# Q4 2015 Earnings Call

## Company Participants

- Constantine P. Iordanou
- Marc Grandisson
- Mark Donald Lyons

## Other Participants

- Amit Kumar
- Charles Joseph Sebaski
- Josh D. Shanker
- Matthew J. Carletti
- Meyer Shields
- Michael Nannizzi
- Sarah E. DeWitt
- Vinay Misquith

## MANAGEMENT DISCUSSION SECTION

### Operator

Good day, ladies and gentlemen, and welcome to the Arch Capital Group Fourth Quarter 2015 Earnings Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session, and instructions will follow at that time. As a reminder, this conference call is being recorded.

Before the company gets started with its update, management wants to first remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the Federal Securities laws. These statements are based upon management's current assessments and assumptions and are subject to a number of risks and uncertainties. Consequently, actual results may differ materially from those expressed or implied. For more information on the risks and other factors that may affect future performance, investors should review periodic reports that are filed by the company with SEC from time-to-time.

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

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

I would now like to introduce your host for today's conference, Mr. Dinos Iordanou. You may begin.

## Constantine P. Iordanou {BIO 2397727 <GO>}

Thank you, Abigail. Good morning, everyone, and thank you for joining us today. We would like to begin our call by first welcoming Marc Grandisson who has joined us this morning, and he will be part of our future presentations to you.

For those of you who may have missed our recent release announcing Marc's promotion to President and Chief Operating Officer, let me remind you that all of our operating businesses now report directly to Marc. Many of you already know him as he was an integral part of the original reinsurance team with Paul Ingrey and others that helped establish Arch Reinsurance Group as the best-in-class global reinsurer.

In addition, Marc played a prominent role in establishing a mortgage business which has become a significant contributor to our group results. You will hear more about the business environment from Marc in a few minutes, but let me very briefly describe how are the operating conditions in the markets we participate in.

To invoke a bit of a sailing analogy, we're facing headwinds in our reinsurance group, overcapacity, pressure on ceding commissions, more excess of loss purchasing at inadequate pricing. So, that describes a bit the reinsurance market conditions.

We see reasonably calm conditions in our insurance group, some sectors under pressure from a pricing point of view, but other sectors offering good opportunities, especially in small customer segments. And, of course, there is tailwinds in our mortgage segment. The underwriting is very strong in this particular sector and the macroeconomic conditions affecting the housing market, they're very favorable.

Turning to our operating results, our fourth quarter earnings were driven by solid reporter underwriting results, while investment returns were challenging, continue to be affected by yields available in the market.

Group-wide and on a constant dollar basis, our gross written premium decreased by 3.6% n the fourth quarter over the same period in 2014, while net written premiums were down 8.2%, as underwriting actions in our insurance and in reinsurance business were only partially offset by growth in our mortgage business.

We continue, and I know Marc will emphasize this, to emphasize underwriting discipline with all of our operating units. On an operating basis, we earned $143.6 million or $1.15 per share for the fourth quarter, which produced an annualized return on equity of just shy of 10%; 9.8% for the 2015 fourth quarter. And as it compares to a 9.7% return on average common equity for the year ending December 31, 2015.

Net income movement on a quarterly basis can be more volatile as these earnings are influenced by changes in foreign exchange rates and realized gains and losses in our investment portfolio. Investment volatility during the fourth quarter and for the full-year 2015 caused net income to fall below operating returns. This is, I believe, for the first time in the last five years that our operating returns were below net income returns.

On a net income basis, Arch earned $4.09 for all of 2015, which equates to a return on equity of 8.8% for the year. While operating return on equity generally produces a more stable stream of earnings in the short term, we believe that net income provides a better view of value creation and book value growth over time.

Over the past five years, on average, net income ROE has added 230 basis points to our operating return. Our reporter underwriting results remain acceptable in the fourth quarter, as reflected by a strong combined ratio of 86.8%, and were aided by low level of catastrophe losses and continued favorable loss reserve development. Group-wide, we believe that, on an expected basis, the present value ROE on the business return in the 2016 underwriting year will produce ROEs in the range of 10% to 12% on allocated capital.

Net investment income per share for the quarter was $0.53 per share, down $0.01 sequentially from the third quarter of 2015. Positive returns on equities in the quarter were not enough to offset negative returns on fixed income, as the total return on a constant dollar basis on our investment portfolio was a negative 10 basis points in the fourth quarter of 2015. The strengthening of the U.S. dollar also impacted total return, which was a negative 33 basis points for the quarter on a reported basis.

Our operating cash flow, excluding Watford, was approximately $100 million in the fourth quarter, as compared to approximately $225 million in the same period last year. Mark Lyons will discuss the changes in cash flow in a few minutes, but approximately one-third of the decline in cash flow reflects the timing of premiums paid to Watford.

Our book value per common share at December 31, 2015 was $47.95 per share, a slight increase from the third quarter of 2015 and a 5.2% increase from December 31, 2014.

With respect to capital management, we continue to have capital in excess of our targeted level. However, we did not find any opportunities to purchase shares in the fourth quarter that will meet our previously stated criteria for share repurchases.

We have found some of those opportunities to repurchase shares in the first quarter of 2016. Through February 5, 2016, Arch purchased 1.050 million shares under our 10b5 program at a cost of $69 million. With those purchases, we have approximately $450 million remaining on our board authorization. We will review that in our board meeting in May of 2016.

Before I turn over the call to Marc Grandisson, I would like to discuss our PMLs which continue to decline from underwriting actions we have taken in our cat portfolios. As usual, I would like to point out that our cat PML aggregates reflect business bound through January 1, while premium numbers included in our financials are through December 31. And the PMLs are reflected net of all reinsurance and retrocession we purchase.

As of January 1, 2016, our largest 2050 (sic) [250] (10:16) year PML for a single event remains the Northeast at $489 million or approximately 8% of common shareholders' equity. I believe that's the lowest level on a percentage basis in our history. Our Gulf of Mexico PML decreased to $444 million at January 1 and our Florida Tri-County PML decreased to a low $362 million.

I will now turn it over to Marc Grandisson to comment on market conditions as he sees them, before Mark Lyons discusses our financial results. And after Mark Lyons, we will take the questions. So, Marc, welcome and go at it.

## Marc Grandisson {BIO 4369887 <GO>}

Thank you, Dinos. It's great to be here. I already know many of you, and I look forward to know you better as I move into my new role.

As we look across our three segments, insurance, reinsurance and mortgage, we see not only the challenges of competitive conditions as Dinos has mentioned in stock pricing, but we also see opportunity in each of our three business segments. While macro events and the interest rate environment have brought down total ROE expectations to a new normal level, we are positioning ourselves in all of our underwriting units focusing on specialty niches that have some inherent competitive protection and for which we believe we will achieve our 15% ROE target over the cycle.

As far as the overall insurance markets are concerned, commercial pricing remains under pressure, especially in the more commoditized product lines. Primary P&C rates are declining in a mid- to low-single-digit range, although there are pockets of re-strengthening. Terms and conditions in general are stable.

Turning first to our insurance operations in the United States. We saw a 140-basis-point effective rate decrease this quarter, but a rate decrease of only 20 bps for the full 2015 policy year versus 2014. Expected ROEs on allocated capital in many lines are still comfortably in the double digits. Those lines of business include construction, national account programs, some areas of low capacity, executive assurance and professional liability. Together, these lines represent over 70% of our 2015 volume.

