Q4 2018 Earnings Call

Company Participants

- François Morin, Executive Vice President, Chief Financial Officer & Treasurer
- Marc Grandisson, President, Chief Executive Officer & Director

Other Participants

- Amit Kumar, Analyst
- Elyse Greenspan, Analyst
- Geoffrey Murray Dunn, Analyst
- Josh D. Shanker, Analyst
- Kai Pan, Analyst
- Meyer Shields, Analyst
- Michael Zaremski, Analyst
- Seth Rosenberg, Analyst
- Yaron Kinar, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

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

Before the company gets started with its update, management wants to first remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the federal securities laws. These statements are based upon management's current assessments and assumptions and are subject to a number of risk and uncertainties. Consequently, actual results may differ materially from those expressed or implied. For more information on 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 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 also available on the company's website.

I would now like to introduce your hosts for today's conference, Mr. Marc Grandisson and Mr. François Morin. Sirs, you may begin.

Marc Grandisson {BIO 4369887 <GO>}

Thank you, Shannon, and good morning to you all. Once again, this quarter, strong earnings from our mortgage segment offset the effects of catastrophe losses in our property casualty segments as Arch produced an annualized operating return on equity of 8.8% and 10.7% for the 2018 fourth quarter and full year, respectively.

Given the level of catastrophe losses across the globe in 2018, our results demonstrate again the value of our core principles of diversification, sound risk selection, underwriting discipline and cycle management. François will provide more commentary on our financial results in a moment, but it's worth pausing for a minute to thank all employees at Arch who are committed to meeting the needs of our clients while producing superior returns.

Given the notable catastrophe events for the past two years, we will begin our discussion of market conditions with the January 1 renewal market in property cat reinsurance. As you may have heard on other earnings calls this quarter, on average, property cat rate increases at Jan. 1 were positive, but below expectations, given the record level of insured cat losses that were reported in the past two years. Across the industry, loss-affected property accounts saw rate increases of 10% or more, while some property accounts in Europe were flat to down 5%.

Hidden within the underlying property cat industry average rate changes, there are some signs of tightening capacity within the retro and facultative markets. But in many case rate levels, relative to risk remain inadequate to deploy additional capital from our perspective.

At Arch, we believe that we enhance our odds of doing better than the industry average by allocating capital dynamically to areas with a better risk/reward trade-off and that disciplined underwriting and risk selection will remain at the core of what makes us and has made us successful.

There is reason to believe that some rate improvement may occur throughout the year as the market absorbs the recent history of large cat losses. However, uncertainty with respect to both the expected amount of capital and the return on capital within the property cat market make it difficult to predict where cat rates will be by year-end 2019.

In the interest of time, I'm not going to review market conditions line by line as I'm sure you have already heard about that on other calls this quarter, but I will instead address the underwriting environment in general. In our P&C segments, in some of our insurance lines, rate increases appear to be outpacing claim trends. But, as we have discussed in prior quarters, we continue to believe that the risk of claim inflation rising above its long-term trend is high and we remain cautious in our allocation of capital and in setting our loss picks.

The modest improvements in rates are concentrated primarily in the short-tail cat exposed business, in the U.S. commercial auto and some areas of casualty. As always, we focus on the absolute level of risk-adjusted returns, not just relative rate changes.

Turning now to our mortgage segment, the underwriting environment remains very attractive with ongoing growth in our insurance in force producing strong increases in earned premium and will contribute to a future stream of earnings that is both stable and predictable. For the fourth quarter, our U.S. MI new insurance written or NIW were $16.7 billion, a 16% increase over the same quarter last year, and the proportion of single premium business remained low at about 9% of NIW this quarter.

Within our U.S. primary business, the credit quality of loans insured remains excellent and our key risk barometers are still at very healthy levels. To put this in historical context, our risk indices tell us that the current borrowers' credit characteristics are still substantially higher, in fact, by roughly a factor of 2 relative to the borrowers of the late 1990s and early 2000s.

We have seen mortgages with greater than 95% loan-to-value grow slightly as a percentage of our NIW to about 16% in the fourth quarter, while credit quality, as indicated by FICO scores, remained high across our in-force book with a weighted average score of 743. As far as the new mortgage risk transfer programs with the GSEs, the so named IMAGIN and EPMI facilities, we believe that these programs will continue to grow within our expectations roughly at a modest 2% of total NIW for the market on an annualized basis.

Briefly, with respect to our investment operations, higher yields available in the financial markets and growth in invested assets led to a 16% increase in net investment income in the fourth quarter over the same period a year ago. We remain underweight credit and interest rate reflecting our cautious outlook.

Moving to capital management, despite our exposure to property cat in 2018, we were able to deploy some of our capital towards expanding our distribution capabilities, deleveraging our debt and repurchasing our shares. As you know, we recently closed on acquisitions in the U.S. and the UK that are expected to expand our distribution base.

Volatility in the equity markets also gave us opportunities to repurchase approximately $100 million of our common shares in the quarters at attractive prices. As in all of our capital allocation processes, we employ a rigorous and disciplined assessment of available opportunities to deploy capital in order to generate long-term returns for our shareholders across all phases of the cycle.

