes, the April Chilean earthquake and other small miscellaneous catastrophes.

The 2014 second quarter consolidated combined ratio also reflected 9.4 points of prior year net favorable development, net of reinsurance and related acquisition expenses compared to 9.1 points of prior period favorable development on the same basis in the 2013 second quarter.

This resulted in 93.8% current accident quarter combined ratio, excluding cats, for this quarter compared to 91.7% of an accident year combined ratio for the second quarter of 2013.

The 2014 accident year combined ratio, excluding cat for the reinsurance segment, was 92.1% compared to 82.1% in the corresponding quarter last year.

In the insurance segment, the 2014 accident year combined ratio, excluding cats, was 95.8% compared to an accident quarter combined ratio of 98.6% a year ago.

Approximately 78% of the net favorable development in the quarter, excluding the associated impact on acquisition expenses, which from the reinsurance segment, with approximately 54% of that due to net favorable development on short-tailed lines concentrated in more recent underwriting years.

Furthermore, roughly 60% of reinsurance segment net favorable development was attributable to medium tailed lines spaced throughout many underwriting years and about 40% due to net favorable development on longer tailed lines, primarily from the 2002 through 2007 underwriting years, the youngest of which is 90 months in age.

The remaining 22% of the net favorable development on consolidated basis was attributable to the insurance segment and was primarily driven by short-tailed lines from the 2008 through 2013 accident years.

Similarly to prior periods, approximately 69% of our consolidated $7.3 billion of total net reserves for loss and loss adjustment expenses are IBNR or additional case reserves, which continues to be a fairly consistent ratio across both the insurance and reinsurance segments.

On a consolidated basis, the expense ratio for the second quarter of 2014 was 32.8% versus the prior year's comparative quarter of 32.2% expense ratio.

The marginal increase in the operating expense ratio component reflects the addition of our U.S. mortgage insurance operations and incremental expenses due to certain platform expansions of both our reinsurance and insurance businesses, partially offset by a higher level of net premiums earned.

Our U.S. insurance operations achieved a 2.5% effective net rate increase this quarter, which was slightly above our view of weighted loss cost trends. This average effective rate change reflects rate reductions in some units such as nearly an 8% reduction in property businesses and a 3% reduction in D&O financial institutions businesses and healthy increases of nearly 10% in our private not-for-profit D&O line, 7.5% in E&S casualty and approximately 5% in both construction and excess workers comp.

As always, we make capital allocation decisions based upon our view of the absolute returns and not relative improvements alone.

For example, although our insurance property businesses did not experience margin expansion this quarter, our deal was that this line is still producing acceptable net returns for our shareholders.

The ratio of net premiums to gross premium in the quarter, on a consolidated basis, was 73.2% versus 77.9% a year ago. In the reinsurance segment, the net to gross as 83.1% this quarter compared to 91% a year ago, primarily reflecting sessions to Watford Re and more retro purchases protecting their property book.

The insurance segment had a 67.9% net to gross ratio compared to 71.3% a year earlier. This decrease net retention predominantly reflects the impact of new alternative market accounts added during the quarter following a renewal rates agreement entered into with Sparta insurance.

This agreement added nearly $93 million of gross written premium, but only $25 million on a net written basis due to inherent captive sessions [ph].

The worldwide Insurance Group net to gross ratio would have been 72.9% without the Sparta impact, which is in line with last year's comparative quarter.

The mortgage business posted an 85% even combined ratio for the quarter. The expense ratio, as expected, continues to be high as front-ended operating expenses, acquired through the CMG PMI acquisition outpace premium production until proper scale was achieved.

The net written premium increase of approximately $32 million in the quarter is driven by our new U.S. primary operation, mostly via the credit union channel and from 100% quarter share of PMI's 2009 to 2011 underwriting years as part of the acquisition of CMG and PMI's platform.

At June 30, 2014, we run risk for $10 billion of risk-in-force, split $5.3 billion from our U.S. mortgage insurance operation, $4.6 billion to worldwide reinsurance operations and $139 million for resharing transactions.

It's important to note that U.S. operations utilize policy-specific coverage ratios to determine risk-in-force from insurance in-force figures. As you may recall, insurance in-force represent the aggregate amount of the individual loans insured.

