Q3 2015 Earnings Call

Company Participants

- Constantine P. Iordanou
- Mark D. Lyons

Other Participants

- Amit Kumar
- Brian R. Meredith
- Charles J. Sebaski
- Ian J. Gutterman
- Jay Arman Cohen
- Jay H. Gelb
- Kai Pan
- Meyer Shields
- Michael Nannizzi
- Rob G. Hauff
- Ryan Byrnes
- Ryan J. Tunis
- Sarah E. DeWitt
- Vinay Misquith

MANAGEMENT DISCUSSION SECTION

Operator

Good day, ladies and gentlemen, and welcome to the quarter three 2015 Arch Capital Group earnings conference call. My name is Emma, and I will be your operator for today. At this time, all participants are in listen-only mode. We will conduct a question-and-answer session towards the end of the conference. As a reminder, this call is being recorded for replay purposes.

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

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

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

And now I'd like to turn the call over to Mr. Dinos Iordanou and Mr. Mark Lyons. Please proceed.

Constantine P. Iordanou {BIO 2397727 <GO>}

Thank you, Emma. Good morning, everyone, and thank you for joining us today.

Our third quarter earnings were driven by solid reported underwriting results while investment returns were impacted by a decline in the equity markets. Group-wide and on a constant dollar basis, our gross written premium increased by nearly 4% in the third quarter over the same period in 2014, while net written premium was up approximately 1%, as underwriting actions in our insurance and reinsurance business were offset by growth in our mortgage business. Changes in foreign exchange rates reduced our net written premium on a U.S. dollar basis by approximately $21 million or 2.4% of our volume in the quarter.

On an operating basis, we earned $126 million or $1.01 per share for the third quarter, which produced an annualized return on equity of 8.6% for the 2015 third quarter versus a 9.7% return on equity in the third quarter of 2014.

Looking at it from a trailing 12 months ending on September 30, 2015, after-tax operating income available to Arch common shareholders produced a 9.9% return on average common equity, while net income available to common shareholders produced an 11.6% return on average common equity.

On a net income basis, Arch earned $0.60 per share this quarter, which was lower than operating income primarily due to realized investment losses. Net income movements 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.

Our reported underwriting results remain satisfactory, as reflected in our combined ratio of 89.7% and were aided by a low level of catastrophe losses and continued favorable loss reserve development.

Net investment income per share for the quarter was $0.54 per share, up $0.01 sequentially from the second quarter of 2015. The strengthening of U.S. dollar impacted total return on the company's investment portfolio, which declined 31 basis points for the 2015 third quarter.

Our operating cash flow excluding Watford Re was $359 million in the third quarter as compared to $319 million in the same period a year earlier, primarily reflecting a higher level of premium collections. Our book value per common share at September 30, 2015 was at $47.68 per share, a slight increase from the second quarter of 2015 and an increase of 8.3% from September 30, 2014.

With respect to capital management, we continue to have capital in excess of our target levels. However, we did not find many opportunities to repurchase shares in the third quarter that would meet our previously stated criteria for share repurchases. As you may recall, our philosophy with respect to share repurchases is based on the relationship of expected returns to the premium to book value, with the exception that we could earn the premium back over a reasonable period of time. Considering the underwriting environment we're operating in and the returns we're achieving, we believe that it would take more than three years to recover the premium paid.

With respect to overall market conditions, reinsurance industry pricing remains under pressure. To date, we have not yet seen significant erosion in the insurance business with the exception of certain lines, which I will discuss in a moment. We believe, however that the ability to buy reinsurance by us and our competitors on favorable terms will eventually lead to more competitive conditions across the insurance industry in the future.

As we have discussed in prior calls, there are several areas in the insurance sector that are experiencing increasingly more price competition. They are, E&S, property, global property, large accounts, professional liability lines, including D&O, especially in the foreign markets, as well as marine, aviation, and energy, business lines in which we continue to reduce our exposure and our participation.

Turning back to our quarterly results, the insurance segment's gross written premium on a constant dollar basis grew 5.6% and 2.8% on a net written basis in the quarter over the same time period in 2014, with most of the growth coming from our construction and national accounts, travel, and accident and health business units. Mark will comment further on premium volume in a few minutes.

In our reinsurance segment, we responded to soft underwriting conditions by reducing gross written premiums on a constant dollar basis by approximately 2% over the same period over a year ago. Increased cessions, primarily to Watford Re in the quarter, led to a further reduction in our net written premium also on a constant dollar basis of 6% for the quarter-over-quarter comparison.

Our mortgage segment includes primary mortgage insurance written through Arch M.I. in the U.S., reinsurance treaties covering mortgage risk written globally, as well as GSE credit risk-sharing transactions. Beginning in 2015 third quarter, the current quarter, new credit risk transactions now follow insurance accounting, which Mark will discuss in a few minutes.

Gross written premiums in the mortgage segment were $74.7 million in the third quarter of 2015 or a 12.5% increase than in the same quarter in 2014, driven primarily by growth in Australian mortgage reinsurance premium along with Arch participation on GSE credit risk-sharing transactions. Net written premium grew 14.3% over the same period to $66.4 million, as we retained a higher percentage of Australian business written in 2015.

Our U.S. mortgage insurance operations produced approximately half of the segment's net written premium in the third quarter, with $24 million coming from the credit union channel and approximately $8 million of premium written from the bank channel. Of note this quarter, underwriting income for the U.S. operations moved into positive territory, with about $2 million of underwriting income in the quarter reflecting the slow but steady progress we're making in this area.

We continue to make progress in the expansion of the bank channel, as Arch M.I. has approved 835 master policy applications from banks, and more than 350 of these banks have submitted loans to Arch M.I. for underwriting. In the third quarter of 2015, we reached a modest milestone, when new insurance written within the bank channel of $1.8 billion surpassed our credit union production of $1.4 billion of new insurance written.

While we continue to see good opportunities in mortgage reinsurance, the GSE risk-sharing transactions issued by Fannie Mae and Freddie Mac are becoming an important component of our mortgage segments' revenues. We pioneered one of the first of these structures over two years ago by building upon the expertise of our mortgage team and working with the GSEs to provide insurance coverage.

Since we're talking about innovation in the sector, it might be worth a minute now to discuss the introduction of RateStar to mortgage lenders last week. We began this project approximately five quarters ago with a goal to develop a more robust risk-based pricing tool that in many ways will parallel what we do across our entire enterprise and is a hallmark of the Arch Underwriting Group approach.

To us, the current rate card approach, which uses just two factors, FICO scores and loan-to-value ratios, while very important variables, over-simplifies the issue. Our team reviewed the very rich proprietary data that we acquired from PMI and other available industry data that would allow us to establish an appropriate price for the risk exposures assumed.

RateStar will enable us to more effectively allocate capital and calculate the appropriate risk-based returns on mortgage insurance at the individual loan level. While this may be a relatively recent innovation for the mortgage insurance industry with United Guaranty, the first to introduce a risk-based pricing tool, this approach has been utilized in our other lines of business within Arch for many years.

As many of you know, the return on risk-based capital serves as the basis for our incentive compensation plan. Our underwriters are paid on the basis of what profit they produce on allocated capital. We are pleased that we're now at the point where we are making the appropriate filings and where appropriate seeking regulatory approval for mortgage insurance, and expect to introduce this into the marketplace during December 2015.

Let me now turn back to the overall market conditions. Across all of our markets, insurance, reinsurance, and mortgage, conditions are competitive to varying degrees. However, Arch's diversified mix of business and our willingness to exercise underwriting discipline should allow us to continue to generate acceptable returns. Group-wide, we believe that on an expected basis that the present value ROE on the business we have written this year will continue to produce an underwriting year ROE in the range of 10% to 12% on allocated capital.