Turning now briefly to risk management, for the past few years and continuing into 2019, our property cat exposures remain at historically low levels with our 1-in-250 year peak zone at about 4.5% of tangible common equity at January 1. We have the ability and the capacity to deploy more capital to this sector if available returns improve to acceptable levels this year.

For Arch clients and investors, our ability to increase our support in times of need is a significant benefit to the marketplace and a source, we believe, of long-term value creation for our shareholders. In our mortgage segment, our issuance of insurance-linked notes known as Bellemeade securities have significantly reduced our shareholders' exposure to the tail effects on our business from economic recessions and have paved the way for a significant reduction into our risk profile despite growth in our insurance in-force.

With regards to PMIERs, as of December 2018, Arch MI's sufficiency ratio was 141% of the GSE capital requirements known as PMIERs as I had mentioned. It also exceeds the proposed GSE revisions under PMIERs 2.0, which is to be effective on March 31, 2019.

With that, I will turn it over to François. François?

François Morin

Thank you, Marc, and good morning to all. I'd like to give you some comments and observations on our results for the fourth quarter. Consistent with prior practice, these comments are on a core basis which corresponds to Arch's financial results, excluding the other segment, i.e., the operations of Watford Re. In our filings, the term consolidated includes Watford Re.

After-tax operating income for the quarter was $189.2 million, which translate to an annualized 8.8% operating return on average common equity and $0.46 per share. For the full year, our operating ROE stands at 10.7%, a solid result in light of the elevated catastrophe activity in the second half of 2018 and a pricing environment in the P&C sector that remains competitive. Book value per share was $21.52 at December 31, a 1.7% increase from last quarter and a 6% increase from one year ago despite the impact of higher interest rates on total returns for the quarter and the year.

Moving on to underwriting results, losses from 2018 catastrophic events in the fourth quarter, net of reinsurance recoverables and reinstatement premiums, were $118.2 million or a 9.7 combined ratio points. These losses were predominantly the result of Hurricane Michael hitting the Florida Panhandle and the California wildfires, but we also felt the impact of other minor events across the globe.

As for prior-period net losses or development, we recognized approximately $74.4 million of favorable development in the fourth quarter net of related adjustments or 6.1 combined ratio points compared to 4.6 combined ratio points in the fourth quarter of 2017.

All segments were favorable, led by the reinsurance segment with approximately $33 million favorable, the mortgage segment also at $33 million favorable and the insurance segment contributing $8 million. This level is consistent with the third quarter 2018 results as we continue to benefit from significant favorable development in our first-lien portfolio in the mortgage segment where cure rates this year continue to be materially higher than long-term averages and expectations.

The insurance segment's accident quarter combined ratio, excluding cats, was 98.3%, slightly lower than for the same period one year ago. Most of the improvement came from lower levels of attritional losses and acquisition expenses.

The reinsurance segment accident quarter combined ratio, excluding cats, stood at 96.2% compared to 103.2% on the same basis one year ago. As we mentioned on prior calls, we tend to look at trailing 12-month analyses in order to assess the ongoing performance of our segments, given the inherent volatility in the business that can emerge from quarter to quarter.

The year-over-year comparison for the reinsurance segment is affected by a few notable items. First, as we mentioned on the previous call, our acquisition expense ratio last year reflected the federal excise taxes associated with a large internal loss portfolio transfer. Second, our loss experienced this quarter was impacted by a large attritional casualty loss arising from the California wildfires. And third, we had a noticeable amount of reinstatement premiums and premium adjustments this quarter that benefited our combined ratio. Once we adjust for these variations, the underlying performance of our reinsurance segment remained strong this quarter.

The mortgage segment's accident quarter combined ratio improved by 1,410 basis points from the fourth quarter of last year as a result of the continued strong underlying performance of the book, particularly within our U.S. primary MI operations. The calendar quarter loss ratio of 2.1% in the fourth quarter of 2018 compares favorably to the 17.8% in the same quarter of 2017 due to substantially lower delinquency rates. Part of the difference is attributable to increased favorable prior development, which was approximately 320 basis points higher than last year.

In addition, there was approximately $13 million or 410 basis points of favorable development on 2018 delinquencies due to very strong cure activity in the period. The expense ratio was 20.5%, lower by 160 basis points than in the same period one year ago as a result of expense savings achieved.

I'd like to remind everyone that due to the nuances of purchase accounting, the amortization of our debt asset should continue to increase in 2019 by an amount that is approximately $8 million higher on an annual basis than 2018 levels, increasing acquisition expenses. These results highlight the contribution to our pre-tax underwriting income from the mortgage segment, which remained strong this quarter.

After allocating corporate items such as investment income, interest expense and income taxes to each segment, the mortgage segment's contribution to our 2018 net income decreases to approximately 75% of the total after normalizing our results for catastrophic activity.

Total investment returns for the quarter was a positive 51 basis points on a U.S. dollar basis and a positive 83 basis points on a local currency basis. These returns highlight the defensive high-quality position of our fixed income portfolio and solid result in our alternatives portfolio in light of a volatile quarter across global financial markets.

During the quarter, we continued to move away from municipal bonds and into corporate and government bonds due to relative valuations. The repositioning of our portfolio during 2018 combined with the reinvestment of shorter maturity bonds and other swap activity at higher yields generated higher investment income year-over-year.