In contrast, we have seen worsening, as mentioned by Dinos, of the rate levels in property, also in healthcare and higher capacity executive assurance. As a result, we are writing less in those lines.

Our insurance group's premium written decreased 2.5% in the fourth quarter 2015 versus 2014 on a gross basis, but 6% down on a net basis. The changes in our gross versus net reflects the change in our underlying mix as well as our ability to buy reinsurance on more favorable terms. Ceded written premium increased 6.1% in our insurance group this quarter over the same period last year.

Our international insurance operations, which are based in the UK and underwrites risk globally, are under heavier pressure from a rate level perspective. Rate changes there were minus 7% across all of our product lines. Needless to say, we are continuing to actively underwrite and manage this portfolio and are trying to move into areas such as accident and health where competition, we believe, is less intense.

Turning to our reinsurance group now. We continue to develop and allocate our resources to specialty markets and products that are somewhat more shielded from competition. Business lines such as property, including catastrophe, excess of loss and marine are yet again experiencing rate declines in the 10% range. At the same time, some segments like UK motor and U.S. professional liability have experienced small rate increases, and that has created some opportunities for Arch Re.

We find it challenging, if not impossible, to uncover opportunities in a broader U.S. casualty, global aviation and medical malpractice reinsurance market. The returns there are just not satisfactory. In our view, capacity is plentiful. In short, the lines of business where we are focusing our efforts still provide us with expected ROEs on allocated capital in excess of 10%, but the days of low-hanging fruit are gone.

However, reinsurance group net premium written has declined 26% in the fourth quarter of 2015 versus fourth quarter of 2014, led by decreased writings in our short-tail segments. Our property cat portfolio for the full 2015 year is down over 30% over prior year 2014 on a net basis.

In addition, we have seen and reacted to rate erosion by writing less in many other product segments such as international credit insurity, workers' comp clash, and French motor third-party liability business. Cheaper retrocessional protection has also led us to lower retentions in our reinsurance group on a shorter-tail line.

Switching now to our mortgage insurance segment which includes, to remind you, our primary operations in the U.S., our mortgage reinsurance on a global basis, as well as the GSE risk-sharing transaction business. We had another solid quarter of growth in written premium, growing this quarter by 30% over the third quarter of 2015 and 65% over the same quarter last year. The growth came mostly from the U.S. GSE risk-sharing program and from a reinsurance contract with one of the major Australian lenders.

We continue to make progress in the expansion of our U.S. market share. Arch U.S. MI has approved 904 master policy applications. 460 of these clients have submitted loans to Arch MI. In addition, we are capturing additional share of the U.S. MI market through our GSE risk-sharing programs.

At December 31, 2015, our total mortgage segment risk in force is $11.5 billion, which includes $6.8 billion from our U.S. mortgage insurance operation, $3.5 billion through worldwide reinsurance operations, and approximately $1.2 billion from the GSE risk-sharing transactions.

Our primary U.S. mortgage operation had $2.6 billion of new insurance written during the fourth quarter of 2015, which was approximately 60% through the bank channel and 40% via our credit union clients. Our credit union channel continues to perform exceptionally well, as our bank channel business development efforts gain traction.

Our lender-paid mortgage insurance single net insurance written was only 18% of the total production, as Arch MI responded to competitive conditions and lower returns as we see on this business.

Last quarter, we introduced our new risk-based pricing model RateStar and have rate filings approved in 46 days. Through December 31, 2015, 783 customers have elected to use RateStar and the technological transition has gone smoothly. We believe that RateStar enables us to improve our assessment of risk and will help Arch MI create better risk-adjusted ROE. We are very pleased with the initial response and the applications that we are receiving through RateStar at this point.

We estimate the overall mortgage markets, NIW, that was down actually for the fourth quarter versus third quarter by 20%, most of the drop occurring in November and December as both purchase and mortgage refi volume declined. As one of the newer player in the mortgage insurance market, we are well positioned to take market share with our innovative approach to MI and a high credit rating that our diversified business platform allows.



With that, I will hand it over to Mr. Lyons to cover the detailed financial results.

## Mark Donald Lyons {BIO 6494178 <GO>}

Great. Thank you, Marc, and welcome aboard. It's good to have two Marks and one Dinos, I think, on the call. So let me just begin by saying what I've said the last few quarters that, terminology-wise, while I use the term core, I refer to our aggregate results excluding Watford Re. And when I use the term consolidated, the term is results inclusive of Watford Re.

Since we're here talking about year-end results, I'd like to take a minute and put our changing mix of business into perspective. On a full-year net written premium basis, the insurance segment reduced by approximately 6%, as Marc just mentioned. The reinsurance segment declined by about 25%. There's an asterisk on that that I'll get to later. And the mortgage segment increased substantially by 65%.

More importantly though, this results in a mix change on a core basis as follows: The insurance segment changed from 59% to 61% of total core net written premiums. The reinsurance segment shrunk from 35% to 31%. And the mortgage segment increased from 5.7% to 8% of the core net written premium. The mortgage segment's total contribution is actually larger though, since some GSE risk-sharing transaction has received derivative accounting treatment, and therefore, contributed no net written premium.

And as we shall discuss shortly, the mortgage segment in its growth mode combined ratio on an accident-year basis, which also has an asterisk that I'll get into in a bit, decreased by 530 basis points over that of 2014. So you can see we're growing and shifting in areas of improved profitability.

Okay. Moving to this quarter's results, the core combined ratio for this quarter was 86.8% with 1.9 points of current accident year cat-related events, compared to the 2014 fourth quarter combined ratio of 87.5%, which reflected 2.3 points of cat-related events.

Losses recorded in the fourth quarter from these catastrophic events of this year net of reinsurance recoverables and reinstatement premiums totaled just shy of $16 million, primarily stemming from UK storms and other global events emanating mostly within our reinsurance operations.

The 2015 fourth quarter core combined ratio reflects 8.6 points of favorable prior-year development net of reinsurance and related acquisition expenses, compared to 8.3 points on the same basis in the 2014 fourth quarter. This resulted in 93.5% current core accident quarter combined ratio excluding cats for the fourth quarter of this year, compared to an identical 93.5% accident quarter combined ratio in the fourth quarter of last year.

In the insurance segment, the 2015 accident quarter combined ratio excluding cats was 96.3%, essentially unchanged from the accident quarter combined ratio of 96.4% a year ago. The reinsurance segment 2015 accident quarter combined ratio ex-cats was 90.1%, compared to 87.3% in last year's fourth quarter. As noted in prior quarters, the reinsurance segment's result reflect changes in mix of premium earned, including a much lower contribution from property catastrophe business, as Marc has alluded to.

The mortgage segment 2015 accident quarter combined ratio was 83.1%, compared to 98.9% for the fourth quarter of 2014. It's important to recall that the concept of accident year is more of a P&C concept and not directly analogous to the mortgage business due to their accounting convention. Theirs is much more of a reported year convention.

The full year now, the full accident year 2015 core combined ratio excluding cats was 94.5% versus 94% even for the full 2014 accident year. By segment, insurance group's full accident year ex-cats was 96.1% versus 96.3% in the 2014 year. And the reinsurance group's full 2015 accident year was 93.3% versus 90.7% for the 2014 full accident year. Mortgage segment, on the same basis, was 84.1% versus 89.4% for the full year from 2014. That's the 530 basis points improvement I referenced earlier.

