Q4 2016 Earnings Call

Company Participants

- Constantine P. Iordanou, Chairman & Chief Executive Officer
- Marc Grandisson, President & Chief Operating Officer
- Mark D. Lyons, Executive Vice President, Chief Financial Officer and Treasurer

Other Participants

- Charles Joseph Sebaski, Analyst
- Elyse B. Greenspan, Analyst
- Ian J. Gutterman, Analyst
- Jay Arman Cohen, Analyst
- Kai Pan, Analyst
- Quentin McMillan, Analyst
- Sarah E. DeWitt, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day, ladies and gentlemen, and welcome to the Arch Capital Group Q4 2016 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 the 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 risk and uncertainties.

Consequently, actual results may differ materially from those expressed or implied. For more information on the risk 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 are subject to the Safe Harbor created thereby.

Management also will make reference to some non-GAAP measures on the financial performance. The reconciliation to GAAP and definition of the operating income can be found in the company's current reports on the 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 hosts for this conference call, Mr. Dinos Iordanou, Mr. Marc Grandisson and Mr. Mark Lyons. Sirs, you may begin.

Constantine P. Iordanou {BIO 2397727 <GO>}

Thank you, Kevin. Good morning, everyone, and thank you for joining us today for our fourth quarter and year-end 2016 earnings call. We have a lot to talk about today, so let's begin with our completing the purchase of United Guaranty Corporation at the end of 2016. The combination of Arch MI and United Guaranty Corporation not only creates the world's largest mortgage insurer but, equally important, brings a culture of both leadership and innovation to the mortgage insurance industry that we believe will benefit our shareholders and customers for years to come.

Merging two companies is no small task, but I'm pleased to say that the integration of Arch MI and United Guaranty Corporation is progressing smoothly. Across our companies, our employees are working hard to ensure that there will be no disruption to our customer base in both the bank and credit union channels.

Now, let me turn to year-end results. We had a good quarter despite noise from acquisition-related expenses and a few other items, which we will discuss in a few minutes. Our reported combined ratio on a core basis - Mark Lyons will define in a moment what core means - increased by two points over the fourth quarter of 2015 to 88.8% as cat losses added four points to our accident year results for the quarter.

For the year ended 2016, our combined ratio was essentially flat at 88.2% compared to 88% for the full year in 2015. The full 2016 accident year, excluding cat, improved to 93.4% on a core basis versus 94.4% for the 2015 accident year. Accident year results were roughly flat in both our insurance and reinsurance segment despite a softening market where our mortgage segment improved its accident year combined ratio year-over-year to 64% from at 84.2% in 2015 year, due primarily to improving profitability at Arch MI.

Even before considering the acquisition, our mortgage segment went from representing 6.4% of net earned premiums on a core basis in full year 2015 to 8.4% for full year 2016. In the future, these will continue to increase based on our own growth in the business and the acquisition of the United Guaranty Corporation.

Loss reserve development remained favorable in each of our segments which in the aggregate reduce our combined ratio by 6.4 points for the fourth quarter and 7.7 points for the year ending 2016. There were no significant changes that we see in the property casualty operating environment for the quarter. Marc Grandisson will elaborate on what we see in each of the markets in a few minutes.

On an operating basis, we produced a return on equity of 9.4%, while on a net income basis, we earn a return on equity of nearly 11% for the full year 2016. Net investment income per share for the fourth quarter was $0.56 per share, up $0.03 sequentially from the third quarter of 2016. On a local currency basis, the total return on our investment portfolio for the quarter was a negative 166 basis points primarily due to the significant increase in interest rates on our very large bond portfolio. For the full year 2016, again, on a local currency basis, our total return was a positive 235 basis points.

Our core operating cash flow was $279 million in the fourth quarter as compared to $99 million in the fourth quarter of 2015. Our book value per common share at December 31, 2016 stands at $55.19 per share, a 3.5% increase sequentially from the third quarter of 2016 and 15.8% increase from the fourth quarter of 2015. Mark Lyons will give more details on the components of the change in book value per share in just a few minutes.

Before I turn the call over to Marc Grandisson, I would like to discuss our PMLs which are essentially unchanged from October 1, 2016. As usual, I would like to point out that our cat PML aggregates reflect business bound through January 1, while the premium numbers included in our financial statements are through December 31 and that the PMLs also are reflected net of all reinsurance and retrocessions we purchased.

As of January 1, 2017, our largest 250-year PML for a single event remains the northeast at $492 million, or 6.6% of common shareholders' equity. Our Gulf of Mexico PML stands at $427 million, and our Florida tri-county PML decreased slightly to $394 million.

I will now turn the call over to Marc Grandisson to comment on our operating units and make some remarks on market conditions. Marc?

Marc Grandisson {BIO 4369887 <GO>}

Thank you, Dinos. Good morning to all. First on this 14th day of February, I would like to wish my wife and daughter the Happy Valentine's Day.

Constantine P. Iordanou {BIO 2397727 <GO>}

You're such a great father and a great husband.

Marc Grandisson {BIO 4369887 <GO>}

Thank you. As Dinos mentioned, the integration of UG into Arch is going very well. Culturally, we are finding that the UG team is basically cut from the same cloth as the Arch team. They have been creative with capital solutions, and we share a pricing philosophy based on risk assessment and also a dedication to analytics and technology development. The combined entities, abilities provide us with a strong and we believe sustainable platform in the U.S. private mortgage insurance space. For the fourth quarter of 2016, Arch U.S. MI excluding UG had new insurance written or NIW of $8.8 billion, about the same level as of third quarter's. On a combined basis, we estimate our primary U.S. market share at approximately 25% to 26% for the fourth quarter including UG, which is line with the third quarter of 2016.

In addition, we continue to lead in the U.S. GSE risk-sharing transactions with approximately $2.2 billion of risk-in-force at the year-end 2016. Our Australian mortgage insurance relationship continues to generate good volume. However, we've increased the level of our Australian quota share retrocession to 37.5% from 25%, for those of you keeping track, which explains the healthy amount of premiums ceded in the segment this quarter. With the acquisition of UG, we have multiplied our U.S. primary risk-in-force by more than 5 times with over 87% of the exposure written up to 2008, a period in which the underwriting quality of the insurance written has been at its peak. The MI data containing the quarterly supplement reflects the quality of the combined primary portfolios with average FICO scores of 743 and a low-90s loan-to-value ratio.