We extended the duration of our investment portfolio in the quarter to 3.38 years, up from 2.94 years on a sequential basis as global economies weakened. Operating cash flow on a core basis was a strong $384 million in the quarter, reflecting the solid performance of our units.

The corporate effective tax rate in the quarter on pre-tax operating income was 16.8% and reflects the benefit of the lower U.S. tax rate, the geographic mix of our pre-tax income and a 210-basis-point expense from discrete tax items in the quarter.

As a result, the effective tax rate on pre-tax operating income, excluding discrete items, was 14.7% this quarter, higher than the 9.9% rate last quarter. The difference from this rate to the numbers noted in our recent pre-release is primarily attributable to discrete items and a higher level of U.S.-based income, which triggered a true-up of tax accruals for the first three quarters of the year.

As we look ahead to 2019, we currently believe it's reasonable to expect that the effective tax rate on operating income will be in the range of 11% to 14%. As always, the effective tax rate could vary depending on the level and location of income or loss and varying tax rates in each jurisdiction.

With respect to capital management, we paid down the remaining $125 million of our revolving credit facility during the quarter and we also repurchased 3.6 million shares at an average price of $27.11 per share and an aggregate cost of $98.2 million under our Rule 10b5 plan that we implemented during this quarter's closed window period.

Our remaining authorization, which expires in December 2019, stood at $164 million at December 31, 2018. Our debt to total capital ratio stood at 15.5% at year-end and debt plus preferred to total capital ratio was 22.5%, down 390 basis points from year-end 2017 and a full 620 basis points from year-end 2016 when we closed the UGC acquisition.

Finally, I would like to bring to your attention a change we are introducing in 2019 regarding our incentive compensation practices. As you know, equity grants made to employees had historically been awarded in May of each year. Starting this year, equity grants are expected to be awarded in the first quarter, subject to board approval. As a result, we would expect a small distortion in the timing of our operating expenses. The impact of this change based on 2018 equity grants is an expected shift of approximately

$11 million to $13 million in operating expenses from the second quarter to the first quarter of 2019.

Two-thirds of that expense is expected to be reflected within our operating segments with the remainder in corporate expenses and investment expenses.

With these introductory comments, we are now prepared to take your questions.

Q&A

Operator

Thank you. Our first question comes from Kai Pan with Morgan Stanley.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you. Good morning. The MI segments continued to show very strong results. Is the 16%, the underlying loss ratio, a good run rate going forward or you see continuing improvements from there?

A - Marc Grandisson {BIO 4369887 <GO>}

The loss ratio has been very good and actually better than we had anticipated probably a year, year and a half ago. So, we have ongoing improvement in notice of the falls in curing rate. So, right now, everything we're pointing to is much less than the long-term average, which would be 20% I would think overall cycle. So, yes, you could pick your number, Kai. It's very hard to predict the future, but certainly we are in a very benign loss environment.

Q - Kai Pan {BIO 18669701 <GO>}

That's great. But if you take out I mean the large amount of reserve leases, the reported loss ratio is below 10%, have been around 10% for the last several years. At what point the regulator would just say, hey, the result is too good and will (00:19:53) be more focused on either pricing or competition could start to come in?

A - Marc Grandisson {BIO 4369887 <GO>}

Well, I think I'm not sure what the regulators would do, but from our perspective, this is still a risky insurance product like everything else that's out there and what matters is really about the return. And I would argue that even if you have a little bit higher-than-average return in the current environment, that probably more than makes up for some of the bad years that have occurred in the industry.

So, we're not losing sleep over this. There's no commentary to the effect that the loss ratio is too high or too low. In fact, I would even argue that the new capital framework from the GSEs are leading us in a direction of still appropriate level of capital and return in the industry to make sure it's a solid framework for housing finance.

Q - Kai Pan {BIO 18669701 <GO>}

That's great. Hopefully the industry have a long (20:48) memory. So, on the reinsurance side, the top line growth is very strong even without the reinstatement premiums for the quarter. Could you talk a bit about where do you see growth opportunity and what kind of return are you getting from those businesses? Are they higher than your existing business?

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. So, the growth year-on-year is a little bit distorted. If you look at the last four quarters, it's more consistent. The growth that we've seen over the last 12 months continues to be areas that we've talked about before, international motor quota share, actually some commercial auto, we have some opportunities in there, and some workers' comp opportunities of all things and some property-specific – property cat-related exposure in the reinsurance group as well.

So, the growth that we're seeing in reinsurance is consistent with our fishing and looking around in the world for good returns, better risk-adjusted return if we can, and away (00:21:45) from probably the more traditional commoditized reinsurance business. So, it's a little bit more bespoke than the rest of the things you would hear about the marketplace.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. Last one if I may on California, you had losses both from the property side as well as the liability side. So, how do you think of the market going forward in term of pricing, in term of like any – sort of like your risk appetite in the market on both the property side as well as the liability side for the utilities?

A - Marc Grandisson {BIO 4369887 <GO>}

Yes. So, on the liability side, it's a little bit easier to answer, because these things almost – there's a lot of question mark in the industry as to whether these are insurable and at what level and at what price. And as you know, it's not a big market. And currently the player that's been tagged or have been identified as being liable for that loss is going through a lot of difficult times. So, we'll see how that develops. So it's currently developing as we speak.