Outside the U.S., we've followed market practice to estimate risk-in-force on a similar basis while for risk-sharing transaction, risk-in-force reflects our percentage participations within bound layers, as well as the impact of contract limits. That is, risk-in-force on risk-sharing transactions does not exceed the contractual limits of liability involved.

The other segment being Watford Re, reported 108% even combined ratio for the quarter and $51.8 million of net written premiums and $13 million of net earned premiums.

As stated earlier, these premiums reflect 100% of the business assumed rather than simply Arch's approximate 11% common share interest.

The total return on our investment portfolio was a reported 180 basis points in the 2014 second quarter, driven primarily by strong equity and alternative investment performance, along with improved returns on both investment and noninvestment-grade fixed income sectors.

Excluding foreign exchange, total return was 163 bps during the quarter.

It's worth noting that equities and alternative investments account for roughly 15% of invested assets as of June 30, 2014, which is virtually identical to its proportion 1 year ago and amounts to $2.2 billion. This allocation on a portfolio basis, we believe, have the potential to ameliorate future impacts of fixed income securities from rising interest rates and widening credit spreads.

Our embedded pretax book yield before expenses was 2.17% as of June 30, compared to 2.27% at March 31, 2014. While the duration of the portfolio is short and slightly to 3.14 years from last quarter's 3.24 years and 3.04-year durations from June 30 a year ago.

The current duration continues to reflect our conservative position on interest rates in this current yield environment.

Reported net investment income in the 2014 second quarter was $72.5 million or $0.53 per share versus $67 million in the 2014 first quarter or $0.49 per share and versus $68.4 million or $0.50 per share in the 2013 second quarter.

The increase this quarter is primarily due to a $4.1 million interest distribution from 1 alternative investment fund. Such distributions are extremely lumpy and should not be viewed as a run rate change.

Our effective tax rate on pretax operating income for the second quarter of 2014 was an expense of 3.6% compared to an expense of 3.3% in the second quarter of 2013.

Approximately $1.4 million or 80 basis points of the company's second quarter tax expenses associated with a catch up of the first quarter to this higher effective rate.

Additionally, we have 30 basis points of discrete tax items within the annualized 3.6% rate mentioned

earlier.

Fluctuations in the effective tax rate can result for variability in the relative mix of income or loss reported by jurisdiction, along with forecast variances for the last 6 months of the 2014 year.

Our total capital was $7.13 billion at the end of this quarter, up 5% relative to March 31, 2014, and up 8.9% relative to yearend 2013.

During this quarter, we did not repurchase any shares under our buyback authorization.

Our debt-to-capital ratio remains low at 12.6% and debt plus hybrids represents only 17.2% of our total capital, which continues to give us significant financial flexibility. We also continued to estimate having capital on excess of our targeted capital division.

Book value per share was $43.73 at June 30, 2014, up 5.3% versus March 31, up 9.8% relative to yearend 2013 and up nearly 19% relative to 1 year ago at June 30, 2013.

This change in book value per share this quarter primarily reflects the company's strong, continued strong underwriting performance, as evidenced by the 30% increase in underwriting income relative to the second quarter of 2013.
So with these introductory comments, we're now pleased to take your questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Jay Gelb with Barclays.

Jay H. Gelb
Barclays PLC, Research Division

Mark, I want to touch base, first, on the normalized growth rate in the insurance segment. If my math is right, if I take into account the one-time nature of the Sparta transaction, it looks like normalized top line growth was around 8% on a gross basis and 10% on a net basis, is that as...

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

That sounds right.

Jay H. Gelb
Barclays PLC, Research Division

Do you -- is that a pretty reasonable run rate going forward, or could that have been elevated by some other factors?

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

Well, when you look at the sources coming from contract-binding businesses, coming from program businesses, it's pay off of investments that were done recently in contract-binding operation. Some E&S [ph] casualty business has been strengthened through accumulative rate changes. So I would say, yes, you could view that as an ongoing item. However, if rates start to fall off in unit casualty, for example, of course, we're going to make other decisions.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. It's always, Jay, it's always subject to what the market will give us. We're very, very diligent in monitoring pricing as we do. And at the end of the day, if conditions remain as such, and they don't deteriorate, yes, that will be appropriate. But surprises happen either way. So sometimes, it's not always predictable where the market is going to go.