We continue to see favorable reserve development from both legacy MI portfolios, and at the end of the first quarter, we will provide you with more clarity on the progress we're making with the integration process and fully-combined U.S. MI statistics. Switching over to the P&C insurance world; the level of rate decrease had slowed somewhat, but it's still broadly negative. This is especially true for the larger accounts. For that reason, both our insurance and reinsurance groups continue to move towards less-competitive smaller accounts and more specialized areas of the market. We continue to move away from lines such as excess liability, E&S property, and property cat, while focusing our efforts in less-volatile and specialized lines such as travel, differentiated programs or reinsurance of agricultural business.

In our primary U.S. P&C insurance operations, we had margin erosion of 40 basis points for all lines in the fourth quarter and above 100 bps for the full year 2016. For the full year 2016, our controlling and low volatility segment, which represents about 70% of our primary insurance portfolio had rate increases of 210 bps, while our cycle managed business, the remaining 30%, experienced 410 basis points of rate decrease. Our UK insurance operation has experienced similar pressures from a rate level perspective. Rate decreases across all our product lines were 7.6% this quarter, and just as we have discussed in the U.S. we continue to shift to smaller accounts.

On a group-wide basis, we had modest growth in the quarter in our insurance segment's construction, national accounts, travel and alternative markets line. Our executive assurance, E&S property and casualty businesses are areas where current rate levels lead us to a more defensive strategy. Turning over to reinsurance; it's a similar story to our insurance group in that we continue to focus on opportunities with relative rate strength and more favorable return such as facultative, agriculture and motor, while the more commoditized segments such as property cat, excess liability and marine continue to experience rate decreases, and we accordingly are shrinking in those lines. Overall, we estimate single-digit rate decreases across our reinsurance portfolio. At the heart of Arch's long-term success, there are two factors. First, we focus on seeking favorable returns across industry cycle, and then we practice prudent capital and risk management towards maximizing risk adjusted returns.

As we enter into 2017, we continue to do just that. Within our P&C units, we are defensive and shifting our risk exposures to relatively more attractive area. With MI, we have made a strong commitment to one of the best return opportunities available in its specialty area. And we have also improved the diversification of our risk portfolio. Our corporate culture and platform of specialty businesses, we believe, allow us to pivot or to move towards markets where we can earn appropriate returns, while shying away from markets or business lines where the volatility around expected returns requires a more cautious approach.

And with that, I'll hand this over to Mark Lyons.

Mark D. Lyons {BIO 6494178 <GO>}

Great. Thank you, Marc. And, as Dinos alluded to, there's a lot of ground to cover this quarter. So on today's call, I'm going to depart from the usual commentary structure and focus more on the unusual accounting impacts, driven largely by the UGC transaction. First, I'll highlight just a few items about this quarter, but, as a reminder, the usual quarterly topics that we usually talk about and comment on, can be found in the earnings release and the associated financial supplement.

Okay, so now for some summary comments on the fourth quarter, all on a core basis and as a refresher, as Dinos alluded to earlier, the term core corresponds to Arch's financial results excluding the other segment, which is Watford Re, whereas the term consolidated includes Watford Re. Okay, so losses recorded in the fourth quarter from 2016 catastrophic events, net of reinsurance recoverables and reinstatement premiums, was $34.1 million or 4 loss ratio points compared to 1.9 loss ratio points in the fourth quarter of 2015 on the same basis. The activity was primarily driven by Hurricane Matthew, the New Zealand earthquake and the Tennessee wildfire.

We believe this continues to highlight our property cat underwriting discipline, as actual reported losses on cat event continue to correlate with the exposure reductions that have been implemented over the last several years. As for prior period development, approximately $55 million, a favorable development, or 6.5 loss ratio points, was reported in the fourth quarter, led by the reinsurance segment with approximately $42 million of favorable development, the insurance segment with about $8 million, and the mortgage segment providing nearly $5 million of favorable development.

The calendar quarter combined ratio on a core basis was 88.8% and when adjusting for cats in prior period development, the core accident quarter combined ratio was 91.2% compared with 93.5% in the fourth quarter of 2015. The reinsurance segment accident quarter combined ratio, again, excluding cats of 91.2% showed modest deterioration of 110 basis points compared to the fourth quarter 2015, while the insurance segment's accident quarter combined ratio excluding cats remained flat at 96.3%, but saw an accident quarter loss ratio increase of 90 basis points offset by a corresponding expense ratio reduction of 90 basis points.

These competitive conditions were more than offset by the continued improving profitability of the mortgage segment, amplified with their net earned premium being a larger proportion of the total. The mortgage segment's accident quarter combined ratio improved to 59.5% from 83.1% in the fourth quarter of last year. And their net earned premiums represented nearly 10% of the total core net earned premium, compared to only 6.9% in the corresponding quarter of 2015.

Now, moving on to some of the unusual financial statement impacts this quarter, I'd like to focus on the UGC transaction as it affected, among other things, reported corporate expenses, financing expense, book value and our capital structure. The transaction closed at 11:59 PM on December 31. So, UGC is reflected in our year-end balance sheet, but not our income statement.

As for non-recurring expenses, the company incurred $25.2 million of such expenses related to the UGC transaction in the quarter, arising primarily from investment banking, bridge financing and credit facility fees, along with the usual legal, rating agency, accounting and consulting fees with such banks.

Given the non-recurring nature of these expenses, we have excluded them from operating income as they are not relevant to our true underlying performance. However, I would like to provide some alternative insight into our operating income per share by providing results on three basis, which we feel is important to distinguish: the official reported operating income per share; and then two alternative pro forma views, which I will define now. First, we view the official reporting of operating income per share as in the earnings release as being a hybrid. And by that, we mean it excludes the non-recurring UGC transaction expenses, but includes the UGC financing cost since we did raise that additional capital and are obligated to incur interest expense and pay additional preferred dividends per the terms of those instruments.