This is still a very small market right in a broader scheme of things. As far as the property is concerned, it's really uncertain. As I said in my opening remarks, the capital supply is still plentiful. There were talks at the beginning, Kai. Maybe that's what you allude to, to the fact that there might be some changes to the modeling of California wildfires, but it's still very early. People are still trying to figure out what they have and what it means in their modeling.

And as you know, it's a more – it's a little bit isolated, in fact, right. It's isolated to one area of the country and people have a way to manage a portfolio and deploy capital in other areas. So, it's a very hard question to answer, because we don't know what the supply of capital is going to be by mid-year, but logic would dictate it should go up to some extent, but we'll see what happens.

Q - Kai Pan {BIO 18669701 <GO>}

Great. Well, thank you so much and good luck.

A - Marc Grandisson {BIO 4369887 <GO>}

Thanks, Kai.

A - François Morin

Thank you.

Operator

Our next question comes from Geoffrey Dunn with Dowling & Partners. Your line is open.

Q - Geoffrey Murray Dunn {BIO 3447798 <GO>}

Thanks. Good morning.

A - Marc Grandisson {BIO 4369887 <GO>}

Hey, Geoff.

Q - Geoffrey Murray Dunn {BIO 3447798 <GO>}

I was hoping you could comment a little on the ILN market. Now that just about all the MIs are using that market and indicating that they plan to use it on a recurring basis, are you seeing any change in terms, conditions, appetite or is it as steady as it was over the last few years?

A - François Morin

No. What we've seen – there's actually no indication that it's weakening. We see tremendous investor appetite for the product. As you know, the GCs (00:24:13) really started and we were in there as well as the sole MI that was accessing that market. In the last year, most of the others have jumped into, I call it, on the bandwagon and it just makes it for – I mean investors now have the ability – when they do their research, they do the analysis, they feel it's something that's repeatable. They can access that type of product not only through us, but also through some of our competitors.

So, as far as we can tell, there's still tremendous appetite for the product. It's expanding a little bit, getting some of our instruments rated. There's also help, but we see that as something that we – there's nothing on the horizon that suggests that we won't be able to execute on it.

A - Marc Grandisson {BIO 4369887 <GO>}

And to add to this, Geoff, I would also argue that the spreads are not widening. At least, we don't see any indication of spreads widening. So, this appears to be a stability of pricing expectations in the product as well.

A - François Morin

Yeah. Recognizing...

A - Marc Grandisson {BIO 4369887 <GO>}

There's some volatility here and there, but in the long term, we think, yes.

A - François Morin

Yeah.

A - Marc Grandisson {BIO 4369887 <GO>}

Spreads have been very stable.

A - François Morin

Yeah.

Q - Geoffrey Murray Dunn {BIO 3447798 <GO>}

It looks like you took another dividend this quarter. Should we take that to assume that the regulators are also comfortable with this market and view it as true capital relief?

A - François Morin

Absolutely.

Q - Geoffrey Murray Dunn {BIO 3447798 <GO>}

Okay.

A - François Morin

I mean, we argue it's even better than traditional reinsurance, because we have the cash on hand. So, it's collateralized on – and from that point of view, they agree with it, they accept it and they should have been happier than just other forms of capital. I mean, aside from just additional equity.

Q - Geoffrey Murray Dunn {BIO 3447798 <GO>}

Okay. And then, a follow-up on new notice development. Is the company's book reaching an inflection point where even though the newer vintages are of very high quality and outperforming, but the book size is obviously and the ceasing is going to drive decent new notice levels? Are the more recent vintages now exceeding the benefit of the runoff of the 2008, meaning that we should see on average new notice growth going forward?

A - Marc Grandisson {BIO 4369887 <GO>}

I think we will at some point. I'm not sure that we've crossed it yet. It's very hard for us to see and to predict that, but you're right, over time, we would expect as the 2009 in prior – or the 2008 in prior is rolling off. Yeah, we would expect that. And I'm not sure that we are there yet.

Q - Geoffrey Murray Dunn {BIO 3447798 <GO>}

Okay. Great. Thank you.

A - Marc Grandisson {BIO 4369887 <GO>}

Thanks, Geoff.

A - François Morin

Thanks.

Operator

Our next question comes from Josh Shanker with Deutsche Bank.

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

Good morning, everybody.

A - François Morin

Good morning.

A - Marc Grandisson {BIO 4369887 <GO>}

Good morning.

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

So, I was noticing the trend and it was not so surprising that the proportion of new policies being run on the mortgage segment that are coming from refis gets smaller and smaller all the time, now down to 5%. Is there any difference ultimately you think in the quality of a refi-ed mortgage versus a new mortgage. I guess you know the refi-ed mortgage is better, at least the market knows them better. How should we think about that?

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. Clearly, there tends to be at the margins better quality for the refinance market, but it's clearly not a target market for the MI market, right? So broadly, you are right. But in terms of what pertains to be MI market, our penetration for origination of MI – of mortgages in refinance is 5% or 6%. So, it's very, very small. The market that we are targeting that is really our bread and butter, if you will, is the purchase market and that's still pretty healthy and that's really what we've been focusing on.