Jay H. Gelb
Barclays PLC, Research Division

All right. And then on the mortgage insurance operations, could you discuss what you feel the impact or perhaps even the benefit of the new proposed capital rules for mortgage insurers will be for Arch, given that your business is essentially fresh capital as opposed to your competitors, which are largely dealing with legacy issues?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, clearly, the higher capital requirements. For once, there is 2 issues: One is, we were required to capitalize the unit to begin with, in essence, to gain the approvals, and we are waiting for us to generate the revenue to fit into the capital requirement. So, in essence, maybe we got a size 10 shoe and a size 3 foot right now and we got a long way to go to fill it. So for the short term, I think it's a great advantage for us. Over time, I think, the higher capital requirements will require some adjustment in pricing because everybody is going to be looking for appropriate returns. But I don't know how the market is going to react to that. And also, it might affect the fees that the GSEs -- they're charging. So it's not defined on rule, it's a proposed rule, I hear in comment. But from our perspective, I think it's positive. It puts the MI business in more solid financial footing with more capital requirements. And in essence, it might create more demand for new capital like ours in the marketplace. So we view it as a positive event for us.

Jay H. Gelb
Barclays PLC, Research Division

And my follow-up to that is, what do you feel the normalized return on equity in the MI business once it gets to steady state [ph] for Arch taking -- if the new rules are, in fact, adopted?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it's still, I believe, in the 15-plus range based on the macroeconomic condition that we are experiencing. Delinquencies are going down and the average loss per delinquent loan has improved from a year ago. But you can't expect that to continue forever. So the environment is good, but in some sectors, when you really get into the details especially on the high LTV and low FICO score area, the new capital requirements, it will require price increases in order for returns to be achieved. So we'll see how the market reacts to that, but that's the way we see it.

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

Jay, I would also add to Dinos' comments that we are not wholly a U.S. primary mortgage operation. Although reinsurance group is in the U.S. and beyond, that is the primary side having an Irish operation, plus with these risk-sharing transactions, which reported in the segment as the amalgamation of all those things. So I think as Dinos pointed out in his opening comments of our -- the way we diversify, we continue to do that and thinking even though it's a new line of business for us.

Operator

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

Vinay Gerard Misquith
Evercore ISI, Research Division

The first question is on the mortgage insurance business, just trying to model the numbers out near term. We have seen the combined ratios the past couple of quarters in the low 80s. Is that what you expect going forward next year? Or do you expect that to come down a little bit?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It will come down not a little bit, more than a little bit. Don't forget, we have a startup cost issue with a significant sales force that we have created and no revenue to go against that sales force. Even though -- and I share the numbers in my opening remarks as to how many contracts we have or how many banks, et cetera, that activity is not going to stop producing premium revenue until the fourth quarter, first, second quarter of next year. It's a tedious, laborious effort. You have to integrate systems, you got to get on their rotation, and then once you get on their rotation, you start receiving accounts and premium. So in the meantime, we probably -- we have finished the buildout of our sales force. And our sales force is some 50-plus people for the bank channel. Of course, the credit union channel, our sales force is rented through a contractual agreement for CUNA Mutual. So all that expense, it's in these numbers, and we expect those numbers to improve significantly next year when there is premium attached to it. Mark, you want to add more detail on that?

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

I have nothing to add.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Okay.

Vinay Gerard Misquith
Evercore ISI, Research Division

So just looking at the loss ratio, it was 30% this quarter, about 21%, 22% last quarter. I mean, was there a one-time spike this quarter for any reason?

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

I believe it's just more a function of mix of business between all the sources we talked about before. Outside of risk-sharing because risk-sharing isn't accounted for in an insurance principle's way. It's derivative accounting. But it's as simple as that, Vinay.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay. But the bottom line is that we expect maybe slightly lower than, say, the high 70s or sort of it combined next year on this business.

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

Not unreasonable.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Not unreasonable, even better than that, yes.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, okay. Right. From your words to God's ears. Okay, great.