Before I turn it over to Mark, I would also like to discuss our PMLs. As usual, I would like to point out that the cat PML's aggregates reflect business bound through October 1, while the premium numbers included in our financial statements are through September 30, and that the PMLs are reflected net of reinsurance and retrocessions. As of October 1, 2015 our largest 250-year PML for a single event remains Northeast at $509 million, or approximately 9% of common shareholders equity. Our Gulf of Mexico PML decreased to $473 million as of October 1, and our Florida Tri-County PML also decreased to $414 million.

I will now turn it over to Mark to comment further on our financial results. And after his comments, we will come back and take your questions. Mark?

Mark D. Lyons {BIO 6494178 <GO>}

Great, thank you, Dinos, and good morning all.

As was true on last quarter's call and the last few quarters, my comments that follow today are on a pure Arch basis, which excludes the other segment, that being Watford Re, unless otherwise noted. So same as in previous calls, I will be using the terms core to denote results without Watford Re and the term consolidated when discussing results that include Watford Re.

Okay, the core combined ratio for this quarter was 89.7%, with 2.3 points of current accident-year cat-related events, net of reinsurance and reinstatement premiums, compared to the 2014 third quarter combined ratio of 88.5%, which reflected a lower level of cats at 1.6 points.

Losses reported in the third quarter from 2015 catastrophic events net of reinsurance recoverables or reinstatement premiums totaled $18.8 million versus $14.2 million in the corresponding quarter last year, primarily emanating from the Chilean earthquakes and the California fires along with various smaller events.

The 2015 third quarter core combined ratio reflects 7.1 points of prior-year net favorable development net of reinsurance and related acquisition expenses compared to eight points even of prior-period favorable development on the same basis in 2014's third quarter. This results in a core accident quarter combined ratio excluding cats for the third quarter of 94.5% compared to 94.9% in the third quarter of last year.

In the insurance segment, the 2015 accident quarter combined ratio excluding cats was 95.8% compared to an accident quarter combined ratio of 98% even a year ago. This 220 basis point improvement was driven by a 150 bp reduction in the loss ratio and a 70 basis point reduction in the expense ratio, with the loss ratio decrease reflecting lower large loss attritional activity than was the case in the third quarter of last year. Taking this into account, the insurance segment accident quarter loss ratio was slightly higher this quarter versus the third quarter of 2014.

The reinsurance segment 2015 accident quarter combined ratio, again excluding cats, was 94.6% compared to 90.6% in the 2014 third quarter. As noted in prior quarters, the reinsurance segment's results reflect changes in the mix of premiums earned, including a continued lower contribution from property catastrophe and other property businesses. This quarter, most of the combined ratio increase relative to the third quarter of 2014 stemmed from the expense ratio and from a marginally higher level of larger attritional losses.

The mortgage segment 2015 accident quarter combined ratio excluding cats was 82.5% compared to 88% for the third quarter of 2014. This decrease is predominantly driven by the continued low level of reported delinquencies benefiting the loss ratio associated with the CMG business we acquired in 2014 along with excellent credit experience to date on business written since the acquisition. Some of the benefit on the CMG business is offset by the contingent consideration earnout mechanism negotiated within the purchase agreement.

As we commented on last quarter, an accident quarter approach to the mortgage business does not have the same meaning it does on the PC side because of the way the business works and the way the accounting works.

The insurance segment accounted for roughly 16% of the total net favorable development this quarter and was primarily driven by medium and longer-tailed lines, predominantly from the 2007 to 2012 accident years. The reinsurance segment accounted for approximately 78% of the total net favorable development in the quarter excluding the associated impact on acquisition expenses, with approximately 39% of that due to net favorable development on short-tailed lines concentrated in the more recent underwriting years, and the balance due to net favorable development on longer-tailed lines, predominantly from underwriting year 2009 and prior. The remaining 6% of the net favorable development emanated from the mortgage segment, which reflects the continued improvement in the U.S. book delinquency rate.

Approximately two-thirds of our core $7.3 billion of total net reserves for losses and loss adjustment expense are IBNR and additional case reserve which still continues to remain fairly consistent across both reinsurance and insurance segments.

The core expense ratio for the third quarter of 2015 was 34.2% versus the prior year's comparative quarter expense ratio of 33.5%, partially driven by a 3.6% decrease in net earned premiums, and I will discuss each segment's expenses shortly.

The insurance segment's expense ratio decreased 70 basis points to an even 31.0% for the quarter compared to 31.7% a year ago. The net acquisition ratio decreased 90 basis points, whereas the operating expense ratio increased by only 20 basis points. The insurance segment net acquisition ratio reduction continues to reflect materially improved treaty ceding commissions on an earned basis associated with quota share contracts ceded.

It's important to note, however, that on a written basis, the front-end gross commission ratio worldwide actually decreased 50 basis points, whereas the average quota share cede commission ratio improved a substantial 260 basis points, which as you will recall is identical to the benefit achieved last quarter. These overall net acquisition improvements, however, will continue to be felt as these ceded written premiums are earned over the next few quarters.

The reinsurance segment's expense ratio increased from 32.6% in the third quarter of 2014 to 35.6% this quarter, primarily due to a 12.2% lower level of net earned premiums, a higher level of treaty cede commissions, and a slight increase in operating expenses, although serially the expenses actually dropped compared to last quarter.

The net acquisition ratio increased 100 basis points due to market forces, whereas the 200 basis point increase in the operating expense ratio is almost exclusively driven by the net earned premium reduction mentioned earlier. As I commented on last quarter, separating components of the expense ratio can be a little fallacious because of the accounting does not go back and reflect the reimbursement of operating expenses contemplated in the cede commission itself.

The ratio of net premium to gross premium on our core operations in the quarter was 73.1% versus 75.5% a year ago. The insurance segment had a 72.2% ratio compared to 74.2% a year earlier, whereas the reinsurance segment had a net-to-gross ratio of 72% in the quarter compared to 75.8% a year ago, primarily reflecting increased cessions to Watford Re as a reinsurer.

Our U.S. insurance operation saw a 60 basis point effective rate decrease this quarter net of ceded reinsurance. As commented on the last couple of quarters, the pricing environment is quite different for short-tailed versus longer-tailed lines, as Dinos also referred to. Our short-tailed first-party lines of business had an effective 4.4% rate decrease for the quarter compared to a 30 basis point effective rate increase for the longer-tailed third-party lines, both on a net-of-ceded reinsurance basis.

Looking more deeply, some lines incurred rate reductions such as an 8.9% decrease in property and an 8.1% decrease in high-capacity D&O business, while others enjoyed healthy increases such as plus 6% in our low-capacity D&O lines and a 4.1% increase in our program businesses. Also, our lower-capacity D&O lines have now achieved 17 consecutive quarters of rate increases.

Now, turning to our continuing market cycle management, the insurance group worldwide reduced gross written premiums in the highly competitive and volatile lines of E&S Property and Global Property by 12% and Energy and Marine by 15% quarter over quarter. By contrast, lower-volatility lines of contract binding and travel expanded north of 20% on a gross basis, partially offset by a decline in program business due to purposeful underwriting actions.

As stated in last quarter's call, some volume impacts were a result of underwriting actions taken on two programs, whereas another program administrator has been purchased by a competitor, and the premium loss impacts will be felt beginning next quarter.

Lastly, as Dinos has already stated, the insurance segment's construction business saw growth this quarter. However, much of this book has project policies and odd time policy terms, which can result in lumpy premium volume quarter to quarter.

The reinsurance group only had 9% of its net earned premiums represented by property cat this quarter. And property cat net written premiums were reduced by another 11% quarter over quarter, reflecting our view of that marketplace.

Additionally, the property other than property cat line had a net written premium decrease of roughly 6% this quarter, and the reinsurance group also reduced net volume again in motor quota share and crop hail by approximately 20% in response to market conditions.