So, having said all of this, if you look at historically at the blend of the cycle, the blend of the DTI, it's been fairly consistent and I think that speaks to – there's not that much of a difference between the credit requirement whether you refinance or whether you purchase.

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

And not to belabor too much on the refi, but typically if you are writing the MI on a refi-ed mortgage, are you the MI on the mortgage it's replacing?

A - Marc Grandisson {BIO 4369887 <GO>}

Not necessarily, because you could be refinancing with the different financial institutions and at the end, that institution may have a different agreement with a different MI. Not necessarily.

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

Okay. And switching gears, on the wildfire liability, look, obviously that was a difficult loss two years in a row, but the pricing might have been adequate to take that. A lot of times though in certain markets, the market really isn't big enough to give you a payback, no matter how good the pricing is. Do you think you'll get a chance to write wildfire liability this year and is the market sizable and attractive enough to make it a worthwhile business to write on a multi-year basis?

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. The answer is yes to all of those. I think, in general, we don't think of either being in the market or not based on size. I think what it means to us is we would put in relation to the market size our commitment to that marketplace and you have to – the interesting in re-insurance, Josh, is you have to forget last year and look forward, because if you look back to what the losses you had, you don't have to make the money the way you lost it. That's clearly one thing that we always live by every day, but certainly, every time a proposition comes to us, provided we have the right information and the right perspective on the loss, if it's a profitable thing, we would do it regardless of the size of the market. The only thing that we would do is right-size our commitment to that specific market based on its size relative to the broad capital base of the company.

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

And is that a mid-year renewal?

A - Marc Grandisson {BIO 4369887 <GO>}

I believe so. I believe so.

(00:29:58)

Yeah, yeah, it was a multi-year, yes. Correct. Sorry, yes.

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

Okay. Thank you.

A - Marc Grandisson {BIO 4369887 <GO>}

Thanks, Josh.

Operator

Our next question comes from Mike Zaremski with Credit Suisse. Your line is open.

Q - Michael Zaremski {BIO 20606248 <GO>}

Hey. Good morning.

A - Marc Grandisson {BIO 4369887 <GO>}

Good morning.

Q - Michael Zaremski {BIO 20606248 <GO>}

First up, François, in the prepared remarks, you made comments about actions you take on the expense side to improve the ratio and the trend has been improvement over the last year or so. This quarter came in, I think, better than expected. Any one-time items in there or is that improvement somewhat sustainable?

A - François Morin

Well, are you referring specifically to mortgage?

Q - Michael Zaremski {BIO 20606248 <GO>}

Yeah. Yeah.

A - François Morin

Yeah, well, mortgage, right, we acknowledge internally that it's been two years since the acquisition and we're basically complete with the integration. And we told – hopefully you guys will remember that we told you it'd be a journey, would take a couple of years to fully integrate the two operations and we're at this stage now when you compare obviously year-over-year Q4 2017 to Q4 2018 where we just realized more savings in technology and people, et cetera.

So, I think we're kind of there. There's also a bit of seasonality that comes into play, but we're truly in a good spot in terms of where we think our expense base and especially operating expenses will be going forward.

Q - Michael Zaremski {BIO 20606248 <GO>}

Okay. Got it. And sticking with the mortgage segment, Marc, you made a – interesting stat you made in the prepared remarks about mortgage credit quality being approximately – I think you said two times better than crisis levels. Maybe you can further elaborate on what's behind that viewpoint?

A - Marc Grandisson {BIO 4369887 <GO>}

We have internal proprietary credit analysis evaluation and you could also look at some things that are published by outfits such as the Urban Institute and you will look at the relatively credit quality based on an index looking at late 1990s, early 2000s, factoring income, credit score and all these various aspects of a creditworthiness of a borrower. And when you run it through the grinder, if you will, and you come up with a number at the end, that number is half of what it was back in the late 1990s and 2000s. So, this may, on a comparable basis, long stand to be as apples-to-apples as can be.

Q - Michael Zaremski {BIO 20606248 <GO>}

Okay. It's interesting because yeah, we know qualitatively there's a lot of reasons why credit quality is most likely better. So, it's interesting that you're trying to quantify it, that's helpful.

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. Very, very much so. Yeah.

Q - Michael Zaremski {BIO 20606248 <GO>}

And so, I'll just follow-up on that and maybe I'm missing this on the supplement. I can get it offline, but at what percentage of the mortgage insurance portfolio has reinsurance protection and what's the average duration of that reinsurance protection?

A - François Morin

That's a good question. I mean I don't have the numbers right in front of me, but it's...

A - Marc Grandisson {BIO 4369887 <GO>}

There are a couple things. So at 50% quota share with AIG...

A - François Morin

20 years.

A - Marc Grandisson {BIO 4369887 <GO>}

2014 through 2016. Then, you have Bellemeade. We have about $1.1 billion of outstanding limits on the Bellemeade that covers...

A - François Morin

About two-thirds.

A - Marc Grandisson {BIO 4369887 <GO>}

It's about...

A - François Morin

Third-thirds.