Constantine P. Iordanou
Chairman and Chief Executive Officer

No. I mean, that's what we get paid to work towards. So we do go to church, but also, we work hard, too.

Vinay Gerard Misquith
Evercore ISI, Research Division

The second question is on the cat business. I mean, Dinos, I think your company is the only -- like one of the few companies that have actually cut back significantly on cat reinsurance. Now the level of cutback is significant, 46% this quarter, I think, year-to-date about down 40%. How do you view some people's arguments that you can buy retro and therefore, you can arbitrage, and therefore, you should write the business on your own balance sheet?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, that approach is not totally foreign to us. As I share those numbers with you, we did try to do quite a bit of that, of maintaining our relationship with our reinsurance customers, and then retrocede some through the purchase of retrocessional covers for us. And that's an approach that even some of our competitors are following. So when you look at our numbers, it's not always obvious to you that we cut a lot of our market relationships. We try to maintain as much of that depending as to how advantageous it was for us to maintain that relationship and by retrocession. So in essence, on an expected basis, we still have the same return characteristics. Believe me, if I can write as much cat business as I wrote a year ago and not affect return, I would have done it. But we -- our reinsurance team and our cat teams in Bermuda, I think, they're one of the best groups in the business. And I spent a lot of time with them, but we have utilized the same approach as some others. We maintain bigger gross lines, and then we retroceded out because we believe the price on the retrocessions, it was advantageous to us.

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

And Vinay, I would also add because our diversified platform on the Insurance Group side because of that softening. As I said being [ph] provider or a purchaser, they're taking maximum advantage of this, helping their net economics much more dramatically than their gross economics.

Vinay Gerard Misquith
Evercore ISI, Research Division

Sure. That's helpful. And just to clarify, so on the property cat, you're saying that despite the purchase of retrocessional, your -- the profitability is still lower this year than it would be last year, correct?

Constantine P. Iordanou
Chairman and Chief Executive Officer

?

Well, you can't take 15-or-so rate off the table and expect the same profitability. Now the profitability is not the same across every part of the curve. And when we buy retrocessional cover, sometimes it's lazier to be to in where we believe is the least appropriately priced segment on the curve, probability distribution. So -- and like I said, half the guys we got working on our cat team are smarter than me. So I -- and I have a lot of confidence in them and they have a track record of 12 years of doing extremely well. So even though I spend a lot of time with them, most of the time, they're educating me, and I like the education I get.

Operator

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

Joshua David Shanker
Deutsche Bank AG, Research Division

You mentioned a little bit in the prepared remarks, but I'm just looking at the loss ratio decline or deterioration on the reinsurance business, and there's all sort of things you are talking about. It just seems it is sizable. Can you break down the components business mix, higher or lower price on reinsurance, or can you give us more color into understanding it?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I'll give you the high level and Mark or maybe on follow-up with Don, I'll give you more detail. But the basis is, you take the cat business and the expected -- combined ratio in that business is South of 80, and you're replacing some of that volume with liability business that we -- at least will reserve early on in the 100 to 105, that's 20, 25 points difference in comparing combined ratio. So once you take in big chunks, and you saw our property, property cat premium went down by some 40%, and you're replacing that with -- on an economic basis still very acceptable business because with the duration of liabilities, you're still going to earn double-digit returns, but on a combined ratio, that business we're booking at 100, thereabouts. That mix change is what's causing for us the current accident year to be booking at the levels that we have. Mark, do you want to?

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

Yes, I mean, it is mixed. Dinos is right. It's right on point. But I would want to reemphasize and I get lost in the sauce with Dinos just differentiated between combined ratio and return. 1.5-year duration business versus a 4.5-year duration business even allows the interest rates -- has a different economic outcome characteristics than that clearly. The other thing I would just mention is you guys have placing bets on -- between companies about what their reserving policy is and how conservative they are. I think our track record speaks for itself. We've mentioned that our 2013 reserve position from the views of outside actuarial firms was stronger in the end of 2013 and was in the end of 2012. So you draw your own conclusions, but we're happy with where we're booking it, and it's mix and it's also our -- we believe our level of conservatism. The longer tailed line it is, the more you get different kinds of risk associated with it, you get legal theory risks, you got all kinds of different risks that manifest itself, so we have to reflect those in our initial aspects.