The mortgage segment posted a 75.2% combined ratio for the calendar quarter. The expense ratio, as expected, continues to be high as the operating ratio related to our U.S. primary operation will continue to be elevated until proper scale is achieved.

The net written premiums of $66.8 million in the quarter is driven by the $31.2 million from our U.S. primary operation and $35.6 million of net written premium from our reinsurance mortgage operations primarily. This segment also had $3.6 million of other underwriting income for the quarter versus approximately $1 million in the comparative quarter last year due to our GSE credit risk-sharing transactions. This quarter marks the first time that we have reflected some mortgage risk-sharing transactions with insurance accounting rather than derivative accounting treatment.

The net written premium this quarter under insurance accounting totaled $2.2 million, whereas legacy risk-sharing transactions shall continue to be accounted for as derivatives; that is, reported in other underwriting income. One should also note that mortgage reinsurance premium growth is driven by the fact that the Australian business is a single premium market as opposed to the United States, which is predominantly a monthly premium market.

At September 30, 2015, our total mortgage segment risk in force is $10.3 billion, which includes $6.5 billion from our U.S. mortgage insurance operation, $3 billion even through worldwide reinsurance operations, and approximately $800 million primarily compared of the GSE risk-sharing transactions.

Our primary U.S. mortgage operation bound $3.2 billion of new insurance written during the quarter, which was approximately 57% through the bank channel and 43% via credit union clients.

The weighted average FICO score for the U.S. primary portfolio remains strong at 737, and the weighted average loan-to-value ratio held steady at 93.2%. Those states risk-in-force represents more than 9% of the portfolio, and our U.S. primary mortgage insurance company is operating at an estimated 10.2-to-1 risk-to-capital ratio as of the end of September.

The other segment, that being Watford Re, reported a 99.4% combined ratio for the quarter on $125 million on net written premiums and $99.2 million of net earned premiums. 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 29% of the $131 million in gross written premium this quarter was written directly on Watford paper, with the remainder ceded by Arch affiliates. It should be noted, however, that this sourcing mix can vary materially quarter to quarter.

The total return on our investment portfolio was a reported negative 31 basis points on a U.S. dollar basis this quarter, primarily reflecting declines in most areas other than investment-grade fixed income. Total return was negatively impacted from the strengthening U.S. dollar and most of our foreign denominated investments.

Excluding foreign exchange, total return was a positive four bps in the quarter. On a year-to-date nine-month perspective, total return was a positive 76 bps on a U.S. dollar basis and a positive 173 bps excluding the effect of foreign exchange.

Our embedded pre-tax book yield before expenses was 2.1% as of September 30 compared to 2.18% at December 31, 2014, while the duration of the portfolio lengthened slightly to 3.42 years. The current duration continues to reflect our conservative position on interest rates in the current yield environment and tactical moves in the fixed income portfolio.

Reported net investment income in the quarter was $0.54 a share or $67.3 million versus $0.53 a share in the 2014 third quarter or $72.2 million. As always, we evaluate investment performance on a total return basis, and as such, invest in asset sectors which may not generate above-the-line net investment income.

Interest expense for the quarter on a core basis was $12 million, which is more consistent with our normal quarterly run rate versus last quarter and the third quarter of 2014 that were affected by periodic adjustments for a certain loss portfolio transfer.

Our effective tax rate on pre-tax operating income available to Arch shareholders for the third quarter was an expense of 5.7% compared to an expense of 2.5% in the third quarter of 2014. Approximately $1.8 million or 22% of this quarter's tax represents a true-up to bring the first half of the year to this now higher effective tax rate. Reflecting this, the nine-month or annualized effective tax rate is 4.5% of pre-tax operating income. As always and as demonstrated this quarter, fluctuations in the effective tax rate can result from variability in the relative mix of income or loss that occurs or is projected by jurisdiction.

Our total capital was $7.05 billion at the end of this quarter, which is virtually flat with total capital as of June 30, 2015 and December 31, 2014. Approximately $522 million remains under our existing buyback authorization as of the end of this quarter.

Our debt-to-capital ratio remains low at 12.6%, and debt plus hybrids represents only 17.2% of our total capital, which still continues to give us significant financial flexibility. And as Dinos has mentioned, we continue to estimate having capital in excess of our targeted position.

Book value per share was $47.68 at the end of the quarter, up 4.6% relative to the end of the year of 2014. The change in book value per share this quarter primarily reflects the company's continued strong underwriting results.

With that said, we are now happy to take your questions.

Q&A

Operator

And your first question comes from the line of Amit Kumar from Macquarie. Please go ahead.

Q - Amit Kumar {BIO 19777341 <GO>}

Thanks and good morning and congrats on the quarter.

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

Thank you.

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

Thank you, Amit.

Q - Amit Kumar {BIO 19777341 <GO>}

Just maybe one or I guess one or two questions. Number one is, going back to the discussion on RateStar, there was some confusion in the marketplace when the press release came out as to what it means for pricing and your competition. Can you talk a little more about it and, without obviously giving away the secret sauce, talk about the expected ROEs? And maybe talk about how should we think about the adoption rate of RateStar going forward. Thanks.

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

As Coca-Cola will never reveal their formula, we won't reveal our formula either. But at the end of the day, we're in the underwriting business. And I think the more robust analytics you have in the way you allocate capital and price risk exposures, the better off you are as an organization. So this effort is towards that goal. We're trying to go from a more simplistic approach to pricing mortgage risk to something a bit more sophisticated that we introduce other variables in the decision-making and in essence affecting the pricing.

Now, it doesn't mean we're going to abandon the rate card. The rate card is out there, and there are some bank channels, some customers they prefer that. And basically, they will only do business on that basis. We will continue to do that, but also there are other channels that they prefer to go to a more sophisticated pricing methodology that more appropriately allocates the right premium to the exposure, and we're going to go forward with that where appropriate. So you're going to continue to see us having both the rate card and RateStar, and only the marketplace will tell us as to how much of which is going to be used over time.

Q - Amit Kumar {BIO 19777341 <GO>}

Got it, that's helpful. The only other question I have is going back to the discussion on capital management. And again, it's a high-quality problem. I'm not sure the capital is burning a hole in your pocket. Would you consider other avenues to return capital, or are we not there yet? How should we think about that?

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

That's the million-dollar question. At the end of the day, yes, we always consider other avenues. Having said that, there is also the unknown that you might want to have a little bit of ammunition in case opportunities come as the market turns, and so it's more of a complicated issue for us.

What was not complicated in this quarter was that we usually stick to our knitting. And when we made the calculations, we felt that it might take four to five years to earn back the premium we're going to pay when we repurchase shares. And we said let's not do that; let's see what other opportunities we have or other avenues. Having said that, we're going to have those discussions both internally as a management team and also with our board when we meet, and we'll make determinations at that time.

Q - Amit Kumar {BIO 19777341 <GO>}

Okay, fair enough. That's all I have. Thanks for the answers.

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

You're welcome.

Operator

Thank you. And our next question is from the line of Michael Nannizzi from Goldman Sachs. Please go ahead.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Thanks so much, just a couple of hopefully quick ones. On the U.S., on the M.I. business, can you talk about how much of your NIW in the quarter was singles versus monthly premium?

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

Mark, you have those numbers.

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

Yes, it is approximately 24% would have been singles.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay. And the RateStar is relevant to the monthly business, I take it?

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

Yes, predominantly yes.

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

You can apply it on both sides because even when you do singles, you get granular mortgage-by-mortgage attributes, so you can apply that. But at the end of the day, when you go to single, you try to look at your return, what kind of a price you're going to get. And that's why you saw a significant reduction in us for the quarter as to how much we wrote in singles.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. And then if we were to think about the RateStar versus the rate card, what demographic – I'm guessing for some types of business it's going to be cheaper and for others it's not going to be. So is there any way to think about?