The first alternative pro forma view of earnings that I'll get into is as if the UGC transaction did not occur. This view provides a clear comparative picture to last year's fourth quarter and the third quarter of 2016 and is likely most representative of views from the Street. This first alternative pro forma view excludes the UGC transaction expense and excludes the debt and preferred stock financing expenses and excludes the incremental investment income gained as a result of raising that additional capital.

The second alternative view provides for this quarter's operating income would include all non-recurrent expenses and the financing cost and the additional investment income associated with the transaction. So, the official operating earnings per share to common shareholders as reported in our earnings release is $1.13 per share. The first alternative pro forma view, which completely excludes the UGC transaction as respects transactional expenses, financing costs and additional investment income is $1.16 per share. The second pro forma alternative view, which reflects as discussed above, all UGC transactional expenses financing (20:17) costs and investment income is $0.96 per share.

Hopefully, these three views will provide useful information for your analysis of this busy quarter on the different basis as defined. Okay. So, rather than going through the mindnumbing annual and incremental fourth quarter tax rates on a pre-tax operating income for each of the three views discussed, I will instead provide a 2017 forward-looking tax rate since the fourth quarter reflects so many unusual impacts and is not indicative of what could be expected on a run rate basis.

As we have previously discussed, 2017 should provide on an expected basis, higher mortgage segment income and a different taxable income mix by jurisdiction. As a result, we anticipate that the expected tax rate for pre-tax operating income in 2017 to be in the low to mid-teens range without giving any consideration to evolving tax changes, potentially emanating from the Trump administration. This preliminary range is primarily driven by varying jurisdictional profit assumptions, cat loss assumptions and varying loss ratios.

Having said all these, the annual tax rate on pre-tax operating income for 2016 as reflected in our official earnings of $1.13 per share was 5.2%, which caused a fourth quarter incremental tax rate or pre-tax operating income of 2.1%. This reflects an approximate $5 million true-up tax benefit for the first three quarters of the year or nearly $0.04 per share to achieve this 5.2% annual tax rate.

Since the 2016 fourth quarter results only partially reflect the additional effects of the UGC financing transactions, it makes sense to provide a run rate for interest expense as well as for preferred dividends. Total interest expense for 2017 is expected to be $24.9 million per quarter. This reflects new and prior debt issuances, as well as borrowings under our credit facility.

Similarly, the run rate for quarterly preferred dividends also from new and prior issuances is expected to be $11.4 million per quarter. This does not contemplate any potential actions being taken on our $325 million of series C preferred that becomes redeemable beginning in April of 2017.

Lastly, as a result of the UGC acquisition, we took the opportunity to conform accounting standards between the segments as a respect to deferred acquisition expenses. As a result, book value was negatively impacted by $0.31 a share due to the charging off of previously capitalized deferred underwriting-related expenses, largely through shareholders' equity with a small portion through the income statement.

As a respect to our capital structure in connection with the UGC transaction, we raised capital in 2016 as reported on last quarter by issuing $450 million of 5.25% non-cumulative perpetual preferred. And in December, we raised $950 million of debt by issuing 10-year and 30-year vintages.

We also tapped our credit facility for $400 million and utilized roughly $384 million of internal cash resource. We also issued series D convertible preferred common equivalent shares to AIG at a fair market value of approximately $1.1 billion.

Before I get into our updated capital structure ratios, it's important to understand how we've accounted for the new equity issuance. There are no restrictions to ownership of these shares by AIG, except for the passage of time as a respect to certain lock-up provisions. And these shares rank equally in all material respects to our existing common shares.

The series D convertible preferred common equivalent shares are being treated in our calculation of book value as if they are common shares. Therefore, the approximate $12.8 million common equivalent shares issued to AIG are added into our common share account to determine book value per share now totaling 135.6 million shares.

GAAP common equity at 12/31/2016 is approximately $7.5 billion and total GAAP capital is approximately $10.5 billion. On a GAAP basis, our total debt to total capital ratio is 21.3% and total debt plus preferred to total capital is 28.7%. Accordingly, December 31, 2016 book value, as Dinos has mentioned, per share is $55.19 which represents 3.5% increase over the prior quarter and nearly 16% over year-end 2015.

Book value per share primarily grew as a result of the $1.1 billion of series D common equivalent shares issued to AIG as mentioned earlier. We issued those shares at a price-to-book multiple of approximately 1.61x. And accordingly, our book value gains in immediate accretive benefit of approximately $470 million at issuance.

Now, since we made commentary today about operating income per share excluding the impact of the UGC transaction, it's only fitting to provide the corresponding impact on book value per share as well that excludes the series D common equivalent issuance to AIG, eliminates the debt and preferred financing costs, the UGC non-recurrent transactions, investment income differences and other conforming adjustments. So, basically, as if UGC hadn't occurred. Book value per share excluding the UGC transaction would have fallen by 2.1% or a $1.12 per share.

We did not repurchase any shares during the fourth quarter of 2016 and don't anticipate repurchasing any during 2017. Our remaining authorization which was due to expire on this December 31 has been extended to 12/31/2019, but the amount remains the same at $446.5 million.

Additionally, as a respect to the acquisition, we recorded approximately $189 million of goodwill on the books or $1.39 per share and have established an additional $507 million of intangible assets as of December 31, 2016. $480 million of which are subject to amortization. We anticipate that this associated amortization to be the highest in calendar year 2017 at approximately $110 million, then decline thereafter such that approximately 75% of the amortization will be recognized within five years. I refer you to page 7 of the earnings release to see more information about these intangible assets.

So, with these exhausting introductory comments out of the way, we're now prepared to take your questions.

Q&A

Operator

Thank you. Our first question comes from Sarah DeWitt with JPMorgan.

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

Hi. Good morning.

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

Hi, Sarah.

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

Now that the United Guaranty acquisition is closed, I wanted to get your thoughts on the potential for any additional expense savings or upside on the earnings accretion. I know the accretion of over 35% included some expense savings, but if you could provide any more exact numbers on that, that would be very helpful.

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

Well, first and foremost, let me remind everybody that we didn't make the acquisition on the basis of expense savings. As you probably will know, that with any merger of two companies, there is significant redundancies which we're going to experience over the next two years as we put the companies together.