Joshua David Shanker
Deutsche Bank AG, Research Division

And thinking forward into the coming quarters or years, is the 2Q '14 results a reasonable way to think about where loss ratio is given the new mix of business or is the evolution going to continue?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, if the mix doesn't change, it's a reasonable place to be. But what a lot of people haven't really caught up with us, and hopefully, I hope the competition never does, is that we navigate, and we try to go where we believe we can find business with the proper returns. And sometimes, our shifts, the zigging and zagging, is severe. I remember when we started Arch, Paul Ingrey once told me that, "I don't care how big you get as a company as we're growing, but I hope we're not going to lose the agility of navigating like a BT boat instead of an aircraft carrier". And that's been our strategy, it's not just getting in and out of certain things but going from large accounts to small accounts and all that. And we try to react very, very quickly, and we don't worry too much about these optics that, "Oh, my reinsurance combined ratio on a current accident year is going to go up by 10%." That doesn't tell you absolutely nothing. Is that business that you ride acceptable on a total return over time or not, that's the key issue, and that's where all of our guys are focusing on. And then we let the accounting take -- and then we explain the accounting later on. But believe me, our guys are not going to write business that are not in the double-digit expected return, including the investment income component.

Joshua David Shanker
Deutsche Bank AG, Research Division

Makes sense. And I think I mis-asked my question. I guess, what I'm interested in is the relationship between premium earned and premium written, given what has been earned through in 2Q '14. Does that represent the book of written business that you guys think you are going to earn through over the next 9 months?

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

Well, it has to ship somewhat. I mean, to the extent -- we're still getting earned premium from property cat business. It's now been 40% reduced from the prior comparative quarter. So I don't think you're going to hit a steady-state until closer to 4Q.

Operator

Your next question comes from the line of Kai Pan with Morgan Stanley.

Kai Pan
Morgan Stanley, Research Division

Just a quick question on the capital management side. Looks like you took a pause in buybacks in recent quarters and to focus on the MI acquisition, as well as some other initiatives. Now with that behind you, largely, and you still have excess capital and your price book probably coming down from the level we have seen earlier. Are you sort of like -- how do you think about your priorities in terms of capital management?

Constantine P. Iordanou

Chairman and Chief Executive Officer

Well, nothing has changed in our philosophy. Excess capital belongs to shareholders. Eventually, we'll find a way to get it back to them. Where our share price is today, probably share buybacks make a lot of sense. The only thing that is in our minds, we're still in the hurricane season. Usually, we'd like to be a bit conservative around that part of the season. But because you can't predict if you're going to have a storm or not, and you might need to write some big checks. Absent of that, I think is an appropriate time for us based on what you describe for us to buy back shares. But we'll make that decision in due time and due consideration based on those parameters. We still have a big authorization, we do have excess capital, but we've got the rest of the year to worry about. Right now, when I go to church and I light a candle is not to have a cat.

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

Just don't go into the confessional.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes.

Kai Pan
Morgan Stanley, Research Division

All right. Since -- then if there's no big cats, so what's your view on the general like property cat pricing? I just wonder, are we closer to the floor? How much more you can take that your return on the business well below your target returns?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I think that business, especially on some parts of the curve, they have been pushed below double digit. I think some of that business is being priced at a high-single digit return. And at least from our perspective, as gray-hair old underwriters being in the cat business and pricing it with an expected return of 8%, 9% or 10% is insanity. I don't -- that's what we are, but I don't know where it's going to go. I mean, if I was that smart, I'll be a lot wealthier. It's -- I don't know what the competition is going to do. There is new capital that is coming in, that 8%, 9%, 10% returns are very acceptable to them on an expected basis. So if you ask me to guess, I'll probably say we're getting very close to some people that are going to say, "Hey, this thing has gone far enough." But I've been surprised in my career as to how cheap reinsurance can get sometimes. I've seen reinsurance get priced at negative ROEs many times. We just -- I just hope we're smart enough that we'll never going to do it and I have confidence in our guys that they are smart enough, as far as I'm concerned, that they're not going to get there ever.