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

This type of business is exposure, Michael. It's exposure. Let me turn it over to you and you tell me the difference. If you have two loans, they're both 750 FICO and 90% LTV, but one borrower has a coverage ratio of 35% and the other one 25%, which one loan would you prefer? And at the end, how do you reflect that in your pricing? I'm not going to get into all the algorithms that we have because then it's not only you listening, our competitors are listening.

Q - Michael Nannizzi {BIO 15198493 <GO>}

I understand.

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

But introducing additional variables, you've seen it in a lot of other P&C lines. You've seen it a lot on the selection of risk in the automobile business. Progressive is very good and famous for it, GEICO, et cetera. And at the end, it makes for a better return for shareholders and probably a fairer charge to the consumer based on their own risk characteristics.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it, okay. And so just last one on – not about the algorithm. But for the players or for your customers that do accept or prefer RateStar, have you seen a meaningful change in submission volume?

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

We haven't yet introduced it to them. We finished the project. We made the press release. That's why I talked about it. And our sales force is in discussions with the marketplace and starting to introduce it. At the end of the day, we're going to continue having both rating engines available, and it will be up to our customers to choose which one they prefer.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it. Thank you so much for that, Dinos, I appreciate it. And then really quick, Mark, I was just looking at Watford written premiums versus reinsurance ceded premiums, and there is a growing gap there. Is Watford or is the insurance sub or segment ceding business to Watford, or is Watford picking up business from outside of Arch as the difference?

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

As I commented, on a gross basis here's the way to look at it. Twenty-nine percent of it is coming natively on their paper. But we're continuing to get Arch Re affiliates and Arch Insurance to be sending over either a retrocession or reinsurance. And I think this quarter there was slightly more proportionately from the insurance segment.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it, okay, and then last one on the reinsurance expense ratio. I'm just trying to think about that a little bit. So it sounds like the expense ratio to procure businesses for reinsurance is going up, so that's a prior tailwind to the insurance expense ratio. So that's going to raise the acquisition cost I guess for reinsurance, but then you have an offset from Watford because I'm guessing the same dynamic exists between Watford and the reinsurance company. How should we think about - do those things neutralize each other, or is there more of a headwind or more of a tailwind from those intercompany transactions?

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

Your observations are right. The net impact is really market force driven. And there is some element of Watford that is reflected on the fees, reflected in acquisition expense. So as Watford continues to grow, that will become cessions that will continue to be more meaningful as an offset, which I think is the question you were asking. It's probably close to neutralizing but not quite, so you still could perhaps see a net increase but nowhere near the increase it would be without the existence of those.

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

Let me add something to your question from a different perspective. At the end of the day, our intellectual factory that produces great results is the underwriting talent that we have within the reinsurance group. And this management team, me down to Grandisson and Lyons and Papadopoulo, et cetera, we strongly believe that we have very good underwriters, talented underwriters and independent the market might not allow us to utilize them at 120%, which we usually do. We're not willing to send those underwriters back into the marketplace for our competitors to hire, et cetera.

So I never saw a company have problems because their expense ratio went up maybe a point or two. I've seen all companies having a lot of difficulty when their loss ratio balloons by five points, 10 points, 15 points, or 20 points. So you've got to understand; that's our philosophy. Yes, we expect our managers to manage expenses, and there is attrition within the organization. But we're not willing to let go good talent just because we can utilize the factory at full capacity. That to us, the underwriting step we have is our intellectual factory that produces the profits, and I'm going to hold on to that.

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

And one other technical point, Michael, because what Dinos just talked about is a core principle really for us. But on the technical side, there is a little bit of a difference in shift. The treaty business is falling off a bit more, whereas the facultative is not, and that has a direct sales force. So you get a little bit of that weighting pushing it up as well.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got it, thank you both so much for the answers. I really appreciate it.

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

You're quite welcome.

Operator

Thank you. Our next question is from the line of Ryan Tunis from Credit Suisse. Please go ahead.

Q - Ryan J. Tunis {BIO 16502263 <GO>}

Hi, thanks. So, Dinos, your point I guess on the tiered pricing is it allows for better risk selection. That makes sense. But there still seems to be a concern in the market I guess if you look on how some of the stocks have acted in the past week or so that if you're successful at implementing tiered pricing, competitors may follow, and that would then lead to broader pricing pressure. And I guess I'm just curious if that's also a concern of yours and do you think more tiered pricing in general for the industry could lead to pricing pressure?

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

I don't believe it will because the other factor you haven't factored in is what expected returns different us and our competitors are looking for. So better selection doesn't mean that you have lowered your return expectations. All you're doing is pricing more appropriately to the type of exposures you're getting. This is not about reducing pricing in the marketplace. This is about assigning the right price to the right exposure. And at the end of the day, our return characteristics, they're no different if we use the rate card or RateStar.

So having that in mind, it would tell you that basically the whole effort was to improve how we think from an underwriting point of view, not to gain market share as some people – I've heard comments to that effect. If we wanted to do market share or reduce prices, the easiest way to do it is take the rate card and you shave a few bps in each one of the categories. And I don't have to be spending a lot of brain power with a lot of our people over a number of – thousands of man hours in developing something that is more sophisticated.

So I think there is a misunderstanding in the marketplace. But eventually for those who know Arch and know our underwriting approach, they will understand that at the end of the day we're trying to be better in the way we're going to select and price risk appropriately, which is the foundation of this company.

Q - Ryan J. Tunis {BIO 16502263 <GO>}

Got it. So I guess my follow-up then is just talking about assigning the right rate to the right exposure. In doing that, is there a segment of the marketplace that you envision Arch M.I. becoming quite a bit less competitive in that comes to mind?

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

Yes, there are going to be segments that are going to become more competitive and segments that are going to become less competitive. If you expect a certain return from the pie and now the pie is cut a little differently, you're going to have the pluses and the minuses. Now the question is, are you getting a lot more on the pluses and a lot less on the minuses and what kind of return you're going to have with that. Only time will tell. But we're more comfortable with our ability to price the exposures better by using more variables than just FICO score and LTV.

Q - Ryan J. Tunis {BIO 16502263 <GO>}

Thanks, Dinos, good luck.

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

Thank you.

Operator

Thank you. Our next question comes from the line of Sarah DeWitt from JPMorgan. Please go ahead.

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

Hi, good morning.

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

Good morning, Sarah.

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

The GSE growth opportunity sounds pretty interesting for you. How should we think about sizing that? And if we look out over the next five years, what percent of overall earnings do you think that could be?

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

Mark, do you want to take a shot at that?

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

Over the next five years, my crystal ball doesn't go out even five months. But still, we do view it as a positive opportunity. And I think one way you should think about it is that the advent now of Fannie joining Freddie on this, and it seems that because they're expanding and looking for others to participate in this, they're going through the effort to establish a broader market, which gives credence to the fact that they're here to stay and it's not just a transitional thing. So with Freddie continuing to do this and Fannie continuing to do this, we do think it's an exciting opportunity. And so it's definitely going to be a growing piece. Now as long as pricing stays sane, we will continue to be participants in that growing marketplace.

So far on the Fannie deals, they've all had the same structure. They've all been 2.5 points excess of 0.5 point on subject loans that are out there. This is why it's difficult. We don't know how those structures are going to change over time, how they're going to be, higher attachment, lower attachments. So it's very difficult to put your thumb on volume, let alone how much of these are going to be pushed out into the marketplace. But we view it as an exciting opportunity for us.

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

Yes, and they might change to go to first loss or, right now it's excess of loss, so using insurance terms. This is an evolving area, but the demand is robust.