A - Marc Grandisson {BIO 4369887 <GO>}

Two-thirds. Two-thirds of our portfolio has reinsurance against it. Thank you.

Q - Michael Zaremski {BIO 20606248 <GO>}

Okay. And the duration of the Bellemeade transactions roughly?

A - François Morin

Well, they're 10-year transactions, right. So they're all a bit different. Some have features where we tried to have the coverage be in-force for a bit longer, but I would say about five years is probably something where we – that we – and as we keep rolling off or adding new ones, so I think that should remain pretty stable as we move forward.

Q - Michael Zaremski {BIO 20606248 <GO>}

Yeah. Thank you very much.

A - Marc Grandisson {BIO 4369887 <GO>}

Thank you.

Operator

Our next question comes from Elyse Greenspan with Wells Fargo. Your line is open.

Q - Elyse Greenspan {BIO 17263315 <GO>}

Hi. Yes. My first question, so you guys said if you normalize for cats, that your see (00:34:13) mortgage, I think you said about 75% of earnings, I guess. What do you guys view as your normal cat load, since your PMLs have come down, right, but we're coming off of two years of pretty high cat losses?

A - François Morin

Well, the cat load roughly is about $30 million a quarter, $30 million to $35 million a quarter, that's kind of where we've been, what we've been running at the last couple of years and these numbers that I quoted, really all we do is replace, effectively, the actual cats with the expected or the cat loads. So, hopefully that answers your question.

Q - Elyse Greenspan {BIO 17263315 <GO>}

Okay. And then, so when you give us the tax rate guidance for the coming year, you're also assuming that cats fall within that normal level, correct?

A - François Morin

Correct. Yes. That's fully a full-year forecast with an expected cat year, which as you know is usually not the case. It's either lower or high, but yes.

Q - Elyse Greenspan {BIO 17263315 <GO>}

Okay. And then, on reinsurance, you guys seemed to kind of be cautious and balanced in terms of what might happen at the mid-year renewals. Marc, how much would you say you need rates to go up for Arch to want to materially write more cat business, if you want to talk separately about what you might want to see at April 1 versus, 06/01 and 07/01 in Florida?

A - Marc Grandisson {BIO 4369887 <GO>}

I guess I could tell you a lot more, but that's not going to get you what you want. So I think if you look back, Elyse, at one of my comments about six quarters ago, looking back at the characteristics, at the time, the numbers were 35% to 40% to really start getting us to the risk-adjusted return that we believe is appropriate. We've had since maybe 10% to 12% rate increase. So, that tells you we're probably 25% to 30% still short of rate change to really get there.

And again, I want to caution everyone that is listening to this saying that that 20%, 25% is not going to come across the board all at once. There are some pockets that need a bit more than this, some that need a little bit less than this, but that gives you a flavor for how much more we believe we need to get us to start going the path of deploying more capital.

Q - Elyse Greenspan {BIO 17263315 <GO>}

Okay. Thank you. That's helpful. And then, on the mortgage side, as some of your competitors have adopted risk-based pricing models as well, have you started to observe a broader impact on the market, kind of anything changing there?

A - Marc Grandisson {BIO 4369887 <GO>}

Nothing yet. It's still very, very early. So we'll have to wait and see how it is rolled out, how it's actually developing in the marketplace. And I would say that for everybody's benefit that our risk-based pricing was created back in 2011. This is our UG (00:37:00) - well now, Arch U.S. MI operation and there's a lot of things that need to happen to have a run rate.

So, we're going to have most likely some bumps along the way. Our competitors are going to be trying things and figuring out things that work and don't work out as well. So we're bracing for it, but the key thing from our perspective is we're keeping steady in our grid and our risk-based pricing. And we're going to take whatever market - however they react, we'll be the beneficiary or we'll lose some business because it's mispriced based on our own. But, it's too early to tell, Elyse. It's going to take a while.

Q - Elyse Greenspan {BIO 17263315 <GO>}

Okay. Great. And then, there's some concerns on the outside in terms of recession and impact on credit and how that might play out late this year, maybe into 2020. As you guys obviously alluded to credit being really strong relative to past cycles, but what would you be paying attention to, to see the potential turn in the credit cycle?

A - Marc Grandisson {BIO 4369887 <GO>}

Right now, I think if you look historically at what went wrong, it really did not – I mean certainly the credit quality, the credit worthiness of the borrower is extremely important, right. But what happened historically that really created the issue is a product development. If the product (00:38:20) like the low doc, no doc, Alt-A, all this stuff comes back to the market, this is what we'd be worried about.

Of course, the other macro thing that could impact everything is a housing price depreciation across the economy. But one thing that we're not worried about – the reason why we're not so worried about right now is because there is a shortfall on housing supply and it's been there for quite a while. So everybody is predicting a smaller price increase in-house prices, but still positive for the next two, three years. So, a recession could probably put a bump on this. So, if you look at it historically in some recessions in the past, we had times when house price increased by 1%.

The only time it went down, guys, for your benefit and that's actually very useful to know, is only in 2007/2008 crisis. For the last 45 years, it never – the house price index, despite having gone through five, I think, different recessions, only came down once, the price index came down once.

So, that the product is really the problem, Elyse, and we don't see anything yet.