Our focus is mostly on making sure that our customers don't get disturbed, so we continue to provide the service together, bringing the two companies together with an eye that if we can improve the expense ratio by saving, we will do it and we will continue reporting to you on a quarterly basis what those savings are.

I don't like to make projections, because sometimes when you make projections, you might make your predictions come true and make the wrong management decisions. I rather have our people free to make the right decisions as we bring the companies together on a week-by-week basis and that's the basis we're going to run the integration.

Mark, you want to add to it or...

A - Mark D. Lyons {BIO 6494178 <GO>}

No. Well said..

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

Okay.

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

Okay. That's fair. Thank you. And then also, how should we be thinking about the size of the combined premium base for the company taking for United Guaranty and AIG's mortgage business, taking into account how much will be non-renewed as well as the AIG quota share?

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

Okay. Well, there's two points here. One, there will be some actions on our part. Mostly what we said in the past that I think probably a participation in singles will probably get reduced a bit over time. Having said that, there might be some action by our customers, because they might feel that the combination of the two companies might create some overlay and significant exposure. Based on our analysis, the latter doesn't seem to be a problem. It seems that there wasn't a lot of overlap between us and United Guaranty. So, I don't expect that to be much. And then, I believe that long-term as we said before, we expect our market share to come down in the low 20%s, it can be anywhere from 22% to 24%, we are at maybe 25%, 26% today.

I don't see a significant change in that, that it will be dramatic quarter-over-quarter. It's implementing our pricing strategies that we're going through now in combining the risk-based pricing of the two companies together. And don't forget, a mortgage business is more global in nature, you're only focusing on the MI (30:59) in the U.S. So, we take how much we're going to write in mortgage from a global point of view, including the bulk transactions, our Australian business and our European business.

So, Marc, you want to elaborate a little bit further?

A - Marc Grandisson {BIO 4369887 <GO>}

One thing I would echo on this is also the 2016 was a bit higher in the last half of the year, because of the refinancing slew (31:21) that we got. So, the market overall expect a slower market in 2017. That's something you need to keep in mind. So, generally, the way we look, the high level look at the premium that can be generated by the portfolio is you take the insurance in fourth which we provide in our supplement and you can ascribe a 50 bps roughly rate to it. And that's what gives you the run rate as to what kind of premium you get per year. And you could put some persistency around it which you've heard on other calls as well, 75%, 76%. And then, this is how you sort of get to the run up of the portfolio and then you ascribe some new written for this year based on your view of the market, which really at this point in time is very, very difficult to see, have any clarity on.

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

Okay. Great. Thank you. That's very helpful.

Operator

Our next question comes from Quentin McMillan with KBW.

Q - Quentin McMillan {BIO 19411547 <GO>}

Hi. Good morning, guys. Thanks very much. I just wanted to talk about the mortgage business and the Australian contract that you have ceded. It looks like the net-to-gross in that portfolio dropped down the last two quarters in kind of a 60% to 70% range. And I'm kind of just curious whether that was sort of one-off because of the Australian contract or do you expect to sort of retain a little bit less of that business as UGC earns in? And potentially, would you look to maybe retain a little bit more of the Australian when it comes back up for renewal if the terms look attractive again next year?

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

Well, I mean, the terms, they're attractive in Australian business, otherwise we wouldn't be there. But our attitude is we look at all of our business. I don't care if it's insurance, reinsurance, mortgage insurance and we have a risk management perspective about aggregations, how much we want to have either in a particular territory, et cetera, et cetera. Our desire or ability to reinsure part of the book, it comes out of that process when we sit down internally at the senior management level with our chief risk officer and his team and we look at all of our aggregations, we make those determinations.

So, we purchase, as Marc said, 37.5% quota share going back to inception for our Australian book, and that was a judgment that we made – that judgment might change in the future, but it's a decision we make on a lot of stuff here including how much retrocession we buy in our reinsurance book, on our cat book, et cetera. It's part of our risk management methodology. So, Marc, elaborate a little more on this.

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. The quota share goes back to May of 2015, and it's on for three years. So, the panel has been set and the reason we had more session this quarter was because of the catch up. We went from 25% session to 37.5%, so that 12.5% additional premium ceded has to be retroactively ceded back to our partners. And this is exactly what we did this quarter.

We have also good partners with us alongside bring some value in terms of knowledge of the markets and capital and are helping us, as Dinos said, just right-size the overall risk on the balance sheet. At this point in time, there is no plan to change. If somebody else would want to take more of it or help us provide some structure, we are, as usual, always interested entertaining such things. But, right now, there's no plan to change.

A - Mark D. Lyons {BIO 6494178 <GO>}

And, Quentin, let me just – just for clarity, given what Dinos and Marc have said, neither the third nor the fourth quarter of this year are indicative in a run rate basis. Both of them had the retroactive cumulative catch-up as Marc alluded to. So, on a go-forward basis, assuming there's no changes to that in a multi-year nature, any new premiums arising in 2017's first quarter, you should expect a 62.5% net arising from those out of Australia and a 37.5% ceded.

Q - Quentin McMillan {BIO 19411547 <GO>}

All right. That's very helpful. Thanks. And then, moving to the investment portfolio, I asked this last quarter as well, but you guys last quarter had about a 2% yield and expecting the UGC portfolio to earn in at about 3.5% yield. Is the assumption sort of similar now and how much impact might that have and what are your sort of expectations to what you will do with the portfolio over the next couple of quarters as that higher yielding book earns in?

A - Mark D. Lyons {BIO 6494178 <GO>}

I think, a couple of things. First off is the composition of that portfolio was markedly different than what Arch had natively. It was longer duration in nature. It was made up much more heavily with municipals and corporate credits and lower rated corporate credits. And that will be changed over time. It's going to be a little bit – in fact, some of that's already occurred in the beginning of this year. And that will take a little while to do, because a lot of it's onshore. So, there's tax consequences to everything. So, you've got to be mindful on how it's done. But, I think over time it will conform a lot more closely to the Arch portfolio in the regard. Dinos?