The insurance segment accounts for roughly 14% of the total net favorable development in the quarter. This was primarily driven by shorter-tailed lines from the 2010 to 2013 accident years and longer-tailed lines from the 2003 to 2011 accident years. The reinsurance segment accounts for approximately 80% of the total net favorable development in the quarter, excluding associated impacts of acquisition expenses, with approximately half of that due to net favorable development on short-tailed lines concentrated in the more recent underwriting years and the remaining half due to net favorable development on longer-tailed lines primarily from the 2005 to 2011 underwriting years.

The mortgage segment accounted for roughly 6% of the net favorable development this quarter, which translated to an 8.1% beneficial impact on the loss ratio, resulting from continued lower claim rates from the CMG business we acquired in 2014, along with excellent credit experience to-date on business written since the acquisition.

Some of this favorable development is offset by the contingent consideration earn-out mechanism negotiated within the purchase agreement. This contingent consideration impact, however, in a geography sense is reflected in realized gains and losses and not within underwriting income.

Our core operations across the full 2015 calendar year experienced $272 million of net favorable development, again, net of reinsurance and reinstatement premiums and related acquisition expenses which represent 8.2 combined ratio points, versus $307 million on the same basis in 2014 which represented 8.8 combined ratio points.

The full calendar year net favorable development was approximately 15% in the insurance segment, 80% in the reinsurance segment, and 5% in the mortgage segment.

Approximately 68% of our core $7 billion of total net reserves for losses and loss adjustment expenses are IBNR and additional case reserves, which continues to be consistent across the insurance and reinsurance segments.

The core expense ratio for the fourth quarter of this year was 35.6% versus the prior year's comparative quarter of 34.7%, driven by the U.S. mortgage insurance operations which is operating at a higher expense ratio until this business hits a steady state, as well as the effect of an overall 5.2% smaller core net earned premium base quarter-over-quarter.

The insurance segment maintained a 32.4% expense ratio for the quarter, compared to an identical 32.4% ratio a year ago, reflecting a lower net acquisition ratio offset by an increasing operating expense ratio. However, we continue to focus on the total expense ratio, as mentioned in previous calls, since the slotting of costs and benefits within the net acquisition and operating expense ratios is somewhat artificial, and ceding commissions booked are wholly booked in the net acquisition line and not allocated to every operating expense category that they represent.

The reinsurance segment expense ratio increased from 32.5% in the fourth quarter of last year to 36% this quarter, primarily reflecting a 14% lower net earned premium base. The reinsurance segment expense ratio was also weighted, though, by a reimbursement reflecting a favorable tax ruling affecting federal excise taxes.

The ratio of net premium to gross premium for our core operations in the quarter was 71.6% versus 75% a year ago. The insurance segment had a lower 66.4% of ratio compared to 69.18% a year earlier, driven by increased sessions on a larger alternative markets book that we've commented on in the past, increased sessions on capacity-driven product lines and a reduction in our P&C program business which is kept predominantly net.

It is important to note that, on a written basis, the front-end gross commission ratio decreased by 110 basis points and the average quarter share commission ratio improved by 260 basis points in the U.S. operation. These joint improvements will continue to be felt as they are earned over the next few quarters.

In the reinsurance segment, the net-to-gross ratio was 76.2% in the quarter compared to 85.5% a year ago, primarily reflecting sessions to Watford Re. Also, as commented on during the last quarter's call, last year's fourth quarter call, there was a one-time $50.2 million unearned premium reserve transfer associated with Gulf Re, which correspondently required a $50.2 million written premium to be recorded as well.

This distorts the quarter-over-quarter comparison and can be seen in the financial supplement within the property other than property cat line of business. Adjusting for this, our unearned premium reserve distortion results in the net written premiums for the total reinsurance segment this quarter declining by 8.7% quarter-over-quarter.

The mortgage segment, in addition to the premium growth that Marc mentioned earlier, had approximately $3.5 million of other underwriting income in the quarter from risk-sharing transactions receiving derivative accounting treatment and $4.6 million of underwriting profit associated with risk-sharing transactions receiving insurance accounting treatment. Over time, it is expected that more income will emanate from transactions receiving insurance accounting treatment than derivative accounting treatment.

The other segment being wholly Watford Re at this point reported a 103.8% combined ratio for the quarter, $96.2 million of net written premium and $119 million of net earned premium. As a reminder, these premiums reflect 100% of the business assumed rather than simply Arch's approximate 11% common share interest.

As for business sourcing, approximately 37% of the gross written premium this quarter was written directly on Watford paper, with the remainder ceded by Arch affiliates. It should be noted that the sourcing can vary materially quarter-by-quarter.

The total return on our investment business portfolio on a local currency basis was a reported negative 10 bps in the quarter, as Dinos mentioned, reflecting positive returns of our equity sector that were more than offset by negative returns in both investment-grade and non-investment-grade fixed income as well as the alternative investment portfolio. Even with our shift into a greater equity and alternative allocation over time, 80% of the portfolio was still comprised of fixed income securities.

On a U.S. dollar basis, total return for the quarter was a negative 33 bps. On a full 2015 calendar year basis, total return on a local currency basis was a positive 162 bps. And on a U.S. dollar basis, the return was a positive 41 bps for the year, led by the equity and investment-grade fixed income sectors.

The embedded pre-tax book yield before expenses was 2.16% as of year-end, and duration remained fairly consistent at 3.43 years. Fixed income duration, as we've said in the past, can fluctuate due to tactical decisions as opposed to long-term strategic shifts. And the current duration continues to reflect our conservative position on interest rates in the current yield environment.

Reported net investment income in the quarter was $67 million or $0.53 per share, versus $67.3 million in the 2015 third quarter or $0.54 per share, and $72 million or 56% share in the fourth quarter a year ago. As always, we evaluate investment performance on a total return basis and not merely by the geography of net investment income.

Core cash flow from operations, as Dinos mentioned, was approximately $100 million in the quarter versus $227 million in the fourth quarter of last year. This reduction primarily reflects higher ceded reinsurance payments in total across all reinsurers and retrocessionaires, as well as some timing differences associated with Watford Re ceded payments.

It also reflects lower gross premium collections, reflecting the drop in volume, particularly from the loss of a large MTA (31:16) acquired by a competitor within our insurance group, as has been discussed in previous calls, and a lower level of paid reinsurance recoveries received due merely to timing differences.

The full calendar year 2015 core cash flow from operations was $705 million versus $998 million – $705 billion versus $998 million in this full – I think I misspoke that. The full calendar year 2015 core cash flow from operations was $705 million versus $998 million in the full 2014 calendar year.

Core interest expense for the quarter was $12.8 million, which is consistent with our longer-term run rate. Consolidated, therefore inclusive of Watford, interest expense was $15.8 million, and since because we consolidate Watford, approximately $3 million of interest expense is associated with the use of leverage within Watford's investment portfolio. And as you recall, roughly 11% of Watford's results impact Arch's financial statements.