Q - Elyse Greenspan {BIO 17263315 <GO>}

Okay. Thank you very much. I appreciate all the color.

A - Marc Grandisson {BIO 4369887 <GO>}

Welcome. Thank you, Elyse.

Operator

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

Q - Meyer Shields {BIO 4281064 <GO>}

Great, thanks. Marc, in your introductory comments, you noted not just that loss trends could get worse, but they could resume sort of above-average levels. And I was hoping you could sort of clarify why that is a concern right now?

A - Marc Grandisson {BIO 4369887 <GO>}

Because we're seeing some changes in some of our submissions and some of our data, it's still very early signs. And it's really anecdotal, sometimes anecdotal, sometimes actually real. So, we're seeing price, seeing loss trend picking up in certain areas.

And we believe, it's only a matter of time before we start spreading to other lines of business. And in my eyes, we're students as well as of the industry and the CPI is about 1.8, 1.7. As I mentioned that in prior calls, the inflation on – the insurance inflation is typically running ahead of it by 150 to 250.

So, I would expect the trend that could be recapturing, having a very vibrant economy, exposure growth and more friction in the marketplace. We would expect those to generate more losses. And the reason we're putting that out, Meyer, is because I want to put that into perspective of the price increase that we're talking about on average, being 200 bps to 250 bps or 300 bps, it's just doesn't make for a lot of margin of safety as you go about it analyzing how you allocate capital between lines of business.

And as you know, more probably than I do is when you write a business, an insurance policy, it takes years for you to really find out how bad or how good it's going to be. So we tend to take a more cautious approach to it.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. That's very helpful. And thank you. A quick modeling question, with the recent U.S. and UK acquisitions, are those going to produce any appreciable change in the expense ratio?

A - Marc Grandisson {BIO 4369887 <GO>}

Short term.

A - François Morin

Well, both acquisitions were the insurance (41:27) segments. So I would say that the expense ratio, yes, no question that in one of our acquisitions, the UK, maybe a bit of integration expenses that we'll have – that will be reflected. But all in all, given that the U.S. one was something that we – it's a partner, or it's a business that we've done business with for many, many years, that should not really impact the expense ratio.

And the final thing, which you'll see in the 10-K that will certainly trigger a bit slightly higher intangible amortization expenses that start coming through in 2019.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. And that's segment or corporate?

A - François Morin

Well, the intangibles is all one number, all together. So when we finish up our analysis and we publish a 10-K in a couple of weeks, you'll see the slight changes in – from what we published a year ago, which was primarily UGC-related.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Fantastic. Thank you.

A - Marc Grandisson {BIO 4369887 <GO>}

Thank you.

Operator

Thank you. Our next question comes from Brian Meredith with UBS. Your line is open.

Q - Seth Rosenberg {BIO 21233136 <GO>}

Hey, guys. Seth Rosenberg here for Brian. Thanks for taking my questions. I got one for you. So if you look at the insurance segment, large losses improved versus last year. But if you look back at last year, I think, you had called out 2.2 points, which was elevated at the time.

So if you just take this quarter in a vacuum and not the comparison, would you say that large losses were better or worse, in line with expectations? And I ask because so many companies are calling out a higher frequency and severity of large losses. So just trying to get a feel if there's something in loss cost there that concerns you.

A - Marc Grandisson {BIO 4369887 <GO>}

Right. So our insurance group has some lumpiness to it, right, not as much as reinsurance, for obvious reasons. But there's still some quarters that are above average or below average. This quarter was sort of an average quarter for us in terms of a large risk loss or non-attrition loss as they call it. We have a hard time for everybody's benefit, slicing and dicing and the losses in so many different sections. At the end of the day, we are providing insurance coverage for all kinds of losses. So what you're seeing right now is sort of what is our loss being inclusive (43:31) of all the things that could happen in our portfolio.

Q - Seth Rosenberg {BIO 21233136 <GO>}

Got it. So nothing particular to construction costs or labor that really stuck out and drove severity?

A - Marc Grandisson {BIO 4369887 <GO>}

No. If anything would have happened there, it would be already factored in our loss ratio pick.

Q - Seth Rosenberg {BIO 21233136 <GO>}

Got it. Thank you.

A - Marc Grandisson {BIO 4369887 <GO>}

Yeah.

Q - Seth Rosenberg {BIO 21233136 <GO>}

And then, switching over to a mortgage, last year the delinquency rate spiked up due to the storms in the third quarter. No reason to believe that we would see a similar dynamic in the first quarter from Michael and the wildfires?

A - François Morin

No. We looked at this and we also thought about the government shutdown, which was on the horizon. But there's certainly GSE rulings that prevent us from these potential delinquencies developing into claims.

And going back to the hurricane, 2017 was slightly different in the sense that both - in particular Harvey where the flooding was persisted for a number of weeks. It was more damaging than Michael that came in and through and didn't really have an elongated timeframe to the event. So at this time, we don't think there will be any spike in our delinquency from the cats.

A - Marc Grandisson {BIO 4369887 <GO>}

François, as far as the government shutdown, Trump signed up something at the end of January just releasing back pay, so...

A - François Morin

Right.

A - Marc Grandisson {BIO 4369887 <GO>}

...that should be - should go a long way to alleviate any of our concerns there.

