# Q1 2017 Earnings Call

## Company Participants

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

## Other Participants

- Brian Meredith, Analyst
- Elyse B. Greenspan, Analyst
- Geoffrey Murray Dunn, Analyst
- Ian J. Gutterman, Analyst
- Jay A. Cohen, Analyst
- Joshua D. Shanker, Analyst
- Kai Pan, Analyst
- Nicholas Mezick, Analyst
- Sarah E. DeWitt, Analyst



## MANAGEMENT DISCUSSION SECTION

### Operator

Good day, ladies and gentlemen, and welcome to the Arch Capital Group First Quarter 2017 Earnings Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session, and instructions will follow at that time. As a reminder, this conference call is being recorded.

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

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

Additionally, certain statements contained in the call that are not based on historical facts are forward-looking statements within the meaning of the Private Securities Litigation

Reform Act of 1995. The company intends the forward-looking statements in the call to be subject to the Safe Harbor created thereby.

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

I would now like to introduce your hosts for today's conference, Mr. Dinos Iordanou, Mr. Marc Grandisson, and Mr. Mark Lyons. Sirs, you may begin.

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

Thank you, Chanel. Good morning, everyone, and thank you for joining us today. This is our first quarter to include the combined results of Arch MI and United Guaranty, and we are very pleased with the early days of our integration process. Marc will discuss the integration and more details in a few minutes, but let me say that we are happy with the progress achieved in the first quarter.

Although, it is still early, we are very pleased with the resilience of the United Guaranty Corporation's customers as they make the transition to our systems and platform maintaining the strong relationships they achieve with United Guaranty over the years. As we discussed last quarter, our guiding principles for the integration of these companies is to find and deploy the best parts of each organization on a going forward basis.

I am referring not only to our most important resource, the people who come to work for us every single day, but I'm also including the operating systems, pricing approach and algorithms, along with all back-office functions that they provide customer service.

Our number one task is to create a high quality experience for our customers as we continue to enhance Arch MI's position as a market leader that should earn good returns through this cycle and for many years to come.

One additional benefit or opportunity that comes to or just results of the acquisition of United Guaranty is the opportunity for us to move our headquarters of our global services group to North Carolina. Our global services group manages a lot of the back office work for our insurance, reinsurance, and mortgage businesses. And consolidating the operations over time in one location increases our flexibility to fill jobs that are lost through attrition in other parts of the country to a lower cost environment.

Now, turning to first quarter results, our reported combined ratio on a core basis, Mark will define that in a moment, improved by 7.7 points from the first quarter of 2016, led by excellent results in the mortgage segment, offset by the effects of higher attritional and catastrophe losses in our property and casualty segments.

Accident year results decline in both our insurance and reinsurance segments, reflecting soft market conditions. Our mortgage segment improved its accident year combined ratio quarter-over-quarter to 50.4% from 65.8%, 15.4 points of improvement in the first quarter of 2016 year as the tailwinds of better credit quality and scale drove excellent profitability at Arch MI U.S.

Tellingly, our mortgage segment went from representing only seven point percent of net earned premiums on a core basis in the first quarter last year to 24.6% for the first quarter this year, nearly identical to the earned premium for our reinsurance segment in the first quarter of 2017.

Loss reserve development remained favorable in each of our segments which, in the aggregate, reduced our combined ratio by 8.5 points. There were no significant changes in the property casualty operating environment from last quarter. Marc Grandisson will elaborate on what we see in each of these markets in a few minutes.

On an operating basis, we produced an annual return on equity of 10.3 % while on a net income basis, we earned a return on equity of 12.6% for the first quarter of 2017. Net investment income per share for the first quarter was $0.69 per share, up $0.13 sequentially from the fourth quarter of 2016, primarily due to the assets that came over with the acquisition of United Guaranty.

Our annualized pre-tax investment income yield was 2.13% for the first quarter of 2017, just slightly above the level observed in the fourth quarter of 2016. As you know, we manage our investment portfolio on a total return basis which, on a local currency basis, was up 170 basis points for the quarter and 164 basis points, if we exclude the effects of foreign exchange.

Our book value per common share at March 31, 2017, was $57.69 per share, a 4.5% increase from the fourth quarter of 2016 and a 16.4% increase from the first quarter of last year. Mark Lyons will give more details on the components of their change in book value per share in a few minutes.

Before I turn the call over to Marc Grandisson, I would like to discuss our PMLs which declined modestly from January 1. As of April 1, 2017, our largest 250 year PML for a single event in the Northeast was down to $473 million or 6% of common shareholders' equity. This is the lowest we ever had in our history. Our Gulf of Mexico PML was at $383 million and Florida Tri-County PML decreased to $386 million.