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

Okay, great. Thanks. And then just on M.I. broadly, are you able to be more competitive on price because you have a diversification advantage versus your monoline competitors, or is that not a consideration?

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

That is not a consideration.

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

Great, thank you.

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

You're welcome.

Operator

Thank you. Our next question comes from the line of Vinay Misquith from Sterne Agee. Please go ahead.

Q - Vinay Misquith {BIO 6989856 <GO>}

Hi, good morning.

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

I didn't know you changed your name, Vinay.

Q - Vinay Misquith {BIO 6989856 <GO>}

The first question is on RateStar once again. So what percentage of lenders do you think will use RateStar, and is it the smaller lenders versus the larger lenders?

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

On your first question, I don't have a clue. I can't even project that. On the second question, I would say most likely the smaller lenders will be more adapting to the RateStar than the larger lenders because the larger lenders, they like their more simplicity of the rate card and they have a lot of power in the marketplace, et cetera. Smaller lenders, they're trying to find niches so they can penetrate the market, but that's purely forward guesses on my part. Only time will tell once we introduce this, yes.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay, so that means that this thing could take some time to get through just because the larger lenders I guess make up a bigger portion of the total business, correct?

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

That's correct.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. And my view of this is that the higher FICO scores were subsidizing the lower FICO scores. And so the new rate from the RateStar will reduce pricing for the higher FICO scores and raise pricing for the lower FICO scores. Do you worry that since 60% of your business is in the higher FICO score business that this could lead to higher competition amongst peers and reduce the profitability for the larger pieces of the business?

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

No, you're going in the wrong direction, Vinay. If it was just FICO scores, you don't need to go and make all this effort to create a RateStar with multiple algorithms. It's other characteristics. There is rich data in the loans being provided to us by the lenders, who is the borrower, his co-borrower, what location is that, blah, blah, blah, blah. I'm not going to get into all of the stuff that's within.

If it was purely FICO score, you don't need to make a – you have LTV and you have FICO score. And then if you want to make higher FICO scores cheaper, you take a few points off your rate card and you accomplish that. So that's not what it's all about. I'm surprised as to how much confusion is in the minds of people as to what this is all about. This is a product that will allow us to take other characteristics of the loan and find what we believe is a more appropriate price for the exposure that we're assuming.

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

Vinay, this is just a more sophisticated class-rated plan, just like you have on the PC side as an analogy. But let's not lose the fact that there's already been discrimination between risks with the each M.I. of – I'll use your example of high FICO people. The analogy is schedule rating. You have a file plan, you have a schedule rating, where you can deviate for individual risk characteristics. And I think that's been pretty meaningful up to 20% or 25% to reflect characteristics of each risk. So it's already been occurring with the old rate card that there is discrimination between risks. This is simply we believe a better way to do it and a more consistent way to do it.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay, that's helpful. And just as a follow-up to this mortgage insurance, I had just noticed that the premium growth has slowed a little bit recently, especially on the earned premium side and also on the written premium side. I'm curious as to what's happening there since you're now recording the GSE premiums also as written, correct?

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

The part you didn't mention is a reduction in the singles. The change in the trajectory, I would say it came 100% out of our reduction in the singles.

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

And it's a good time, Vinay, for me to correct something that I said before. I had said that singles were 24% in the quarter. I misspoke, it's 21%. So I believe the trajectory and our view of that continues to drop. So I agree with Dinos's comment.

Q - Vinay Misquith {BIO 6989856 <GO>}

Do you have a sense for what percentage of the business it was last year? Was it a much higher percent last year?

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

Yes, I don't have an exact figure in front of me, but it was substantial.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay.

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

It was the first time we did it last year. And actually pricing on singles a year ago, it was more acceptable to us I think. As the last three, four quarters emerged, it became a more competitive marketplace because we have some competitors that are trying to gain market share through singles. We don't view that as a good place to be, and we're disciplined when it comes to underwriting.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay, thank you.

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

You're welcome.

Operator

Thank you. Our next question comes from the line of Jay Gelb from Barclays. Please go ahead.

Q - Jay H. Gelb {BIO 21247396 <GO>}

Thank you, I may have missed it. But did you mention your Tianjin loss?

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

Insignificant.

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

First off, it's not a cat, so we didn't reflect that within the cat load. And it's just not that large for us, Jay.

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

If it was anything notable, we would have put something out, but it's not notable within our numbers.

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

But there is some exposure from the reinsurance side and the insurance side. And as you know, the uncertainty surrounding these things is quite large. The ability to get in and check things out has really just begun recently. So there's a lot of volatility around it, so you never know.

Q - Jay H. Gelb {BIO 21247396 <GO>}

Okay. Did you add some IBNR just in case?

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

We always do.

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

But it's contained within our standard attritional IBNR, yes.

Q - Jay H. Gelb {BIO 21247396 <GO>}

Okay, perfect. Thank you for that. The other question I have was on the tax rate. So 13% in the third quarter, you said that was a true-up. What do you feel a normalized tax rate is going forward since historically it's been in the low single digits?

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

I think you should - first-off, longer term implies I know where - what jurisdictions are going to give me profits on a go-forward basis, and that really does fluctuate from quarter to quarter. But you're looking at the tax rate on net income as opposed to the tax rate on operating. And just think, it's just the simple arithmetic of it. You've got the tax rate on pre-tax operating income. And to convert over to net income, it's really the realized losses. So you've got the same pack of dollars with a smaller denominator. That's the arithmetic to push it up to 13%. So our current view on operating, trailing 12-month type view on operating income is likely to be 4%-ish - 5%-ish.

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

I would say between 4% and 5%, and that's a better way to look at it. Don't look on net income in one quarter. Look at it from a trailing 12 months, then you've got more of the net income, more of the – and then you can add all the tax and then it will give you a better feel as to what the percentage is.

Q - Jay H. Gelb {BIO 21247396 <GO>}

Okay, that's fine. It just bounced around a little, so I just wanted to quantify that. And then on the buyback, so with the stock now trading around 1.6 times book, it sounds like Arch is really not going to be in the market for buybacks. Is it?

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

I didn't say that. I said something different. I never said I'm not going to be in the market.

Q - Jay H. Gelb {BIO 21247396 <GO>}

Okay. So that valuation seems to be a pretty important parameter. How should we think about it?

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

Valuation is very important. We look at it based on the prospects of what returns we get on the business we write. If my recovery period elongates and we start getting uncomfortable over three years, then we shall wait from – it has nothing to do with how we feel about the stock, it's just purely our approach to it, and that approach might change. I don't know what my discussions with wiser guys, that's why I got pretty wise guys on my board to give me advice on what perspective they're going to have. But based on what I said, we might sit on excess capital because there also might be opportunities for us to deploy in a different fashion in the marketplace.

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

And also, Jay, as you know, we move our mix of business and our capital around depending on what the opportunities are, and we talked earlier about the real opportunities in the GSE credit risk-sharing space. So hypothetically, if that increased at a higher rate than we had anticipated or we have other opportunities around the world, that mixture might increase our view of forward ROE by 200 basis points or something, which is going to come into the equation of time to payback.

Q - Jay H. Gelb {BIO 21247396 <GO>}

Of course, if the stock were valued instead at say 1.5 times book, would that have been within your range of viewing it within the three-year payback period?

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

It could be. It's hard for me to project into the future. It's like describing the guy who can read the obituary pages five years from today and he finds his name there. That's not a good place to be. But we make those decisions and we're flexible on a quarter-to-quarter basis. And we have unknowns, and when we have unknowns sometimes we hold back a little bit. For example, the mortgage GSE opportunities, and I think Sarah is the one who asked the question and I couldn't answer it because I know the opportunity is big, the demand is there, but I don't know how big it's going to be. And I don't know how much of our capital we want to allocate to that.