Q - Seth Rosenberg {BIO 21233136 <GO>}

Great. That makes a lot of sense. Thanks, guys.

A - Marc Grandisson {BIO 4369887 <GO>}

You bet.

Operator

Our next question comes from Amit Kumar with Buckingham Research. Your line is open.

Q - Amit Kumar {BIO 15025799 <GO>}

Thanks and good morning. Just two quick follow-ups, if I may. The first question goes back to the discussion on wildfire casualty losses. I just wanted to understand a bit better. If the utilities numbers change, or if there's any other development, does your current number remain static? Or how is that reserve? Maybe just help me, just explain that a bit more.

A - François Morin

Well, from our point of view, it was a – it's fully reserved. So there's no adverse development that we can see on this on this particular claim. Yes, it might with bankruptcy court and things could change. But if they change, we think they'll be in our favor, they will reduce the number. But we've taken the most conservative view that we can think of at this point. And we'll see how things play out.

Q - Amit Kumar {BIO 15025799 <GO>}

And what is the size of this book for you in terms of percentages or any way to sort of think about it?

A - François Morin

Well, it's really a one-off, right? It's not a book per se. We have a small unit that focuses on these kind of bespoke transactions. Typically, there is a lot of them that are property-type deals. This one is a casualty deal as well. And, as you know, these deals come to the market infrequently that you don't know where they're coming. You look at the opportunity, you assess the risk, you make a decision on the pricing. And if the risk-adjusted returns are there, we try to participate. So at this point, it's really not – it's not really a book in itself. It's an amalgamation of policies that we write on an ad-hoc basis.

A - Marc Grandisson {BIO 4369887 <GO>}

And, Amit, one thing that's interesting we just want you to know because it's such in a high press to get out of press, you don't hear about the 98 others that are actually – that worked out to our favor. But let's leave it at that.

A - François Morin

Yeah.

Q - Amit Kumar {BIO 15025799 <GO>}

That's a very fair point. Yeah. I guess, the only other question I had was going back to the discussion on buyback and I think in opening remarks, you talked about the volatility in the markets giving you an opportunity. The buyback obviously was higher than my numbers and the Street numbers. In the past, we used to talk about a matrix and so there used to be a matrix on your website, which I was having trouble finding, are we still utilizing that payback matrix or how should we think about the future buybacks?

A - François Morin

Well, yes, the matrix that you're referring to is still the starting point of our analysis.

Q - Amit Kumar {BIO 15025799 <GO>}

Yes.

A - François Morin

And the question that comes up often from many of you on the phone is with the growth in the mortgage segment, does that matrix or that view change?

Q - Amit Kumar {BIO 15025799 <GO>}

Yes, sir.

A - François Morin

And the answer is it does, but it's not black and white. What we like, and we told everyone before about the mortgage segment is that we like the visibility and the predictability of the earnings stream that it gives us. So the three-year payback that we've targeted in the past, we have a view that, yes, maybe we'd be willing to extend it to four years, to five years, who knows? But that's always considering all the options that are available to us.

We talk about acquisitions. We talk about reducing our leverage, so there is all these aspects of capital management that come into play and yet – I mean, so hopefully that answers your questions. So the grid is still there, but we have some flexibility around it.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. That's what I was looking for. That's all I have. Well, thanks for the answers and good luck for the future.

A - Marc Grandisson {BIO 4369887 <GO>}

Thanks, Amit. Appreciate it. Thank you.

Operator

Our next question comes from the Yaron Kinar with Goldman Sachs. Your line is open.

Q - Yaron Kinar {BIO 17146197 <GO>}

Hi. Good morning.

A - Marc Grandisson {BIO 4369887 <GO>}

Hi.

Q - Yaron Kinar {BIO 17146197 <GO>}

Just want a quick one. Can you recap the cat losses by events?

A - François Morin

Well, we typically haven't done that. So that's – the number you have in front of you is both for wildfires and Michael, but predominantly with a few small others as well.

Q - Yaron Kinar {BIO 17146197 <GO>}

Okay. And maybe one follow-up then. As you look at the market into 2019, would you expect opportunistically to growth of your property cat book or the – and the property cat exposure?

A - Marc Grandisson {BIO 4369887 <GO>}

Like I said, if we get the rates that we think are warranting an increase, we will increase. And we have increased some property exposure in the last quarter. So there were some opportunities to do it. As we said, it's just not a broad-based market opportunity, but we are always in lookout for specific transactions or relationships to really take advantage of that. So we have a – we're present on Front Street, we're open for business as you know and we will do it if it's there.

Q - Yaron Kinar {BIO 17146197 <GO>}

Okay. Thank you very much.

A - Marc Grandisson {BIO 4369887 <GO>}

Thanks, Yaron.

Operator

I'm not showing any further questions. I would now like to turn the conference over to Mr. Marc Grandisson for closing remarks.

A - Marc Grandisson {BIO 4369887 <GO>}

Thank you very much, everyone. It was a good year. Appreciate your time. And Happy Valentine's to all of you guys.

A - François Morin

Love you all.

A - Marc Grandisson {BIO 4369887 <GO>}

Thank you.

Operator

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