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

Yeah. The only thing I will add is there is a tax component that we have to be mindful of it, especially having more income emanating from the U.S. which is taxable at a very high rate depending what happens with the tax law. And we might not change the municipal component, which is giving us some tax relief, so all that is being considered. We have our teams in the investment department and our finance and tax people looking at restructuring the portfolio. But, over time, it's going to look more like the Arch portfolio, high credit quality, probably a shorter duration. But having said that, we got to take also into consideration the tax considerations.

Q - Quentin McMillan {BIO 19411547 <GO>}

Thanks, guys. If I can just sneak one more modeling thing in, just you gave a lot of guidance there. In terms of integration costs, do you have any updated estimate of what that might be for 2017?

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

Let me reiterate what I just said before. Integration cost, you have cost upfront and then you have significant savings later on. We didn't do this transaction because we had some spreadsheet that says this is going to be wonderful and you're going to have all these kind of savings. We did it because it made a lot of sense going forward, buying a business that it has tremendous potential for earnings. It fits. It's a specialized product that I think we can create value with it.

Having said that, our teams, they're going to look at maximizing synergies, like I said, without affecting customers and volume as we go. So, depending how much we do, you will have the expense upfront and then the savings that come commensurate to that. But I want our teams to have freedom to make the right management decisions and we'll let the accounting take care of itself.

A - Marc Grandisson {BIO 4369887 <GO>}

At a high level, though, it's a timing issue really. As Dinos pointed out, we will have some synergies that we'll be able to extract some cost from, but I think the best thing I can tell you is depending on the glide path that you think we'll be able to execute on, the long-term ratio of rate of expense of a typical MI company is a 25% to 30%. So, that's probably what I would use as an endpoint, depending where that endpoint is for in your mind, as to how well and how quickly we can execute. But again, the speed of execution is not going to come at a cost of losing customer and losing culture and losing the spirit of our company.

Q - Quentin McMillan {BIO 19411547 <GO>}

Perfect. Thanks very much, guys.

Operator

The next question comes from Kai Pan of Morgan Stanley.

Q - Kai Pan {BIO 18669701 <GO>}

Good morning and thank you.

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

Hi, Kai.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you. Thank you so much for providing these two alternative operating EPS estimates. I would add another one, ask for the third one is actually what would be your sort of pro forma earnings would be if you're including both the financing costs as well as UGC earnings in the quarter?

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

I don't have that because we did not have UGC's earnings in the quarter. So, that's something I don't have readily available, Kai.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. All right.

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

Yeah. It didn't report to us. I mean, we don't have the United Guaranty numbers. Yeah.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. I just want to give a try to see what's ongoing sort of going forward run rates earnings for you, guys.

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

Yeah. Be patient. First quarter, we'll give you a lot of disclosure. We'll try to make your jobs as easy as possible and be patient. Another three months and we'll be there.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. Thanks. And then on the capital management, you said there's no buyback in 2017. So I'm assuming the priority would pay down some of the debt. And also, absent like what's your comfort level in term of debt-to-capital ratio, as well as if you're going to 2018 when the buybacks come, would you be prepared to do the buyback in sort of like a common preferred or more in the open market?

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

Well, let me start with 2017. 2017, we did say to the market and to the rating agencies, we will not buy back shares. So 2017, it will be a year for us that we're going to take the earnings, we're going to retain those earnings, and basically we're going to start rebuilding some firepower on our balance sheet. Having said that, I don't know where 2018 is going to be. When I see the year-end 2017 numbers, we'll make then some decisions.

We want to maintain very good relationships with the rating agencies. They've been very fair with us in analyzing not only the transaction with us but the future plans, what we will need to do over the next three years. From our past history, you will know that we try to maintain a conservative balance sheet without a lot of debt on it, so we can have firepower in case markets change so we can take advantage of it. So that's the overall strategy now. With that, I'll turn you over to Mark Lyons, who has more of the details. He does that analysis for all of us on a day-to-day basis. So Mark, go.

A - Mark D. Lyons {BIO 6494178 <GO>}

Sure. I think, Kai, on an overall basis, we said this publicly, is that over a three-year period, we expect to be south of 20% on Moody's adjusted leverage ratios, which, as you may recall, our preferred catastrophe treatment's a (43:02) 50% equity credit, so when you go back and noodle it, you can see how we're thinking. So that's going to be accomplished by a shrinking numerator and an increasing denominator. So both of those are going to go, and because we pulled $400 million out of the credit facility, which is more flexibility, that's likely the target area that if we're going to differ and have the ability to pay back sooner than planned, it'll go to that area.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. Great. Lastly, if I may, is on the U.S. tax reform. And just want to get your guys perspective on banning both a lower corporate tax rate and border adjustability, and also the new bills in the Congress. How would that impact your business going forward?

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

Well, I mean, first, let me start with the first one. A lower tax rate, it's good for business. I mean, at the end of the day, I'm in the minority, but I strongly believe that corporations should pay zero tax and let their shareholders pay the tax when eventually corporation has to distribute it through dividends or through shares, funds to their shareholders and they're all full tax payers, so let them collect their tax on that basis. But put that aside, a reduction in the corporate tax rate is positive, especially with the United Guaranty Corporation acquisition, which is going to increase our domestic or U.S. earned income. So that's a positive.

The other two, they're hypothetical. The border adjustment tax, I don't know what's going to happen, and if it will influence transactions between reinsurers. To me, reinsurance transactions cross-border is more exporting risk rather than importing capital. So at the end of the day, without knowing the details, very, very, very hard to project as to what the effect is going to be. But the kneel wheel (45:18) has been around for a long time. I don't know what's going to happen, but we have alternatives to that. We're multi-faceted, and we're global in nature. So at the end of the day, depending on this hypothetical, we'll react to it if it happens.

Q - Kai Pan {BIO 18669701 <GO>}

Great. Well, thank you so much.

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

You're welcome.

Operator

Our next question comes from Charles Sebaski with BMO Capital Market.

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

Good morning.

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

Hey, Chuck.