Operator

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

Ryan J. Byrnes
Janney Montgomery Scott LLC, Research Division

Just also wanted to -- also in the reinsurance, and also, I guess, the insurance as well, but where -- the impact that rates that are having on the underlying loss ratio. I know there's some business mix shift especially in the reinsurance segment. But are rates having any impact on the underlying loss ratio right now as well?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Go ahead, Mark.

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

I think on -- it has to, and it has to do it on both sides. But we think -- meaning insurance and reinsurance, but we think that weighting factor that we talked about is a waiting of loss ratios that reflect the marketplace realities of some -- with rate increases, some with rate decreases. So we don't do this in bulk, we do this line-by-line with a view of where we think it's going. So on the insurance side and the reinsurance side, we think those reflect exactly the market environments we're living in.

Ryan J. Byrnes
Janney Montgomery Scott LLC, Research Division

Okay. And then, just one other quick numbers one. The impact of Sparta in the quarter on the insurance side, is that -- it should that be a one-time or should that be -- should that have elevated premiums flow through in the third and fourth quarter, and I guess, first quarter next year as well?

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

Well, it's a good question. It's roughly -- it's going to be North of $100 million annualized. It's not even, it doesn't -- I think second quarter is the thickest quarter.

Constantine P. Iordanou
Chairman and Chief Executive Officer

$100 million gross.

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

$100 million gross. Sorry, yes.

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's probably north of $100 million gross, about $33 million [ph], $35 million [ph] net, so assuming that we take everything or the clients because we have to make some adjustments to the pricing and there is a client on the other side that might say yes or no to our adjustments, right? But don't forget, a lot of these clients, they're paying predominantly through these round of captives most of their own losses. That's why you're funding and the excess is only a component, about 25% of the premium gross to net, there about it. So if you're going to do comparisons, I think because we're an A+ carrier and Sparta was going into runoff, I think a lot of the accounts cancel and rewrote just to get on our books. So I would think that's more of a one-time adjustment. Of course, all these premium is renewable next year, and it's going to get again on our books a year from today. But there are not going to be a lot of renewals in the third and fourth quarter because account that they had renewals in the third, fourth quarter even in the first quarter, they truncated their placements by cutting off the prior, and then renewing fresh with us in a much better and stronger paper.

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

But on an annualized basis, right, there's going to quarterly fluctuations. It's reasonable to assume that we'd be maybe $120-ish million [ph] gross and $30 million [ph] net, something like that, $30 million [ph], $35 million [ph] net. So the quarterly breakdown isn't smooth, but if you think of it annualized, then I think that's proper.

Operator

Your next question comes from the line of Amit Kumar with Macquarie.

Amit Kumar

Macquarie Research

Just one quick follow-up on the other segment. Once Watford ramps up, how should we think about, I guess, the longer term combined ratio ranges?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Combined ratio for whom? For us or Watford?

Amit Kumar
Macquarie Research

For Watford and you. I mean, you get the fees, but for them [ph]. I guess, the question I'm trying to ask is, is the business being ceded to them similar to what you would have put on your balance sheet otherwise?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. The business that we price on their behalf and we put on their books goes through the same underwriting scrutiny that we were doing. The only difference between what we do versus what we would do for Watford, Watford has a higher return on the float. So investment income and fee business [ph] to a particular deal will be higher. And so, some deals even though from an underwriting perspective, quality of risks, selection of risks, et cetera, it would be still acceptable. You might not make the cut with Arch because we're applying risk-free rate of returns, it will be acceptable for Watford because the investment income component is more advantageous. That's the only difference between the 2. We still have an expectation over time when we get into a steady-state environment that the Watford Re business, it will be sub-100 combined ratio, probably in the mid-90s, that's what I'm talking. We try to get it in the mid-90s.

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

And let me just add because Dinos' comments were driven mostly towards the loss ratio as opposed to expense ratio. And the componentry there between AC [ph] and acquisition and OpEx is still different. They're going to be thinner on OpEx and thicker on AC. But again, mix is a big deal here, so the line of business is the difference, quarter share versus XOL, is difference on any given quarter, how those things mix in? So as they grow, you got some benefit on OpEx for scale benefits, but it won't be enormous. So quarter-by-quarter, it's really a function of what's written and what the acquisition is associated with that.