I will now turn it over to Marc Grandisson to comment on our operating units and market conditions. Marc, over to you.

## Marc Grandisson {BIO 4369887 <GO>}

Thank you, Dinos and good morning to you all. Before I review market conditions across our segments, I am pleased, as Dinos alluded to earlier, to report that the integration of UG and Arch MI is going very well with a focus on high customer service to maintain or improve our relationships. While the strength of the combined entity is already apparent, we are working diligently to unify the U.S. MI operations and, most notably, we have decided to base our U.S. mortgage insurance headquarters in North Carolina.

We believe that there will be opportunities and additional opportunities to realize efficiencies without jeopardizing our customer relationships and we will keep you informed as those efforts materialize for the next several quarters.

At the end of our first quarter, as a combined global MI company, our expense ratio for this segment declined to 29%. Over the next few years, we are targeting a mid-20s expense ratio in the segment as the business matures. Our new insurance written, or NIW, was $12.7 billion for the first quarter, an increase of 8% over the same quarter in 2016 on an as-if combined basis.

We estimate that Arch U.S. MI's market shares remained in the mid-20s for the first quarter of 2017 consistent on a pro forma basis with the 26% market share indicated last quarter. The current premium yield was essentially unchanged with the last quarter's level. Over 75% of our NIW came through our risk based pricing platform. Rising interest rates in the fourth quarter reduced the volume of refinance activity and accordingly led to an improved level of persistency which came in at 77%. Purchase market accounted for 85% of our volume this quarter. The overall quality of the risk written is still very strong and stable, with average FICO scores of 743 in our monthly singles mix at 82% and 18%, respectively, meeting our post acquisition objectives in the quarter.

Arch also continued to build on its position in the U.S. GSE risk sharing transaction with approximately $2.2 billion of risk-in-force at the end of the first quarter 2017. Arch remains a lead market for this type of risk transfer execution.

Finally, our Australian mortgage insurance relationship continues to generate a good flow of business and contributed roughly $4 million of profit for the quarter. As this business is all single payment upfront, its contribution to profits should grow with time as premiums are earned over the life of the mortgages.

Moving onto the P&C insurance world which represents 50% of our earned premium, as we have indicated on prior calls, market condition remains challenging. Rate decreases have slowed somewhat, but are still broadly less than last trend. This is especially true for larger access accounts which tend to be more commoditized.

The rate change differential between our segment is wide, reaching for 410 bps in the U.S. for the first quarter. A positive 140 bps rate change for the lower volatility line and a negative 270 bps for our cycle managed business. As a result of that market dichotomy, all of our P&C segments continue to move towards smaller account and more specialized areas of the market and are walking away from accounts when returns are not acceptable.

In our primary U.S. P&C insurance operations, we had margin erosion of 70 basis points for all lines in the first quarter. To borrow an expression from Dinos, we have seen what's cooking in the kitchen before and we don't like the taste of that meal.

Turning to reinsurance which represents about 25 % of our earned premium this quarter, it's a similar story and that we continue to focus on the few opportunities that we have relative rates strength and more favorable returns while we are de-emphasizing the more commoditized segments, as rate and loss trends continue to erode margin.

Reflecting on the current trends in a broader reinsurance market, I am reminded of the old adage that I heard often from Paul Ingrey volume is vanity, profit is sanity. Allocating capital judiciously is a cornerstone of our corporate mandate. As we sit here today, mortgage represent one-third of our allocated capital, 25% of our net earned premium and 70% of our underwriting gain at a mid-to-high teens ROE.

We're happy to have the flexibility to allocate capital across our three platforms to the markets which are generating good returns and we believe that this flexibility allows Arch to generate alpha with more stable returns for its shareholders.

And with that, I'll hand this over to Mark to cover the detailed financial results.

## Mark D. Lyons {BIO 6494178 <GO>}

Thank you, Marc, and good morning, everyone. Given that this is the first full quarter after the UGC acquisition, I am going to provide more focus on the associated impact on the call today. First though, I'll highlight just a few items about this quarter. But as a reminder, the usual quarterly topics can be found in the earnings release and the associated financial supplement.

Okay, now, I'll make some summary comments for the first quarter, all on a core basis as Dinos referenced earlier. The term core corresponds to Arch's financial results excluding Watford Re, whereas the term consolidated includes Watford Re. So claims recorded in the first quarter of 2017 catastrophic events that have reinsurance recoverable and reinstatement premiums were $12.3 million or 1.2 loss ratio points compared to 0.5% in the first quarter of 2016 on the same basis, mostly emanating from within our reinsurance segment. The activity was primarily driven by Australian Cyclone Debbie and various other smaller events around the globe.