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

Hey, so just like some thoughts on – you talked about risk management, I think in the past, you guys have talked about mortgage now really feeling out kind of three legs of a stool. But mortgage has got a different risk profile than us P&C people are used to thinking about with PML, and maybe greater exposure to economic risk. As we think about the mortgage business here, how do you think about it from a risk perspective and what's the ability to grow, be it globally, be it from GSE transactions? Is there still capacity to expand it, or do the other leg of the stool need to expand some further? Just how the relativeness between the three divisions and the relative size on a risk basis, and how you guys are thinking about that?

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

Well, let me start with the premise that our brains work in a fashion that, I don't care what you do, you have to understand what your PML is. And you've got to be comfortable on the basis of the balance sheet you have, and are you comfortable with the setting of how much PML you can take within the balance sheet. The fact that, historically, MI companies might have not looked at it from that perspective is not relevant to us. So the task that I have assigned all of our teams, and I personally work with them, because that's a significant bet we're making in another line of business, we should have a methodology of calculating PML. And we do within the third iteration of the model that calculates the aggregation of risk, including both underwriting risk within a mortgage business and also macroeconomic risk, changing unemployment, housing prices, et cetera, et cetera, and we stress-test that to see as to what kind of outcomes we have and how much of that we are willing to take within our balance sheet.

Now, we have also brought other tools that they were not traditional, and some of the other MI companies, they're starting to use them as well. You don't have to retain all the risk on your balance sheet. There is reinsurance transactions you can bring. There is capital market transactions you can bring to bear to manage the risk. So that's the concept that we have. We use it with our cat business. We use it with our P&C and our reinsurance business. We tie retro in different segments. It could be marine. It could be aviation. So we use the same approach because that's our DNA. Our DNA is bring in the risk, understand how much you're taking, risk manage it to the point of comfort, and see if you have more than what you want than either reinsure it out or use capital market transactions to bring it down to an acceptable level. It's the old saying. I use the expression my father taught me. He said, son, I don't care how good the meal is, don't eat too much because you're getting digestion. So we're not a company that is going to over line on risk to the point that I can't sleep at night or, Marc and Mark cannot sleep at night. We sleep like babies.

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

Will you guys be willing to provide – so in your traditional P&C businesses, you talk about tri-county, you talk about northeast, we think about wind exposure and PMLs on 1 in 250 or 1 in 100. Will there be some kind of basis for you to explain to us how these metrics are if it is on unemployment, or on GDP or on interest rates so that we can have some comparability on risk?

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

Yeah. We might do that in the future. And the reason I'm hesitant is that, it's not because we don't like to disclose to you guys a lot of stuff we do, but we don't want to wake up our competitors to understand what we're doing either. And to tell you the truth, we're still in the process with the rating agencies of going back and forth in them understanding all of our methodologies and all the good work we've done. And we haven't come to a complete agreement with that as of yet in those discussions. So we're hoping that this year may be we sooner than later, we'll get to some understandings in sharing our thoughts and our methodologies. And some of the methodologies actually we're using we're taking from them. We look at how they look at mortgage risk, and we try to bring it in.

But the basis of our PML analysis it goes to both; one, things that we can control, meaning, underwriting quality of the mortgages we insure and the pricing we apply to them, and what those potential outcomes are; and second, microeconomic factors that, what if the unemployment rate goes to 15%, what if housing prices collapse by 25%, by 30%, and how rapidly they collapse, and we model all that and then we come up, and there is a lot of other factors. We might share with you maybe some of our methodologies at our investor conference. This way you know our deep thinking into these issues, but I'm not ready yet to be start putting our PMLs out for our competition to know.

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

That's fair. I guess, just a follow up on the mortgage, I guess, any thoughts on new Treasury Secretary, commentary about getting Fannie and Freddie out of government ownership, will the expectation for you guys be that the speed of GSE derisking would accelerate for those companies to come out? Is that how you guys think about that?

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

Well, there's two constants that I think, in our thinking is; first and foremost, there is pressure by Congress to put more mortgage risk to the private markets. So that's a constant. The other constant is. I think there is a recognition by our elected officials that securitization without the ultimate guarantee of the federal government is not possible. So those things we don't believe they're going to change. Now, are the GSEs privately owned and/or controlled by – I don't think, those two factors, they're going to change. So at the end of the day, for everybody who is involved in the mortgage guarantee business, it's positive because there is, independent if you're a Republican or Democrat, there is a movement to put more risk into the private hands and eliminate the tax payer who've been the guarantor of these mortgages. The exemption to that is the FHA who still, I want to remind you guys, it has probably between the FHA and the VA, they got more than what 55%, 57% of the market. So in essence, we do have the tax payer funded facilities competing in the private market. So that to me is more of a concern than what we do on the private side. But I think the future is pretty bright. Marc?

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. The indication that we get, Charles, from talking both the GSEs, and certainly there's various projects and various products that you've heard that were initiated this year, it has more on the horizon. Clearly, the mandate from the GSEs is to be utilizing more of the private market. Absent – we've heard that the new world order in GSE is for five years or six years now. I guess, we'll get to a landing at some point, but I echo what Dinos has said. There's clearly no stopping them trying to leverage their positioning, and utilizing the third party in a private capital to help make that a vibrant market. It's clearly pointing in our direction.

A - Mark D. Lyons {BIO 6494178 <GO>}

And Chuck, I would just add on the GSE because you were asking a pretty broad question. On the GSE credit risk transfer side, when you look at the balanced score cards that are out there and what the Congress expects of the GSEs, there's no dropping off of that. It's a good signal of a continued transfer.

A - Marc Grandisson {BIO 4369887 <GO>}

Yes.

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

Thank you very much for the answer, guys.

Operator

Our next question comes from Jay Cohen with Bank of America.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

Good morning, everybody.

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

Hi, Jay.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

Hey, Dinos. Two questions. The first is on the tax rate that was very helpful to give the 2017 number. I know you're not giving an 2018 number. But directionally, and let's assume for a second that the corporate tax rate doesn't change, so kind of an as-if basis, as you get into 2018 and 2019, would you expect the tax rate to come down because of things you will be doing internally?