Operator

Your next question comes from the line of Ian Gutterman with Balyasny.

Ian Gutterman
Balyasny Asset Management L.P.

I guess, my first question is on the action [ph] ROE, the 11% to 13% you mentioned. I think in the past, when you've given that number, usually the reinsurance has been above whatever the overall number was and the insurance has been below. Is that still the case? Or given the changes in the relative marketplaces, are they now even? Is insurance above reinsurance? I'm just curious how that's going.

Constantine P. Iordanou
Chairman and Chief Executive Officer

On an underwriting year basis, they're getting closer, I think they're about equal. Don't forget, my reinsurance guys don't like to write unprofitable business, but they are accepting -- in the past, they wouldn't accept anything that was South of 15%. Now, they're accepting business at 10%, 11%, 12% ROE. Of course, this is unallocated capital. We allocate capital on every deal, and that's the way they see. The Insurance Group never had the volatility, but also the opportunity to price business at 20% ROE.

You get that on reinsurance, you don't get that on insurance. So the reinsurance group fluctuates from 10% to 15% and thereabouts. I think inception to date, our Insurance Group has produced like 14% ROE inception to date, meaning 12 years. So directly to your question, I haven't done the calculated now. It will be bothering me, so I'm going to do it next week. But I would think they're about the same and -- the mortgage business, once you get to steady state, it would be better than that.

Ian Gutterman
Balyasny Asset Management L.P.

Of course. Of course. You can probably guess part of the reason I was asking is a couple of competitors talked about ROEs and reinsurance being single digit now, so -- or being willing to accept single-digit business. I'm just curious how far you felt it had fallen.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Even if I wanted, my guys won't to it.

Ian Gutterman
Balyasny Asset Management L.P.

Exactly, exactly.

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

One other clarification, we just saw on the quarter that net written, which future net earned is -- was a 15% growth in the insurance group and flat in the reinsurance group. So as the core margins continue to expand on an earned basis from the Insurance Group, and they make up a higher percentage of the total net earned premium, the arithmetic is going to work.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, you got to understand. Our reinsurance team is the same. These are all Paul Ingrey guys. And believe me, whatever he has done, it was like -- they're all brainwashed. They believe in the philosophy, they practice it. And it has been a great thing for the group over the last 12 years. They had one of -- maybe the top teacher in the business if not the top -- one of the top teachers. We get the benefit. I'm not going to do anything to change that. They look at accounts. They see where they're going. They cut back lines. They switch to different lines. They have a methodology and the numbers speak for themselves.

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

And again, remember, we are on both sides of the mirror with the diversified platform. The Insurance Group has a lot of treaties now with ceding commissions that begin with a 3, and that's going to find its way through, as net premiums are earned.

Ian Gutterman
Balyasny Asset Management L.P.

Absolutely, absolutely. The other part obviously you said the MI will be above once it ramps up. I guess, the only concern I had on the MI with the new proposed rules is, it seems the business will be more post pro-cyclical, right, that if we start having delinquencies, the capital charges start spiking up. And I am not necessarily saying if we have an '08 again, hopefully we never see that again. But if we have any kind of downturn, it becomes a lower ROE business than we would have thought. Does that change your sort of long-term outlook? And I'm not saying that's still not attractive but it's a little bit less attractive than when you got into it when you have rules that make it pro [ph] cyclical into a downturn?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, I think it's as attractive as we made. We thought about these issues even when we're making the decision. The big lesson in MI is no different than any lesson in accepting risk. When you throw out underwriting standards, as the MI fraternity throughout in '05, '06, '07, you're looking for trouble. And I can do the same with the DNO, I can do the same with private passenger or throw away [ph] and I can do the same with any line of business. Once you throw out your underwriting guidelines, now, your volume and your production, it will be significantly affected if you maintain discipline. What we have been telling both the regulators and the other investors is, we got into this with the idea that we will be disciplined, no different approach to underwriting MI that we underwrite any other line of business. Now yes, you're absolutely correct. Sometimes, even though you're very disciplined in the quality of the loans you're going to underwrite, the FICO scores, et cetera, macroeconomic conditions will change some of the other drivers like delinquencies and all that. But then, it doesn't mean that you make a decision to get into a particular line of business for just 1 or 2 or 5 years, you look at it over the prospect of it at least 10-year period of time and doesn't make sense or not, still makes a lot of sense for us. And we believe we have the right management to manage it in a prudent way over the future. That's our opinion, and we still believe it's an attractive place for us to be.