Our effective tax rate on pre-tax operating income available to Arch shareholders for the fourth quarter was an expense of 6.9%, compared to an expense of 1.7% in the fourth quarter of last year. The full-year effective tax rate on pre-tax operating income was 5.1% versus 2.4% for 2014 calendar year. This reflects $2.9 million or 26% of this quarter's total tax being a true-up of the first three quarters of the year to this 5.1% annual tax rate.

Fluctuations in the effective tax rate can result from variability and the relative mix of income or loss reported by jurisdiction, as was the case in this quarter. Our total capital was $7.1 billion at the end of this quarter, up 0.6% relative to September 30 and up 1.1% relative to 2014.

Our debt-to-capital ratio remains low at 12.6%, and debt plus hybrids represents only 17.1% of our total capital, which continues to give us significant financial flexibility. We also continue to estimate having capital in excess of our target position.



During the full 2015 calendar year, we repurchased shares at an aggregate cost of $365 million versus the 2014 share repurchase aggregate cost of $454 million. This represents 71% of net income during 2015 and 56% of net income during 2014.

Book value per share was $47.95 at year-end, up 0.6 points and up 5.2% relative to a year ago. This change in book value per share this quarter primarily reflects the company's continued strong underwriting performance, virtually offset by the challenging quarter in the financial markets.

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

# Q&A

## Operator

Thank you. Our first question comes from the line of Sarah DeWitt with JPMorgan. Your line is open.

## Q - Sarah E. DeWitt {BIO 18946247 <GO>}

Hi. Good morning.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Good morning.

## Q - Sarah E. DeWitt {BIO 18946247 <GO>}

Just on the mortgage insurance business, I just want to get your latest thoughts on the growth opportunities there. You've probably seen some of the mortgage stocks are down 40% in the past six months on concerns about growth, pricing and competition. So I'd be interested in your latest thoughts on that sector.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, as I said in my prepared remarks, we like the environment in this sector. The underwriting quality of these mortgages is very high. The macroeconomic conditions, they're positive. You will get fluctuations on a quarter-to-quarter basis on demand. There's nothing we can do about the demand. However, let me point out to you that the GSEs are through the bulk transactions. They're transferring a much more significant portion of the risk to the private market. So there is ample opportunity on these risk-sharing transactions to expand the demand for transferring risk to the private markets which would participate. So, that is the environment.

As far as pricing, yes, there's been spots of competition, especially on the lender single premium sector, but we've seen that easing in the first quarter on the basis that, with the PMIERs and the capital requirements from PMIERs coming into effect, there is a higher capital charge on discounted LPMI business. So, in essence, we've seen not only us doing a lot less in that sector, but some of our competitors doing less. So we're very, very bullish on that.

But I'm going to turn it over to Marc Grandisson to give a little bit of the color, because he is embedded in that business and he has been since the beginning. So he probably knows more detail than I do.

## A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. At a high level, I think the U.S. MI – if I break it down in two pieces or two areas – is the credit union channel that we have. We had already a very significant market share. We're maintaining and actually growing it somewhat. So the growth there is going to follow the overall market growth in MI origination and MI purchases.

The bank channel is going through a tremendous growth over the last year and most of the growth on the MI are – in fact, pretty much 90% of the growth comes from the bank channel. We're still in the early stages of establishing our presence, establishing our relationships, and contacting our clients and growing that and establishing the pipes, if you will, to deal with this.

At the same time, we have, as you know, established RateStar, and RateStar's initial – as Dinos and I have noticed so (37:46) and we see the numbers. It's been a very initial, very good response from the market. And that, I think, will lead to, hopefully, giving us more penetration in the bank channel for the next 12 months.

And that's not even counting the U.S. risk-sharing that Dinos mentioned. The new mandate, the new scorecard, the new – and evaluation that the FHFA will do for the GSEs, they have to – from our expectations right now, the GSEs will have to in the risk-sharing transactions probably buy 50%, possibly more over 2016 versus 2015. So, that's actually a very bullish statement that private market is going to get a bigger place at the table.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Yeah. Let me add also one more point. It's more subtle point but I think it's important based on where the financial markets are today. At the end of the day, we're one of two or three of the highest rated MI companies. And I believe that a lot of the originators, I don't care if it's commercial banks or mortgage originators, et cetera, they're going to stop paying more attention to where they're placing their business.

Even though they're not a counter-party, Fannie and Freddie are the counter-party, I think it's prudent to be placing your business with more highly-rated financial companies. So we're bullish about that because I think it's starting to be recognized especially by the small banks that, hey, we'll rather do business with people that they have a better, stronger financial rating than others who don't.

## Q - Sarah E. DeWitt {BIO 18946247 <GO>}

Okay. Great. Thank you. And then, on the excess capital, I know it's a high class problem. But given the stock back above a level where you'd repurchase stock, how do you think about deploying that, and how long would you sit on the excess capital if the valuation stays at these levels?

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, we don't try to sit on excess capital. I mean, at the end of the day, we look at opportunities to deploy as much of our excess capital. Our first choice is to deploy it in the business. As we can see now, most of our opportunities, they're coming on the mortgage side. And when we get dips in the market, as we have seen in the first quarter, and literally our stock got punished unfairly as far as we're concerned. But at the end, it gave us the opportunity for us to buy some of our shares back.

If people don't like them at certain price, we like it, and that's the opportunities. We take advantage of it. It was in the closed window by the way. And I did put a 10b-5 plan that it worked for us, and it gave us the opportunity to purchase 1 million shares at reasonable pricing as far as we're concerned.

So we're going to continue with that philosophy. And I believe we're going to get opportunities as the market is starting now with some of our competitors to be putting pressure on their financials that we can deploy more capital in the business because, at some point in time, it's going to improve.

Now, if you look at it quarter-to-quarter, you might be too anxious. We have a more longer-term view. We look at it on year-over-year. And I don't mind carrying a certain amount of excess capital for the next year or so in order for me to have my powder dry in case I get opportunities to deploy.

## Q - Sarah E. DeWitt {BIO 18946247 <GO>}

Okay. Great. Thank you for the answers.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

You're welcome.

## Operator

Thank you. Our next question comes from the line of Vinay Misquith with Sterne Agee. Your line is open.

## Q - Vinay Misquith {BIO 6989856 <GO>}

Hi. Good morning. So the first question is on RateStar. I believe you mentioned 783 players have signed up for RateStar, if I'm correct. How many of them are the large players? Are you getting any of the large mortgage insurers, I mean – or the large banks signing up for this program?

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

In general, the smaller banks and the smaller-in-size originators, they embrace RateStar more than the larger banks. But as you know, we give the opportunity to all of our customers to choose either RateStar and/or the rate card. We haven't abandoned the rate card.

What the RateStar does, it tries to evaluate the specific characteristics of a particular mortgage and try to asses that risk and put the appropriate price on that risk. We have not changed our ROE expectations for the entire book of business. We're pricing the business – as a matter of fact, we believe RateStar will give us even better ROEs than the old rate card. But that has been the environment.

The incredible thing about RateStar is that we have the ability, live, to see every single originator who is using the system. So, independent if that mortgage is going to be placed with us – the mortgage insurance is going to place with us or not, we see every single originator, every mortgage officer who is live on our system instantaneously.

So we monitor the volumes, we see who is using it, and which territories they're using, et cetera, which for us is an incredible thing, especially also from a marketing point of view. Because, to tell you a truth, we find some banks that maybe three, four or five of their loan officers use RateStar significantly, and the other three, four, and we know all of them by name, don't use it at all, and then it gives us an opportunity to go and have probably the conversations as to why, why not.