So when I have unknowns, I'd rather say I've got unknowns and here is how we're thinking, but there might be opportunities because I know you want to build your models and project aa year out or a quarter out and all that, but I don't operate on that basis. I'm trying to make sure that our underwriting units, they make the right decisions based on the latest information they have. And if I have excess capital, it's not burning holes in my pocket. So unless somebody is trying to put his hand in my pocket and take it and then I will cut it, that's not a problem. It's a good problem to have.

Q - Jay H. Gelb {BIO 21247396 <GO>}

That's right. Thank you.

Operator

Okay, thank you. Our next question comes from the line of Kai Pan from Morgan Stanley. Please go ahead.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you and thank you for sticking past your souvlaki lunch time. So first one, do you have any...

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

My lunch sandwich is on the grill.

Q - Kai Pan {BIO 18669701 <GO>}

All right. Do you have any exposure to Volkswagen and potential exposure to Volkswagen and Hurricane Patricia?

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

Insignificant, insignificant.

Q - Kai Pan {BIO 18669701 <GO>}

Okay, that's great. And then on probably cat Gen-1 pricing, what's your outlook and you have been reducing the business quite a bit over the past few years. If the market stabilizes, would you become more interested in writing more business there?

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

Listen, our hallmark is putting the right price based on risk exposures we underwrite. If the market improves, we're going to write more. Our appetite has not disappeared. There were times that we were committing 20%, 21%, 22% of equity capital to that line on a PML basis, and we're down to now 9% and actually for Florida and Gulf of Mexico, which is less than that.

So our appetite will depend on the market pricing. Now, predicting what's going to happen on January 1, who knows. If I have to guess, it would probably be as stable as where it is today because I think even for those that participate, the new capital that comes in, even with no real cat their returns are not super-juicy. That's a sad statement to say when there is no cats, you don't have super-juicy because what do you do when you have a cat, right?

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

Kai, I would also add. You used the term if it stabilizes. It depends what you mean by stabilizes. Improving doesn't mean stabilizing to me. And if the rate cuts stay - there are no more rate cuts and it stays zero percent change, we've been shedding volume given that relative level. So I wouldn't expect our business to increase if it stays at the level where it is today. It would have to improve, not merely stabilize.

Q - Kai Pan {BIO 18669701 <GO>}

Okay, and so you're not expecting any meaningful price increases from current levels?

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

Nothing I see in our eyes now that is going to - that is telling me to anticipate price increases. But we don't make decisions on anticipation. We make decisions as to what we see in the marketplace.

Q - Kai Pan {BIO 18669701 <GO>}

Okay, that's great. Then on management succession, Dinos, you've been running. You have a great track record since you founded the company, and I'm sure you are extra-excited running the business as of today. But I don't know if the company has a mandatory retirement age. But is the board considering succession planning, and how do you think about it?

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

We have succession planning in every senior position we have with - it's part of our process within the comp committee. Their responsibility and my responsibility as CEO is not only preparing my successor, but also each one of our key positions has one or two successors ready from within. And that process is not new; it's been in place now for over 10 years.

Having said that, my contract goes all the way to the end of 2017, actually March 1, 2018, so I can sign the 10-K if I decide to just become the Chairman, but no decisions have been made. But there is an existing succession plan within the company that is part of the responsibility of our board. And they take it seriously and we talk about it at least once a year in the company.

Q - Kai Pan {BIO 18669701 <GO>}

That's great, thank you so much for all the answers.

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

You're welcome.

Operator

Thank you. Our next question comes from the line of Meyer Shields from KBW. Please go ahead.

Q - Meyer Shields {BIO 4281064 <GO>}

Thanks, I'll try to be quick. I know it's getting late. Dinos, I think you did a great job of laying out the point of the RateStar program. But if you're allowing lenders to choose between RateStar and the rate cards, doesn't that just invite adverse selection?

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

If you allow them to have both, yes, but basically what we're telling lenders, you can either have one or the other.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay, so they know.

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

You can't have the rate card and then price it that way and then price it on the other way and go back and forth. It's either you choose to participate with us on the rate card or you choose to participate with us on RateStar.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay, that helps. What is the loss trend in the insurance segment that corresponds to the 60 basis points premium rate decline?

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

I'm sorry, could you, the 60 bps rate decline?

Q - Meyer Shields {BIO 4281064 <GO>}

Right, I'm just trying to get a picture of the funding?

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

It's probably short lines outweighing the increases we get on long-tail lines.

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

That's exactly what it is. So as I stated, it's about 4.4% down on the first-party lines, and I think I said 30 or 40 bps up on the third-party lines.

Q - Meyer Shields {BIO 4281064 <GO>}

Right. No, I understand how...

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

And our volume on the short-tail lines is small, so you've got to do weighted average.

Q - Meyer Shields {BIO 4281064 <GO>}

Right, I'm just trying to get the weighted average loss cost trend that corresponds to that.

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

If you remember your Algebra 1, Meyer, you've got all the information you need.

Q - Meyer Shields {BIO 4281064 <GO>}

So the 4.4% was – I'm sorry, I'm probably more dense than...

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

The 4.4% is not an excess of loss trend, it's the pure effective rate change. You need to layer on top of that to do a loss ratio conversion from period A to period B what your estimate of loss trends is. But as we said in the past, it varies widely by line of business.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay, thanks so much.

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

And we go through those calculations. When we say 60 bps there's a lot of work behind it to come up to that. And I'm being surrounded by actuaries usually. We're pretty technical when it comes to that stuff.

Q - Meyer Shields {BIO 4281064 <GO>}

It sounds like a nightmare, but good luck.

Operator

Okay, thank you. Our next question comes from the line of Jay Cohen from Bank of America. Please go ahead.

Q - Jay Arman Cohen {BIO 3220715 <GO>}

Yes, thank you, maybe a bigger picture question on the mortgage business. I believe, Dinos, in the past you've said that when this business gets to scale that I think the segment earnings could be as much as a third of the overall company's earnings. Is that still a view that you believe is accurate?

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

Yes, that's an accurate view. But I also said that it will take three to five years to get to that point. So we believe that yes, we have potential to be earning $150 million to $200 million annually from the mortgage business, but it's got to get to maturity and we're not there yet.

Q - Jay Arman Cohen {BIO 3220715 <GO>}

Right, and then maybe a bit more technical. When I look at the – as you get scale in this business, the expense ratio comes down. I'm assuming the bulk of that shows up in other operating expense ratio. Should the acquisition expense ratio also improve over time, or should that be relatively stable?

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

That should improve because on the U.S. mortgage side, it's really a sales force that's there. So you're going to have those fixed costs. When you write more volume, it should drop.

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

Our sales force is constant. We're not adding – once you get to a steady state on your sales force, maybe you add one person here and there and then there's a little bit of increased cost of living adjustments, et cetera, incentive compensation. So that's more of a steady number. And then as you're building volume, your expense structure on a percentage basis is going to improve.

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

And, Jay, just to clarify on your first question, yes, longer-term view, mortgage could be materially significant piece of our net income or our underwriting gain or loss, but that's the mortgage segment in totality. That is not necessarily USM. You have the reinsurance segment, and as we said, the increasing contributions from the GSEs. It's in totality.

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

That's what he asked. He didn't ask about anything...

Q - Jay Arman Cohen {BIO 3220715 <GO>}

It was the segment, that's what I figured.

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

Okay.

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

Right, right, fair enough.

Q - Jay Arman Cohen {BIO 3220715 <GO>}

Very helpful. Thanks guys.

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

Thank you.

Operator

Thank you. Our next question comes from the line of Brian Meredith from UBS. Please go ahead.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Yes, thanks. I'll be quick also. Just quickly, Mark, I don't know if I caught it, but last quarter when you talked about the difference between on the insurance side, your ceded benefit that you're getting, ceded on the acquisitions or commission ratio versus what increase your paying, I think it was like 60 basis points on the written. Was it similar this quarter, the spread side?