A - Mark D. Lyons {BIO 6494178 <GO>}

Wow, that's loaded. If I could forecast the P&C underwriting cycle, I'd be a gazillionaire. But keeping everything constant, if there is no change at all, there should be minor drift in the aggregate effective tax rate because there should be incrementally more mortgage income associated with it. But that is a very rough and lack-of-confidence number. To the extent that there's changes in any submarket, we're going to allocate and put capital there and that'll change our effective tax rate. And if it's cat, for example, it's going to be Bermuda-centric which is going to drive it down. So that's the best I can tell you.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

No, that's helpful. I just didn't know if there were things you will be doing internally to affect that tax rate just structurally in term of reinsurance or something?

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

There might be a few things we do on the investment side. I mean, it's all – it's part of the restructuring of the portfolio, maybe there is a little more municipal exposure on the investment side because it eliminates some of U.S. tax. But that doesn't move the needle that much. You're probably talking about a point or so. It's the difference between 11 and 12 or 12 and 13 (57:38) so...

Q - Jay Arman Cohen {BIO 1498813 <GO>}

Got it. And the other question was, one of the things the new administration did was they suspended the price cut on the FHA premium. This wasn't a big deal when they were proposing cutting it, but how do you see that affecting you?

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

Well, it affects the market in general, right? The FHA is and the VA is competing with the private markets. And don't forget, they have a tremendous advantage. Their capital requirement is 2%, so they, in essence, they're writing 50:1 where we're at 15:1 or less. So, it's very, very tough sometimes to compete with Uncle Sam. But to us, that's positive because that reduction in our view we would have put more pressure on eventually the taxpayer and by – yes, reducing the cost to the consumer, but also, I'm not so sure that those rates with those kind of risk, it was sufficient to cover the exposure.

A - Marc Grandisson {BIO 4369887 <GO>}

There is some movement, Jay, right now that the GSEs are sort of – the FHA's purpose is really to get home ownership to people that otherwise wouldn't have access to, so there's clearly a response on the GSE with Home Possible. There's a couple of programs that they're putting in place and are starting to implement that will hopefully try and attract and address that specific segment, so it's a bit away from the FHA to try to get into that segment as well which is, again, good news for us because it would be – most of it would be conforming and needing private MI attached to it. So overall that, to echo again what Dino just said, that move was seen possibly by us, but again we want to caution everyone that we're always one decision away from one of these directors to – yet again, put some other rate decrease, but that's the nature of the business that we're in.

Q - Jay Arman Cohen {BIO 1498813 <GO>}

Yeah. Good stuff, guys. Thanks.

A - Marc Grandisson {BIO 4369887 <GO>}

Thank you.

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

Thank you.

Operator

Our next question comes from Ian Gutterman with Balyasny.

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

It must be lunchtime?

Q - Ian J. Gutterman {BIO 18249218 <GO>}

It must be.

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

So, Ian, today on the menu is Pastichio.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Nice.

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

So you can Google it. I'm not going to tell you what it is but you can Google it.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

I think I've had it before.

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

Yeah, my mother made it for our Investor Day.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

I remember. I remember. So my first question for Mark is, it is much of the comment actually is - I think you need to come up with a better term than alternative income because I worry if you stick with that word, Melissa McCarthy is going to be reading your script next quarter.

A - Mark D. Lyons {BIO 6494178 <GO>}

As long as you're an English major Ian, I'll listen to you.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

So first, just a couple of number ones. The other underwriting income was higher than normal this quarter mostly in the reinsurance. What was driving that?

A - Mark D. Lyons {BIO 6494178 <GO>}

Yeah. It's, as we kind of talked about in the past with Watford Re, underwriting and investment fees are put together into a pot and they're shared equally. And it was just a reflection of better performance.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Okay. So, is that like a year-end true-up or was that just a good quarter?

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

No. It was a quarter...

A - Mark D. Lyons {BIO 6494178 <GO>}

No, it's a quarter performance.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Got it. Okay. And then the amortization, you said $110 million for, I guess, this year grading down. Can you just give us some sort of sense of the slope of that?

A - Mark D. Lyons {BIO 6494178 <GO>}

Well, I did give you two data points.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

You did. And I try to just - can I linearly do it or is that a parabolic?

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

A reverse exponential.

A - Mark D. Lyons {BIO 6494178 <GO>}

Yeah. Just do a down slope exponential and you'll be good.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Okay.

A - Mark D. Lyons {BIO 6494178 <GO>}

I think, you can get $480 million of it at the beginning that's amortizable, right? That brings you $110 million in the first year, 75% of that at year five.

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

You can figure it out. You're a math major.

A - Mark D. Lyons {BIO 6494178 <GO>}

I can get my junior high school daughter to do it.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

No, I took a shot. I just want to make sure there wasn't some curvature to that rather than a slope. But the...

A - Mark D. Lyons {BIO 6494178 <GO>}

No. There's always going to be some curvage. There is some curvature. Think of it as it actually it varies by which intangible asset lowers the distribution versus the other. But, as I said, after five years out, it becomes insignificant. I'll give you one more data point. At year six is pushing $20 million area, so that gives you the greater fall off.

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

It's becoming a math exam for you.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

That's okay. I can handle it. I'll compare notes with you next time I see you. See how good my guess is. You can grade me on it. I do sit in the back of the room, but I take good notes. Just on that topic, as we're talking about disclosures for UG, would it be possible to give us some time before next quarter's earnings, say, a four quarter trailing pro forma mortgage insurance segment? I know it's possible. I guess I'm asking is it realistic.

A - Mark D. Lyons {BIO 6494178 <GO>}

Yeah, I...

Q - Ian J. Gutterman {BIO 18249218 <GO>}

We could discuss offline if you like, but that's a request.

A - Mark D. Lyons {BIO 6494178 <GO>}

Well, literally it's the starting point because of the debt and the preferred that we had to issue for the prospectus has the actual UGC information in it that can use as a baseline, because, as you know, this segment on the prior owner reporting was beyond UGC to take back...

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Right.

A - Mark D. Lyons {BIO 6494178 <GO>}

... their quota share (01:03:35). So, that, I think is a useful starting point. Yeah.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Okay. And then just lastly, on the comment on the tax of low to mid-teen, does that assume that you will have a 50% quota share on the entire U.S. MI business including UG?

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

It does.

A - Mark D. Lyons {BIO 6494178 <GO>}

It does.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Okay.