So, Marc, do you want to add anything on the RateStar?

## A - Marc Grandisson {BIO 4369887 <GO>}

No. The only thing I will concur and further confirm that there's – the highest level of application that we receive are coming through the regional and commercial credit union channel. The banks are bigger, a bit longer to go over and make the change and adopt the RateStar application. But we – it's going to take time, but we're going to get there.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Yeah. We have approvals on RateStar, I believe, on 46 states.

## A - Marc Grandisson {BIO 4369887 <GO>}

Correct.

## Q - Vinay Misquith {BIO 6989856 <GO>}

Right. And have you seen a pickup in business from RateStar? And I believe one of your large competitors are not doing it. Have you seen some more competitors trying to do something similar to what you're doing?

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, early sign is a little bit of pickup, where we see - we see more of a pickup in utilization. But, like I said, we only released this about two months ago. It was early December. Now, we're in February. Sometimes, the process takes six weeks to eight weeks for a mortgage to be placed. But, clearly, there is a noticeable uptick in the utilization of the system and the applications that they go through the RateStar and they get a quotation for that mortgage insurance.

Now, if that loan is going to be made and if they're going to place it with us, because I'm sure they're comparing what our price is versus a rate card from some competitor, it's too early to tell, but I'm optimistic.

## Q - Vinay Misquith {BIO 6989856 <GO>}

Sure. And are you seeing other competitors also do something similar to your RateStar?

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Marc, you close it.

## A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. You heard the call on Radian and MGIC. I mean, you can go through that and hear what they have to say, and there's definitely a trend in the industry to go in that direction to actually try and address the inefficiencies, frankly, that resides within the rate card pricing to better address and better assess the risk within a portfolio.

But I need to remind you, as Dinos and Mark did on last call, that that endeavor of ours to create RateStar took over a year to put together. This is no small feat. It included having an amazing dedication and a big group of our people to really put it together. So I would not be surprised - I know I can't speak to them, but I won't be surprised that our competitors feel compelled to have to react to this as well.



## A - Constantine P. Iordanou {BIO 2397727 <GO>}

It's predictive analytics. Independent - if you've seen the auto insurance business or in the mortgage insurance business, et cetera, it's the norm now. And if you're not willing to assess risk appropriately and price it appropriately, at the end of the day you might be subject to adverse selection over time, and we don't want to be in that category. So we do challenge our people to create that innovation independent of the work effort that's involved.

Believe me, it's a five-quarter effort. I was involved in it. Marc Grandisson was involved in it. And all of our CEOs, from Andrew Rippert to David Gansberg and his team in Walnut Creek, we've put a big effort to do this. This is not something that, as one of our competitors says, it's just some black box that spits out. There's a lot of effort, a lot of analytics, a lot of historical data that we have used both from within the old PMI books that we're running off on behalf of the regulator, but also with external databases that deal with mortgage risk.

And we're proud of what we have achieved. And believe me, it's still a work in progress. We will continue to improve it and improve it and improve it because it's not something that is static. As we learn about the predictability of the model, then we will adjust. And it's no different what we've done on the cat business, right? And you've seen our performance on the cat business.

I think we have fared well over the years taking catastrophic risk because, at the end, we - let's face it. I'm the only known actuary in the senior management team. I think they're ready to expel me from the group. Everyone we have is a quant (49:19) here except me, but I keep up with them. Everyone has grouped (49:23) for me.

## A - Marc Grandisson {BIO 4369887 <GO>}

Yes. (49:24)

## Q - Vinay Misquith {BIO 6989856 <GO>}

Sure. That's helpful. Just one follow-up, just some numbers questions, if I may, really quick. So first is on the expense ratio. So, just on the operating expenses, those were higher this year versus last year. Just want to know if you plan to keep them flat next year. And the second piece is on the P&C insurance on the acquisition expense ratio. Do you expect that to decline this year because of higher ceding commissions?

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, Mark, do you want to address this?

## A - Mark Donald Lyons {BIO 6494178 <GO>}

Yeah. Let me do it...

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

And this is Mark Lyons. Because I've got two Marks. I've got Mark square now, so.

## A - Mark Donald Lyons {BIO 6494178 <GO>}

Hopefully not a third phone call question mark. So let's take in reverse order. I think this is the third quarter I commented on the quota share improvement on the Freddie ceding commissions and it's been about 260 bps. It fluctuates a little bit, 260 bps. I think the proportion getting that is increasing. So you get more of a gearing factor, firstly.

Secondly, I'm quoting those on a written basis, so you asked a semi-forward question. We don't give guidance, but I think it's fairly straight forward that if you're getting those kinds of benefit on a written basis, they're going to eat their way in over the next three or four quarters. So I think it's reasonable to expect improvement and then likely flattening at that point. However, there is continued improvement in the gross commission ratio, mostly as a function of mix, and that was 110 bps. And that's a big part of reason for it as well.

On the OpEx side, let's say we like to look at these things in total. On the insurance group side, you had some specials in there that were related, I think, to our UK operation. We had some compliance things we dealt with. We had some Lloyd's cost. We had some overlap of some IT, which I view as non-recurrent, shifting from exchanging to an internal facility we have in the Philippines, actually, which I view those as non-recurrent. And the reinsurance – the mortgage stuff side we know about. That has to come up to scale.

I think on the reinsurance side, that was dominated by the reduction in the net earned premium. There's a little accounting going on when we brought Gulf Re in. But roughly an additional $2 million of costs that come in more explicitly because Gulf Re is now a profit center within the reinsurance group whereas before was more equity accounting.

## Q - Vinay Misquith {BIO 6989856 <GO>}

Right.

## A - Mark Donald Lyons {BIO 6494178 <GO>}

So, a little of that sleight of hand. So, to make the long story short, I would expect continued improvements on the ceding commissions and insurance group, and I would expect increasing management and flattening on the OpEx side.

## Q - Vinay Misquith {BIO 6989856 <GO>}

Sure. Thank you.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Let me give you also a little bit of the strategic view that we have when it comes to expenses. I said many times in many calls, we're not willing to part with our underwriting capability. So we're going to maintain underwriters even if the market might cause us to reduce writings because we're going to maintain – the two religions we have is underwriting discipline and complete commitment to our good people, especially on the underwriting side.

Having said that, we expect our managers to chew gum and walk at the same time. And as a company, we have a very good turnover ratio, but still we have a turnover ratio which is around 11% on an annualized basis. So, within that parameter, you try what I would call on non-critical underwriting jobs to make adjustments on your expenses through natural attrition. And that's been our philosophy from day one. A well-managed company plays with those parameters and make the right judgment.

And our people, they're very good and very flexible and they accept reassignments and we move them from one operating unit to another where the opportunities are plentiful, especially if where they work in, we have to reduce volume.

So, with all that in the mix, I think, Mark, and you got into the minutia, you got into the nitty-gritty on the financials. But I want you to get the flavor of our philosophy and how we're going to operate the company.

## Q - Vinay Misquith {BIO 6989856 <GO>}

Sure. That's helpful. Thank you.

## Operator

Thank you. Our next question comes from the line of Amit Kumar with Macquarie Capital. Your line is open.