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

Yes, on the quarter share treaties that dominate the cessions, it was a 260 basis point spread of – or actually let me restate that, improvement in the ceded commission by 260 basis points 3Q-to-3Q. And last quarter, 2Q-to-2Q, had exactly the same improved spread difference.

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

And at some point in time that would disappear because once we cycle over four quarters it's over until – in comparison quarter to quarter.

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

Right. We keep getting the gain, but the difference will go away.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Right, right, so therefore your acquisition expense ratio should probably continue to come down in the insurance space for at least the next couple of quarters?

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

On the earnings, yes.

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

Barring no change on the front-end direct commission, right.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Got you, okay. And then my second question, I guess bigger picture also, if I look at your overall business, reinsurance return on equity probably continuing to come down here with the rate pressure on insurance maybe flattish to down. Is the increase in the mortgage insurance that you're seeing growth, when you look out here, is that enough to continue to offset the decline you're seeing in the reinsurance ROEs to keep it stable?

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

It's a difficult question to answer because it depends on the volume, but two things I've got to tell you. Don't underestimate how good our reinsurance guys are. They're finding other avenues. Not all of their business is this what I would say large client under a lot of pressure business. They're finding niches here and there to still be relevant and have good returns.

And at the end of the day, yes, if our mortgage business continues to grow, it might offset it, but I don't know that because I can't project volumes. We don't spend time thinking about volumes, and that's why we're not trying to be avoiding the questions. But to us, future projections are not – we don't spend a lot of time on those. Where we spend a lot of time is to analyze what we have and how we're going to behave quarter to quarter based on the market conditions that we see every quarter.

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

Let me just add a little bit to that, Brian. The insurance group when it comes to mass is 60% – 65% of the net written, which will then find its way into earnings, and their margins have continued to improve this quarter as well. Some of that is on the loss ratio side that we've seen and some of that is on like the question about the ceded commission overrides. So we expect continuing contributions from the insurance group which, as I said, is 60% to 65% of the weight.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Got you, great. Thank you.

Operator

Okay, thank you. Your next question comes from the line of Ryan Byrnes from Janney. Please go ahead.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Great, thanks. Good afternoon, guys, just one question for me. I'm just trying to figure out why your Tianjin loss was immaterial. It seemed to affect most of your competitors. I just wanted to see if you guys avoided certain risks or coverages that kept you away from these losses, or if it were just simply luck. I'm imagining it's more the former.

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

You can call it luck. You can call it good underwriting or a combination of both. When you give me the choice, I'd rather be lucky than good. But I think we're both lucky and good.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Okay. Thanks, guys.

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

Thank you.

Operator

Okay, thank you. And your next question comes from the line of Rob Hauff from Wells Fargo Securities.

Q - Rob G. Hauff {BIO 5323815 <GO>}

Yes, thanks for squeezing me in here. When I look at your balance sheet, it looks like your revolving credit borrowings went up by about $239 million in the quarter. But when I look at your calculation of leverage, you don't seem to be including those in your leverage number. So are these Watford borrowings, or is something else going on here?

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

You found it.

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

I love it when you answer your own question.

Q - Rob G. Hauff {BIO 5323815 <GO>}

Okay.

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

That's exactly right. It was a $239 million increase in borrowing from the revolver on Watford. But since we consolidated, of course we have to reflect that on our balance sheet. And you're also correct that our capital composition exhibit is for non-Watford. So you hit it exactly.

Q - Rob G. Hauff {BIO 5323815 <GO>}

Okay. And I don't know if you can discuss what they need the money for and if these borrowings are non-recourse to Arch.

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

Non-recourse to Arch is their borrowings, and they're using them for investments.

Q - Rob G. Hauff {BIO 5323815 <GO>}

Okay.

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

Their business plan always included I think 1.5 times leverage

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

Up to.

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

Up to 1.5 times. So it's a company with over $1 billion of capital. So they would probably borrow up to $400 million to $500 million and use it in their investment strategies. We're not responsible for the investments. We're only responsible for the underwriting side.

Q - Rob G. Hauff {BIO 5323815 <GO>}

Okay, great. Thanks very much.

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

You're welcome.

Operator

Okay, thank you. And your next question comes from the line of Ian Gutterman from Balyasny.

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

Hi, thank you. Dinos, I think Kai called you a little old earlier. I was a little surprised by that.

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

He did. Listen. I've been old for a long time. I got the AARP card 15 years ago.

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

I hope you burned it, but that's a different discussion.

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

I did, I did. I actually threw it in the garbage. I was so mad when I got it.

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

Good. So first, to follow up that last question, is the reason Watford needs – not needs or chooses to use debt to get to their asset leverage because they're behind plan on float and then they thought they would have been on float and they're replacing it with straight debt?

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

I don't. Listen, these are questions for Watford.

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

Okay.

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

But what I'm telling you is that they believe there might have been opportunities now based on what they see in the market and they said hey, we can put some leverage on it and buy some stuff.

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

Okay.

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

And, Ian, just to add, that use of leverage was there from day one on the initial business plan.

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

Okay.

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

But no need to go out and borrow when you haven't even deployed your own capital yet. And don't forget, we're starting to generate float for them. Our premium plans have been hitting based on the original plan, so there is float coming in from our underwriting activity.

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

Exactly, that's what I wanted to make sure about, okay, good. So the first question I was going to ask before was – on the capital discussion, can you remind me? You guys have obviously never paid a dividend, whether it be ordinary or special. Remind me why you guys are averse to dividends. Is it a taxing, is it just you don't want the commitment of it?

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

You're forcing a tax bill to your shareholders.

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

Right.

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

And once you give the money, if the next day you get an opportunity, then you've got to go and borrow to take advantage of it. We always like to have a little bit of excess capital. Maybe we have a lot of excess capital. But right now it's not at the level that is really giving me a lot of angst. Even though excess capital is only earning 2.5% – 3% or thereabouts, it is what it is.

But like I said, we talked to our investors, and some of our investors are opposed to a special dividend. They think that over time – it might not be in the next few quarters, it might be in the next year or two, we'll find the right opportunity and deploy capital. Don't forget, we were talking about excess capital, et cetera. Our mortgage business is a new business for us. We only started it about four or five years ago, and it really is getting scale now.

So if I didn't find that opportunity with our guys, it was predominantly Mark Grandisson who discovered based on our discussions with our investment department and me, et cetera, we wouldn't have that opportunity to deploy today in excess of $0.5 billion of capital into that business. So everybody tries to say if I have this magic balance sheet that is always in balance, that would be utopia. But I'm a realist. There is no such thing as utopia. We try to do the best we can.

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

Very fair, I just want to make sure I was remembering correctly; then on M.I., just a couple quick things. One, I don't think this has come up yet. I believe there's a lot of talk about just pricing changing in the bank channel. I think it's more the community bank channel, if I'm correct. Some of the banks are I guess jealous of the credit union success and saying since the crisis things have changed, and the credit union is not necessarily a better channel than a regional bank anymore given changes in lending standards, and why are we charging so much more for M.I. in the bank channel and therefore we should cut rates to bring it more in line with the credit union experience. Is that happening or is that being discussed? And if so, just what are your thoughts on that?

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

Listen, I don't know if it's being discussed because I haven't really specifically talked to our sales force about that. You're right, some of the community bank experience has been better than what I will call the large regionals or the nationals, and the data shows it. And that's why I said before that maybe some of the RateStar might be more adaptable to these community banks, which have similar characteristics to the credit unions. They're closer to their customers. They know them well. They're in the community. They know who is who. And to a great extent, they spend more time and effort in approving mortgages. So how do you reflect that? That's our secret sauce.