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

Forward. Yeah.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Right. Okay. And, I guess, this isn't an issue for 2017, but if you want to go out to 2018 or 2019 or whatever, if there were a change in U.S. tax rules where something like the Neal Bill happened, any sort of sense of what the sensitivity of that tax rate is?

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

Well, without knowing what the bill is going to say, I can't model it for you. But tell me what the bill is going to say and then I'll model it.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Fair enough, fair enough. Okay. I guess I wondered are there the same opportunities that I think you've hinted at with the P&C business, could they be applied to the MI business as well? Or was that really something that only would work on the P&C business?

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

I don't totally understand the question.

A - Mark D. Lyons {BIO 6494178 <GO>}

Yes.

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

What do you mean, it's sessions from P&C versus MI?

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Right. I mean, are there are other places you can send stuff to I guess, other balance sheets you could use like that?

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

So look, believe me, my door is breaking down by people that want to get a piece of our MI business as reinsurance. Depends how - what kind of terms you negotiate. Do you share in the profit or not, it's a lot of alternatives. We react to what the actual law is and we abide by the law. And then we maximize for our shareholders the potential outcomes. So, not knowing that, is so very hard. But there is alternative, yes.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Got it. Okay. I think that's what I had. Enjoy lunch.

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

Thank you.

A - Mark D. Lyons {BIO 6494178 <GO>}

Thank you, Ian.

Operator

Our next question comes from Elyse Greenspan with Wells Fargo.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Hi. Yeah. Thank you. Just a couple of quick questions, first off, the intangibles that we were just talking about, the $110 million, are those going into net or operating earnings?

A - Mark D. Lyons {BIO 6494178 <GO>}

Well, since that's a 2017 item, in all honesty, we are debating the alternatives, but I believe you can count on us being more transparent, more likely having it itemized in a way that lets you flip it however you choose to look at it.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

So, when you guys talked about the deal, I guess the accretion 35%, was that including or excluding the amortization?

A - Mark D. Lyons {BIO 6494178 <GO>}

It was including.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay. And then in terms of the PMLs, I know, Dinos, you had mentioned how you guys are talking about kind of calculating the aggregate risk including the mortgage exposure. So, as we think about potentially a harder market on the cat side, obviously, it doesn't seem like that's anything you guys are expecting. I guess the right assumption would be that we would never really see 25% of your capital going to cat business because now we have this greater mortgage exposure that you're also counterbalancing against your capital. How are you guys kind of, I guess, thinking about how that kind of all comes together?

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

Well, my authority and the senior management authority from the board is, we can't expose more than 25% of our equity capital on any line of business. That will include MI. So, that's the maximum we can take on a PML basis. If we want to take more, we have the opportunity but it will be, I bet you, a very, very long discussion with our board. And then, jointly, we'll make a decision. And if we make a decision to be something different, we will tell the market about it. So, right now, that's what we are operating under.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay. And then one last question on the, I guess, the pricing side. As we think about higher inflation just overall for the industry, I mean, kind of where you guys pointed to, it seems like still kind of deteriorating on the primary insurance side. Do you see people starting to think about pushing for more price, as we think about higher inflationary levels or you're thinking it will kind of be like what we've seen in prior cycles where as we get companies pushing for price after inflation shows up within margins?

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

Yeah. Unfortunately, we don't see price increases. I'll give it to Marc for more color. But I think there is a time delay. And basically, I think is, it's the other metrics that usually cause us to – all the other industry, I'm not talking us specifically, but the industry to change is when loss cost inflation, which is not always correlate with the economic inflation starts showing up in the numbers, how well the reserves are behaving. Those are the kind of things that cause adjustment to pricing.

For now, I'm not sensing any adjustments to pricing. You saw we reported that for some of our business, we're getting some price increases, but for a lot of them, we get decreases. And in the aggregate, we're negative not positive. So, Marc?

A - Marc Grandisson {BIO 4369887 <GO>}

I think that the difficulty that we're running right now is most people are looking at our portfolio and we've had a very benign trend for the last five or six years. And a lot of your projections or the way you will price your business going forward is dependent on the historical not on the forward-lookings. It's very, very hard to predict what the future inflation will be.

There's a tendency for an underwriting unit or an underwriting company to sort of assume the same old trend will carry on for a little while. That explains why it – the delay and the lag in recognizing trend. And it's especially acute if you are on the excess of loss, if you're excess of a certain threshold, say $3 million, $4 million, $5 million or $10 million. This will be further delayed.

So, unfortunately, we're not seeing big reaction to this. I would also add, a lot of people are expecting yields to pick up and interest rates to increase more, possibly more investment income in the future. So, they're sort of buttressing a little bit that rate deterioration that we're seeing in the moment.

A - Mark D. Lyons {BIO 6494178 <GO>}

Elyse, I'll just throw something as well. We're more concerned with loss cost trend. Sometimes that's frequency-driven, sometimes that's severity-driven. And your question was more severity-driven. But the sense that it's that class-rated business isn't primary, its frequency tends to drive it and you can sharpen your pencil a lot more and so do the competitors. What is long-tailed, long duration, excess in marketing sample, rationalization takes over. And it's not necessarily correlated as much.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay. Thanks again.

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

And don't forget, traditionally, the markets don't turn on these technical analysis and evaluation. The market turns when you have more fear than greed. It's the two emotions that determine the market. We have excess capital. There is a lot of people accepting – meet single-digit returns. They view that as acceptable for the risk business, which I think is insanity, in my view. And at the end of the day, I don't see fear in the market yet. When you start seeing fear in the market, that's when you're going to see rates move up. And we don't see it yet.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay. Great. And thanks for the answers. And congrats on getting the deal done at 11:59.

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

We appreciate that. I had a glass of champagne celebrating the New Year and the closing. So, it was very economical. I paid for one glass, and I celebrated two things.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Thank you very much.

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

You're welcome.

A - Mark D. Lyons {BIO 6494178 <GO>}

Thanks, Elyse.

Operator

And I'm not showing any further question at this time. I'd like to turn the call back over to Dinos Iordanou for closing remarks.

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

Well, thank you, all. We're looking forward to the next quarter. Have a good afternoon.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may all disconnect.