## Q - Amit Kumar {BIO 19777341 <GO>}

Thanks and good morning to two Marks and one Dinos. Just very quickly going back to the realized losses line, did you talk about what exactly was going on in the Watford segment and why it had a realized loss?

## A - Mark Donald Lyons {BIO 6494178 <GO>}

No, I have not talked about that. But I'll take that as a gas pedal. Well, I guess a couple of things. First off, as you know, we kind of report Watford results. We don't drive Watford's investment results. We're a minority owner, as you know. But as far as the accounting world of it, they have elected the fair value option on investments. So, in their line of realized gains and losses, it's actually the sum of realized and unrealized gains embedded in there. So, hopefully, you find that helpful.

## Q - Amit Kumar {BIO 19777341 <GO>}

Got it. And for the ex other segment, what did those realized losses stem from?

## A - Mark Donald Lyons {BIO 6494178 <GO>}

Well, that's I'll call it harvesting or reverse harvesting. But it's just your standard churn of fixed income and other investments that would have occurred throughout the course of the quarter.

## Q - Amit Kumar {BIO 19777341 <GO>}

Okay. I was just trying to figure out if there was anything more going on. That's helpful. The other question I had, going back to the - obviously you spend a lot of time discussing RateStar, and you are correct, other competitors are talking about it, and it's similar to auto insurance where there's an early adopter advantage.

How should we think about sort of the timeline here where you still have that early adopter's advantage for some time before others catch up? Is it fairly easy for them to sort of get up to speed as to what you're doing because it has been done before and it sort of puts you at parity at some point of time? Or is there so much of a separation that it'll take a long period of time for the NMIs or ABNs or others to really catch up with you? How should we think about that?

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

The way you think about it, if you remain standing still, they're going to catch up to you, but we keep walking. I think, as a matter of fact, I hope our guys, they keep running because – and improving it, et cetera.

At the end of the day, it's how good is your thought process, what kind of algorithms that you build into it, how much of empirical data and whatever database is that they give you predictive analytics you're incorporating. And this is not nuclear physics. We're not putting the next man in the moon, but it requires a lot of effort.

I don't know how quickly they can catch up. It depends on to what kind of resources they throw at it. But I can tell you, it was not a small effort on our part. But we're behind it. We incurred the expense. We had a lot of our very senior guys working on it, because both me and Marc Grandisson, and Andrew, and David Gansberg, we were very committed that that's the way for the future. So we made it a very senior priority within the group to do this. Then this is five quarters ago. This is not today.

So, Marc?

## A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. I think from our perspective, it is a competitive advantage. I won't say (58:04) we were first mover because you rightly pointed out that some others have done it, I guess, other competitors have done in fact. But clearly, this is creating, we think, some breathing air, some headwind for us at least now, because of the fact that we already have installed it, it's being used by our client. And we actually are going to be dynamic, as Dinos said, going through the portfolio, analyze it, and modify and adjust it as we go forward. So we feel pretty good where we are.

## Q - Amit Kumar {BIO 19777341 <GO>}

Got it. And then, final question related to that. Does the ratings downgrade of Genworth from S&P and Moody's, does that create a meaningful opportunity for the marketplace? How should we think about that?

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

It's too early to tell. So far, to my surprise, I'm hopefully a financial executive with average intelligence. I would have thought that credit on a credit business will have more of an effect as to who gets the business. But to my unpleasant surprise, it seems that a lot of the mortgage originators sometimes don't care as to where they place the business because at the end they're not the counterparty, Fannie and Freddie is. But I don't think that's the wise choice for them to do. For the time, I believe that will have to have some effect because why would you continue doing business with somebody financially challenged? But I leave that up to the market to determine.

## Q - Amit Kumar {BIO 19777341 <GO>}

Got it. Thanks for all the answers and good luck for the future.

## Operator

Thank you. Our next question comes from the line of Charles Sebaski with BMO Capital Markets. Your line is open.

## Q - Charles Joseph Sebaski {BIO 17349221 <GO>}

Good afternoon.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Hi. Good afternoon.

## Q - Charles Joseph Sebaski {BIO 17349221 <GO>}

Another question on mortgage. How much of your business in 2015 was refi versus purchase?

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Marc will give you that number in a minute. I think you can dig it up.

## Q - Charles Joseph Sebaski {BIO 17349221 <GO>}

I guess I just wonder on the U.S. side if there's a potential slowdown on refi just due to how long interest rates have been down at this level, if that's at all a headwind for you guys in that business. And I guess...

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, I mean, refi creates more opportunities to write more insurance. And if you're penetrating the market, refis have an effect on us because at the end of the day, we like more refis along with new originations, but I don't know.

Marc, do you have the number? We can always offline – Don Watson will give you the percentages. I don't have all the books in front of me right now.

## Q - Charles Joseph Sebaski {BIO 17349221 <GO>}

Okay. Well, and then looking at that, is the mortgage insurance part of the driver and the change to the effective tax rate this year? If we kind of look at 2015, a bit over 5%. Is that a reasonable expectation for 2016 or going forward? Or does the growth in U.S. mortgage have a lifting effect on overall consolidated tax rate?

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, Lyons will give you the answer to that.

## A - Mark Donald Lyons {BIO 6494178 <GO>}

Yeah. I love taxing questions. So, Chuck, it's a good point to bring up. It's partially contributory. There's a lot of areas in higher tax jurisdictions like that that had very good results in the year, mortgage being one of them, our Arch Re Facultative group, our Morristown Arch Reco operation and the core insurance operation. So, a lot of that kind of skewed it.

So, as mortgage becomes a higher proportion of total and as we continue to have these margins, it will only creep up the effective tax rate, keeping everything else constant. We don't know what's going to happen in the PC dynamics.

## Q - Charles Joseph Sebaski {BIO 17349221 <GO>}

Okay. I guess – and then finally, on the P&C side, on the programs, I think you said you had a large non-renewal of a program this quarter. And wanted to kind of get your take on is that a competitive reason? Was that just an absolute result? I guess I'm trying to get some insight on what's going on, on the smaller account risk side of the insurance business because a lot of competitors keep talking about that as a means to deal with the pricing in the large account space.

## A - Mark Donald Lyons {BIO 6494178 <GO>}

Right. Well, it's good to be in a position where we've had it for years and years rather than trying to gain it. So there's more renewals to us than new business to others. And in a tough market environment, getting it on a new basis is a little tougher.

Chuck, it was a program that was bought by a competitor. It was fairly large. It was, on an annualized basis, north of $80 million, hence $20 million in the quarter if we end up flat on it. And we talked about action in other ones, but for calendar 2015, they're immaterial. And this is one program that really affected it.

## Q - Charles Joseph Sebaski {BIO 17349221 <GO>}

Okay. I guess your competitors as well, which you guys fortunately haven't seen, is some adverse development in some of the lines. So I was wondering if there's any comment on loss cost trend going on on some of the longer-tail liability lines. Have you seen any changes coming up or things kind of just status quo as they've been in the last few quarters?

## A - Marc Grandisson {BIO 4369887 <GO>}

We have very favorable loss cost trend across. But we do an analysis every year. But we have not seen anything in the data that makes us change our expectation of loss cost trend. It's still pretty low, but it's very stable for the last couple of years.