Ian Gutterman
Balyasny Asset Management L.P.

Okay, good point. And then just last one before lunch, on Watford real quick. Mark, tell me if I'm doing this math right, it looks like out of this $55 million of gross, about $15 million was sort of new business, third-party new business, if you will, and about $40 million was ceded from Arch's books. Is that about right?

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

Yes, you're kind of in the ballpark, maybe a little more external.

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, no. There is more external, but sometimes we are in the front of it.

Ian Gutterman
Balyasny Asset Management L.P.

Well, that's what I was kind of getting at. So your front -- yes, that's what I'm trying to figure out is how much...

Constantine P. Iordanou
Chairman and Chief Executive Officer

For some deals, and we get a fee and we get -- and also we get 150% collateral behind it. So we do have some agreements that we view when we put our paper out that are beneficial to both of us, them and thus. And for certain clients, we do that. But of course, it increases the cost and then sometimes it doesn't make the deal go through. But in some cases, it does. But they're starting to sell just purely their own paper. Because if you're going to get the best economics for a client, you get the best economics when you buy Watford Re paper.

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

And Ian, I think the big takeaway is that, for those increased market acceptance, the flow of business is strong and getting stronger, and it's across more varied lines of business, and that's exactly what you hope for.

Ian Gutterman
Balyasny Asset Management L.P.

That is what I was wondering. What it was -- was the third party flow in line with what you thought or were you finding you are having to write more business on the Arch paper and cede it out the back door to get acceptance?

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

We're happy where it is.

Operator

Your next question comes from the line of Meyer Shields with Keefe, Bruyette, & Woods.

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

One quick question, Mark. Did the Florida business or the alternative markets business overall have material impact on the acquisition expense ratio in insurance?

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

Let me think about that. It's only $24 million, $25 million of net written, but the ceded is, by definition was another 70 million of ceded. So I can give you a better answer off to the side and comment on it, but I would think it would be a marginal impact on the net acquisition ratio, in the tenths.

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

Okay, perfect. I'll follow-up with that. And then, Dinos when you talk about 11% to 13% underwriting year returns, are those at the level that you're booking the reserves initially? Or how you're actually expect this to play out over time?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We booked the reserves a little more conservative than -- our philosophy on reserves is that you price something let's say has 3- to 4-year duration. The original setting up of IBNR is at the pricing level where we priced it. Any bad results that emerged in the first 3, 4 years we let go through, we don't adjust the IBNR independent -- so any unusual large loss that might come through, we just book it immediately, we don't adjust IBNR. And then we relook at everything usually depending on the duration of the business, 3, 4 years out, and then we'd make judgments at that point in time. So that's been our reserving philosophy. So when you get in the 11% to 13%, and the reason we have 11% to 13% is you can't be precise on an underwriting year as to how well it's going to behave. It's too many moving parts, trend might change on you, et cetera. But that's the philosophy that we have and the allocation of the capital to that calculation is we do it as we allocate capital to the operating unit, and we use the S&P model 2 notches above our A+ rating, and that's the way we allocate capital to the operating unit. So -- and because we are a total return shop and I don't -- maybe I should be putting on exhibit in our releases. Even though operating ROEs smoother and ROE, total ROE is -- it can be volatile depending on realized capital gains, et cetera, you will find out that for the last, probably 3 years or so, that our returns, they've been better than our operating returns from an ROE point of view. And Don can give you those statistics because we keep them and we have them.

Operator

I would now like to turn the conference over to Mr. Dinos Iordanou for closing remarks.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, thank you and thanks, everybody, for bearing with us, and we're looking forward to seeing you next quarter. Have a wonderful afternoon.

Operator

Thank you for joining today's conference. That concludes the presentation. You may now disconnect, and have a great day.