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

Got it, very fair. And then just lastly on the RateStar thing, I guess what's interesting to me, I'm not asking to give us your secret sauce here. But just I always thought about FICO things – again, I know you maybe had some missteps in the crisis, but arguably it was because of lending standards maybe more than FICO itself. And when you look at auto insurance that FICO was the best predictor of whether you're going to get into an auto accident. It seems like it's a pretty powerful variable. What do you see...

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

Absolutely, but we're not eliminating FICO. FICO is very powerful, yes.

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

No, right, right. What are the flaws in it that need to be improved?

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

...and loan-to-value is very powerful. But there are other attributes that they have predictive ability and value. So by ignoring them, is it two borrowers or one co-borrowing, is it coverage ratio, is it 30%, 40%, or 50%. And I can go on and on and on into the other things that what territory you're in, what do you think about the housing market in that territory, et cetera, et cetera, et cetera. And I'm not going to go and tell everybody as to what we've done with this, but we've done a lot of work. We believe that it's – I wouldn't say smarter because that's arrogant. I think it's a different way of looking. But I think it's a better way in our view to assign the right price to mortgage risk.

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

That makes sense. I guess maybe if I ask it a slightly different way, is your sense that FICO is maybe explaining it – I was just going to make up numbers here, but is FICO still good at explaining 90% of the difference in borrowers and this gets you to last 10%, or was it maybe two-thirds and this gives you a whole another third? Do you know what I mean? I'm just trying to get a sense of...

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

I don't know because – I don't know from the work. I've seen some of their work and I've participated in some of their discussions. So I can't put a percentage or predictability on any one attribute. But I can tell you FICO is a very important piece. LTV for some risk is very important, for other risks it might not be. Like a young couple, two MBA students that they – college sweethearts, they both have pretty good jobs, and they can only scrub together a 5% payment because they want to live in a bigger house because they have a lot of income. So the LTV might not be as critical, and they might have super FICO scores and these other attributes in that you might price that loan differently than a simple rate card.

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

Got it, makes sense. Thanks for the explanation.

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

Okay.

Operator

Okay. Thank you. And your next question comes from the line of Charles Sebaski from BMO Capital Markets. Please go ahead.

Q - Charles J. Sebaski {BIO 17349221 <GO>}

Thanks. I didn't think I was going to get in today. I appreciate your time.

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

Charles, you've been very patient. So I think you're the last question and we'll give you all the time you want.

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

Chuck, yes, it's good. You're this call's caboose.

Q - Charles J. Sebaski {BIO 17349221 <GO>}

Excellent. I guess the first is on the GSE business. And obviously, you can't predict how the flow on that risk sharing is going to come in the future or how much. But I guess at the current pricing and structuring level, are there any other constraints other than the flow from the GSE for how you guys would participate at current pricing? Is there aggregation or other issues that might halt that as it comes online?

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

There are two issues you've got to think about this. The number one issue is the GSEs, they're going to put this in the market. That's known, there's a lot of pressure by Congress to derisk and not give the credit providers for loans beyond the mandatory 20% down payment, maybe all the way down to 40%. Now that's why we've been hesitant on volumes. And a lot of this goes to the capital markets, and it depends on what pricing they're getting from the capital markets.

What both GSEs, Fannie and Freddie, are doing, they're developing two parallel markets. They're developing the insurance/reinsurance market, and it fluctuates. Sometimes they allocate 20% to 30%, and then the rest of it goes to the capital markets. But we have no control as to what those allocations. If the capital markets become expensive, maybe they would start allocating 30% to 40% to the insurance markets. And believe me, what happens in the capital markets will also affect the pricing that comes onto the insurance and reinsurance market.

The reason they're doing that, they believe that by creating two avenues and two different source of capital responding to these credit risks, it's good in the long run and it might create more stability for them because they have two different paths to share credit risk into the private domain instead of the government taking it.

So I don't know which way it's going to go, but right now we believe that with insurance accounting being introduced and the innovations that we have worked very closely with the GSEs there and their willingness, and they're talking to a lot of others within the insurance and reinsurance business, I don't know how many of them have the expertise to do it but some do. I think this is going to be a new market for the insurance/reinsurance business, and it can be substantial over time.

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

And, Chuck, the other thing that makes it difficult to predict, as Dinos said, Dinos was describing more how Freddie Mac has done it, whereas the same notional base of loans and capital markets and the insurance/reinsurance industry share on that same set. Fannie has done it a little bit differently, but they're using capital markets and the reinsurance market, but it's a different pool.

So what's gone out to the Fannie deals has been exclusively a pool that went to the reinsurance industry. And a separate pool may have gone through the capital markets. So they may not continue doing it that way, they may wind up doing it similar to Freddie. So there are a lot of different parameters that make the projections difficult.

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

It's a young emerging market, and a lot of it is because Congress in general, they want Fannie and Freddie to derisk. And for that reason, we feel optimistic that this is going to - the demand is always going to be there. Now is it going to go 100% to the capital markets? I doubt it. Now what percentage comes to the insurance/reinsurance versus the capital markets is in their hands, and you've got two big customers here and they hold all the cards.

Q - Charles J. Sebaski {BIO 17349221 <GO>}

I guess I'm not asking you to predict what they are going to put out. I guess what I was trying to understand is what are your constraints. Conceptually, Fannie and Freddie could put out more risk than you guys could possibly take or the insurance market just to the size of the portfolio. What is your guys' constraints if we read that Fannie is accelerating their...

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

As we do with every line of business that we have, we have a - think of it as a PML and how much of our equity capital we want to risk, so there is a constraint. And we have developed - actually maybe we're the only ones, I don't know if our competitors do that or not, I have no idea. I'm sure from a risk management point of view they do something of that sort. But we do calculate on a quarterly basis what the PML values we have for the mortgage business. And that will be a constraint at some point in time. When we reach the upper limit of the available PML, that will be a constraint for us. But we've got other vehicles. We might create a cycle at that time. We might use our knowledge and ability and underwriting ability and the systems we have. Don't forget, you've got to have good systems to price loan by loan, et cetera, to introduce other capital providers into the sector with us. As we've done with Watford, we can do mortgage Watford, so to speak.

So, we have a lot of flexibility. We're nowhere near yet of having that constraint. So for the time being, we've got freedom to operate and we've got plenty of capital to deploy, and it's not violating any of our PML criteria that the board sets as to how much risk you're going to take in any particular. I don't care if it's cap risk or mortgage risk or D&O risk we have. In our risk management principles, we have limits that we want to take.

Q - Charles J. Sebaski {BIO 17349221 <GO>}

And then I guess finally on RateStar, are you guys first in trying to use a more automated multi-variant pricing model here? And if you are, what's the lag time or the lead time? If you guys are pitching this out into the market to the originators and your competitors go Arch is a leg ahead of us here now on this, what's the lead time you guys have on this kind of product?

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

I don't know. We're not the first. United Guaranty, part of AIG, introduced risk-based pricing first. Probably they've been out for about a year now. They were ahead of us. Maybe it's longer than a year. And basically we agree with their approach, it's fundamental to underwriting. Now, how acceptable it's going to be to the marketplace and all that, I don't know. But it seems that United Guaranty, they have some penetration and they have acceptability of it for quite a few of the states from an approval point of view. So we're optimistic.

Q - Charles J. Sebaski {BIO 17349221 <GO>}

I appreciate all the answers. Thank you very much, guys.

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

Thank you.

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

Thank you.

Operator

Okay, thank you. So now I'd like to turn the call over to Dinos Iordanou for closing remarks.

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

Thank you for listening to us. It was a little longer. It was mostly mortgage. I almost forgot that I'm in the insurance and reinsurance business. But we're looking forward to be speaking to you next quarter. Have a wonderful afternoon.

Operator

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