## A - Mark Donald Lyons {BIO 6494178 <GO>}

I mean, Chuck, as we've talked about in the past, it's a different story by area. Mark's right. Across the board weighted, we don't see anything material happening. You probably saw all that securities class action suits, for example, that kind of returned to a long-term normal or it had been below normal, things like that. But luckily, we don't seem to get hit by a lot of the SCAs. So we'll make that someone else's problem.

## A - Marc Grandisson {BIO 4369887 <GO>}

Yeah.

## Q - Charles Joseph Sebaski {BIO 17349221 <GO>}

Thank you.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Marc, you got the number?

## A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. Charles, I have the answer. I want to make sure I got the numbers right before I quote it. It was a market where it was mostly a purchase market. 75% purchase, 25% refi. As you know, the mortgage rates went up and it became more of a purchase market in the fourth quarter.

## Q - Charles Joseph Sebaski {BIO 17349221 <GO>}

Excellent. Thank you very much for the answer, guys.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

You're welcome.

## A - Marc Grandisson {BIO 4369887 <GO>}

Thanks, Chuck.

## Operator

Thank you. Our next question comes from line of Michael Nannizzi with Goldman Sachs. Your line is open.

## Q - Michael Nannizzi {BIO 15198493 <GO>}

Thanks. Just a couple of numbers ones, if I could. In the mortgage - or I'm sorry, in the reinsurance segment, Mark, could you quantify the impact of that tax item that you talked about in your script?

## A - Mark Donald Lyons {BIO 6494178 <GO>}

Yeah. Well, that wasn't really in the reinsurance segment. That was overall. That was $2.9 million, which I said was 26% of the total tax on pre-tax operating income. That's because the effective tax rate is 5.1% for the year. It was less than that. As of third quarter, we have to true it up. We have to bring them up to the same level. I stated...

## Q - Michael Nannizzi {BIO 15198493 <GO>}

Maybe we're getting our signals crossed. I thought you said in the script that there was some settlement of some tax matter?

## A - Mark Donald Lyons {BIO 6494178 <GO>}

Oh, I'm sorry.

## Q - Michael Nannizzi {BIO 15198493 <GO>}

All right.

## A - Mark Donald Lyons {BIO 6494178 <GO>}

I'm sorry. And we're not alone in this. You probably heard it on some other calls.

## Q - Michael Nannizzi {BIO 15198493 <GO>}

Yep, yep.

## A - Mark Donald Lyons {BIO 6494178 <GO>}

It's the favorable tax ruling with regard to cascading FET where we had paid it in the past and then the favorable ruling came down. So it was the reimbursement associated with the prior cost expenditure.

## Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. And that rolled up into the other operating or in the acquisition?

## A - Mark Donald Lyons {BIO 6494178 <GO>}

Well, there's some in insurance, there's some in reinsurance. It's mostly in acquisition.

## Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay, okay. And then, just trying to figure out, like, what we should be thinking about on the forward inning where we could sort of get some quantification of that?

## A - Mark Donald Lyons {BIO 6494178 <GO>}

Well, it was about $3 million.

## Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay.

## A - Mark Donald Lyons {BIO 6494178 <GO>}

And it's for one-time.

## Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. Okay. And then, sticking to reinsurance for a sec, the other operating expense there. I mean, how should we be thinking about that on the forward? Dinos, I think you might have mentioned talking about redeploying folks from one place to another. If we continue to see the business there kind of recede, just given a lack of opportunities there to invest, do you see that – is that an area where we would see that coming down, or do you expect to maintain your infrastructure there?

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

You got to break it into components, right? You got to break it into components. So how much is internal expense and how much is commission, ceding commissions, et cetera. If you don't write the business, you don't have the ceding commission expense.

Our intention is, and I've said it many times, and I know Marc Grandisson and I, we see eye-to-eye to it, we have no intention of eliminating underwriting capabilities we have. I'm not going to give my underwriters to the competition.

So we're going to maintain that because our view of the market is more long-term than short-term. These are the same underwriters that generated significant profits for us when the market was good for reinsurance, and that market will come back again to supply and demand, and at some point in time, it will readjust.

So, from that perspective, for you when you're looking at your numbers, look at the operating expense, break it down into what's internal versus external, meaning ceding commissions and all that. And the internal run rate we're going to maintain, because I don't expect us to reduce our underwriting capability.

## Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay. And then, just sort of thinking about the underlying loss ratio there in reinsurance. I mean, you saw year-over-year improvement despite some mix shift away from what I would guess are higher profitability property lines at least relative to the rest of the book.

How should we think about that? I mean, was there anything sort of happened either in the quarter or the year, just top of your mind maybe, Mark, just that helped to support that result? Or do you feel like 2015 was sort of what it was and that's a good starting point to think about for the future?

## A - Mark Donald Lyons {BIO 6494178 <GO>}

Well, there's always seasonality in the business, firstly. So you got to watch the serial comparisons. But there is some of the mix differences. I mean, the Facultative unit performed well as it generally does and degree by which it well varies quarter-by-quarter.

But as Marc said, the property cat being de-emphasized and if it continues where the margins are not, then we're likely to continue in that way. So the third-party businesses – and the other opportunities that they've been getting there, I'll call, out of-the-mainstream opportunities continue to be in the pipeline.

So it's a little hard because it's probably only half of the business. It's probably what I'd call standard business at this point. But I think fourth quarter is more of a reasonable go forward.

## Q - Michael Nannizzi {BIO 15198493 <GO>}

Yeah.

## A - Marc Grandisson {BIO 4369887 <GO>}

I think to further add to this, we're focusing on returns always and we have very, very agile underwriting teams across the platform and regions and able to maneuver in and out of markets as they see the returns get better or worse. A great example, as I mentioned in my notes, is the UK motor. It has a higher loss ratio component by virtue of being a quota share. You're not going to get a 20% loss ratio on that business unless that's under extreme circumstances. So we are expecting to have a higher loss ratio.

But in the end, we don't worry so much about the components of the loss or expense. We worry about the margin that we can derive from the business. And as I will echo with what Dinos has said, I mean we have a pretty decent, agile team that's able to seek and source and seek and capitalize on opportunities. And we have more always.

## Q - Michael Nannizzi {BIO 15198493 <GO>}

Great. And then, just maybe one last quick one if I could on the MI. Can you break down how much of the action in your underwriting profitability has come from U.S. MI versus whether it's reinsurance or the other business?

## A - Mark Donald Lyons {BIO 6494178 <GO>}

No. We generally don't talk about that. We review it and we manage it in a total segment basis. So the whole strategy that Marc and his team, Andrew and his team has is they balance the mixture of that, but they have a common macroeconomic view and everything else. So we tend to look at in totality and report in totality.

## Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay. Got it. Thank you so much.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

You bet.

## Operator

Thank you. Our next question comes from the line of Josh Shanker with Deutsche Bank. Your line is open.

## Q - Josh D. Shanker {BIO 5292022 <GO>}

Yeah. Good morning, afternoon. Thanks for taking my question in the long hour.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

It's souvlaki time.

## Q - Josh D. Shanker {BIO 5292022 <GO>}

You've got souvlaki this time. I don't want to keep you. So here's a quick question...

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

No, no, no. Go ahead. Go ahead. We've got plenty of time. We can wait.

## Q - Josh D. Shanker {BIO 5292022 <GO>}

No, no. That's it. I'm done. I'm done. No, I'm kidding. The Australian business, how should we think about revenue going forward for the Australian business?

## A - Marc Grandisson {BIO 4369887 <GO>}

It's hard for me to tell what's going to happen. It's an ongoing – the relationship that we've established, as we mentioned over last year, it's been very fruitful. The quota share agreements that we have with one of the major lenders down under, we have – it's ongoing. There are things going on down under as you know. We have various option that we're looking at. So it's really hard for me to tell you how it's going to go for the next year.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

It won't be any less, but we can – we don't know, hard to say what the new opportunities are because we're engaged in a lot of discussions. Sometimes they have food and sometimes they don't.

## Q - Josh D. Shanker {BIO 5292022 <GO>}

Is it going to be lumpy by necessity?

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

No, it would be steady, lumpy on the upside if we do other transactions.

## Q - Josh D. Shanker {BIO 5292022 <GO>}

Right.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

And if we interrupt a relationship, it can be lumpy on the downside, but we don't anticipate that.

## A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. I think, Josh, I will say it's going to be lumpy on the written base, because the business in Australia is written all upfront. The earning is going to take years to go. So, a bit more stability on the earnings over time but the written, yes, rightfully could be very lumpy.

## A - Mark Donald Lyons {BIO 6494178 <GO>}

And just to reemphasize and clarify that, Josh, because I think it's easier to get some confusion. That deal is not a single upfront premium like in the totality to the exposure. Instead, it's a single premium market in Australia. So you're going to have - there is no monthly really. So it's going to be a series of singles that come out through month-by-month-by-month that come in, and we'll record accordingly.



## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Yeah.

## A - Mark Donald Lyons {BIO 6494178 <GO>}

So, not an upfront number.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Right. It's quite mortgage-by-mortgage-by-mortgage-by-mortgage. And you're earning that over the duration of that and it's a long duration, seven years, eight years, nine years.

## Q - Josh D. Shanker {BIO 5292022 <GO>}

Very good. And on Watford, and I don't know enough about the investment strategy at Watford. It looked like the investments had a good quarter last quarter. Now, we're in this bumpy market right now. How should market volatility affect investment results at Watford?

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, I mean we don't make those decisions, Highbridge makes that. But, in essence, their approach hasn't changed. I know when the spreads have widened, they're going to take marks. But they feel comfortable with the quality of the portfolio and the embedded yield which is in the 7% and higher. And now it will be a question as to where the economy goes and would they have any deep holes.

But we don't see – based on our reviews that we get on a quarterly basis as a 11% owner, we don't see significant risk to that. They analyze every investment one-by-one, and they put probabilities of the fall and recoveries. And it depends where the economy goes. But if we don't have a recession, I think they are in good shape.

## Q - Josh D. Shanker {BIO 5292022 <GO>}

Okay. Thank you very much. And should there be another questions, enjoy the souvlaki.

## Operator

Thank you. Our next question comes from the line of Meyer Shields with KBW. Your line is open.

## Q - Meyer Shields {BIO 4281064 <GO>}

Great. Thanks. Two quick mortgage questions, if I can. First, if you look over, I don't know, fourth quarter conference calls, a lot of (01:15:55) are talking about mortgage reinsurance. Are you seeing a more competitive market in general for that?

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

A little bit more, but I don't think it's the competition. It's more participation and a lot of that we see in the bulk transactions that the GSEs, they're purchasing now for the 20% to 40% downpayment. This is the 60% to 80% LTV business that the GSEs buy through the STACR and Connecticut Avenue Securities transactions in the market. And you have a broader participation there by other reinsurance. And of course, some of the MIs that they needed to comply with the PMIER capital requirement, they might have done some transactions in order for them to come up to the capital standards that they need to prove to the GSEs that they're compliant. But I don't see a major change of that going forward. I think most of that participation is going to happen on the bulk transactions. Marc...

## A - Marc Grandisson {BIO 4369887 <GO>}

I agree with you.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

...anything else you wanted to add to it or...

## A - Marc Grandisson {BIO 4369887 <GO>}

Agreed.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Yeah.

## A - Marc Grandisson {BIO 4369887 <GO>}

Well said.

## Q - Meyer Shields {BIO 4281064 <GO>}

Okay. And then second, as – I get that mortgage, at least, written premium growth is going to be lumpy. But as we see better market conditions there than insurance and reinsurance, does that have an impact on the investment portfolio? Does it give you even more room for longer-term investing philosophy?

## A - Mark Donald Lyons {BIO 6494178 <GO>}

Yeah. Yeah. I would say, Meyer, that it's a function of the duration of the aggregate portfolio at that point in time. So I'd say, as it becomes a higher proportion of total, it's going to inch up duration on it and therefore have it matching on it on the investment side.

## Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Perfect. Thank you.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Don't forget, our investment philosophy is basically on the liability side of the business. We match durations with those liabilities. And on the shareholder capital, we have a view that it can be very short, either zero duration all the way up to five-year duration, depending how our investment committee and the board believes the market conditions dictate. And right now, on the shareholder capital, we're above neutral. So our duration is, what, 3.6 years, Marc?

## A - Marc Grandisson {BIO 4369887 <GO>}

3.4 years.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

3.4 years. And our duration of our liabilities is not that different from that. So we're kind of neutral where we are today.

## Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Great.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

But we can elongate that or go short on that, depending what we do with the shareholders' equity capital.

## Q - Meyer Shields {BIO 4281064 <GO>}

Right.

## Operator

Thank you. Our next question comes from the line of Matt Carletti with JMP Securities. Your line is open.

## Q - Matthew J. Carletti {BIO 5249827 <GO>}

Hey. Thanks. Good morning. I just had a follow-up on Amit's question on the realized losses in the quarter. Mark, that was really hopefully, the kind of color on the other segment and how Watford treats it. But I guess my question is on the subtotal of the operating segments. It's still a pretty big number in the quarter relative to history, at least. Particularly the quarter equities are up. So I'm just wondering, is there any OTTI to note there or performance of alternatives, or was it just kind of more very run-of-the-mill?

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

So our OTTI was very small for the quarter. It was in the single millions of dollars. We have a total return philosophy and our portfolio trades quite a bit, and sometimes you're going to see realized losses coming through because they might be repositioning the portfolio from one security to another, and we take the marks. Where other companies, when they buy and hold, they might have more unrealized marks where we might have more realized.

## A - Mark Donald Lyons {BIO 6494178 <GO>}

There's also been a purposeful repositioning of the portfolio. You've probably noticed that not just the movement into U.S. corporates and municipals, but a de-emphasis of mortgage-backed securities and commercial mortgage-backed securities and so forth, so you can compare it year-over-year. So Dinos's point is right. As you know, as you make these decisions and churns, you're moving them into the bucket of just marks that would be unrealized since the – but that's done with the thought of the future view of the portfolio of returns.

## Q - Matthew J. Carletti {BIO 5249827 <GO>}

Yeah. That makes sense. That makes perfect sense. Thanks for the color.

## Operator

Thank you. I'm showing no further questions at this time. I would like to turn the call back to Dinos Iordanou for closing remarks.

## A - Constantine P. Iordanou {BIO 2397727 <GO>}

Well, thank you all for listening to us and we're looking forward to talking with you in the next quarter. Have a wonderful afternoon.

## Operator

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