Again, we believe that this result continues to highlight our property cat underwriting discipline as actual reported losses on cat events continue to correlate with the exposure reductions that have been implemented over the last several years.

As for prior period, pure net loss reserve development, approximately $83 million of favorable development was reported in the first quarter led by the reinsurance segment with approximately $57 million favorable, the insurance segment of about $2 million favorable and the mortgage segment providing nearly $24 million of favorable development. Nearly all of the mortgage segment favorable development emanated from the U.S. portfolio and a meaningful portion or $8.2 million, stemmed from favorable development resulting from subrogation recoveries on mostly second-lien and other portfolios that came over as part of the UGC acquisition and that are, in fact, runoff operations. These subrogation recoveries have been reflected in UGC's historical results over time and could continue this year and in future years, depending upon the associated claims management of the files. The reinsurance segment, net favorable development was across most underwriting years for short and medium tailed lines and predominantly from the 2003 through 2013 underwriting years for long-tailed lines.

The calendar quarter combined ratio on a core non-Watford basis was 78.8% and when adjusting for cats in prior period development, the core accident quarter combined ratio was 86.1% compared to 92.4% in the first quarter of 2016.

The reinsurance segment, accident quarter combined ratio excluding cats of 97.6% compared to the first quarter of 2016's 94.2%, while the insurance segment's accident quarter combined ratio excluding cats was 97.8% compared to 94.9% in the first quarter of 2016. Both results reflect higher loss specs due to current difficult market conditions.

The reported insurance group accident quarter, excluding cat loss ratio, increased approximately 150 basis points quarter-over-quarter. And after controlling for large attritional losses and mix changes, increased approximately 70 bps, which Marc Grandisson referred to earlier.

Competitive conditions in the PC markets, however, were more than offset by the continued improved profitability of the mortgage segment, amplified with their net earned premium of being a larger proportion of the total.

The mortgage segment's accident quarter combined ratio improved 14.4 points, as Dinos referenced, quarter-over-quarter and their net earned premium represented nearly 25% of the total core net earned premium compared to only 7.4% in the corresponding quarter of 2016.

Remember that in the mortgage segment, accident quarter has a different connotation than in PC and it is more similar in concept to claims made businesses in PC space since the notice of default defines the assignment to the appropriate quarter.

Similar to last quarter, there were some expense cost in the first quarter resulting from the UGC acquisition. You may recall that since the acquisition occurred at yearend 2016, only the balance sheet was impacted in the fourth quarter, not the income statement. This quarter, we have a full income statement reflection of the combined portfolios.

As for the referenced expenses, the company incurred $15.6 million of such pre-tax expenses related to the UGC transaction in the quarter as compared to $25.2 million incurred tierly in the fourth quarter of 2016.

The sources of cost were different, however, as this quarter, the cost emanated from UGC acquisition-specific bonuses, severance and outplacement costs and trailing UGC transaction legal costs. More specifically, the UGC specific bonuses and transition compensation costs totaled $6.8 million pre-tax and severance and outplacement costs totaled the $8.2 million, resulting from reduction in force actions taken on January 31 and March 31, affecting approximately 205 employee positions and 60 contractors.

The actual salary compensation recognized in the first quarter associated with these employees involved in the risk-in-force efforts was $4.1 million. Given that the January 31 reduction in force only had one month of salary expense reflected in the quarter and the March 31 reduction in force had a full quarter of salary expense reflected, a $5.7 million quarterly run rate savings of salary expense is anticipated.

We will comment in future quarters about any other actions taken and their financial impact, but these figures reflect only the impact of reductions in force that have already been implemented. Given the nature of these expenses, we have excluded them from operating income as they are not indicative for our true underlying performance.

I'd also like to remind everyone that we issued approximately 12.8 million common equivalent shares to AIG as part of the UGC purchase price. They had an insignificant impact last quarter on average common shares outstanding, given the 12/31 closing date, but had a material impact this quarter as the diluted weighted average common shares outstanding increased to approximately 139 million shares this quarter versus 125.4 million in the fourth quarter of last year. I bring this up because I still see analyst reports and conversations still utilizing pre-common share equivalent numbers. We're using that in all our statistics and we recommend you do too.

As a respect to the effective tax rate with our changing portfolio and geographic mix, I provided full year 2017 indications on the last call that the expected tax rate on pre-tax operating income would likely be in the low to mid-teens range. In the first quarter of 2017, our tax rate on pre-tax operating income was 14.4% with 100 basis points additional reductions of 13.4%, stemming from a change in GAAP accounting affecting stock compensation.

I'd like to point out that we expanded our U.S. primary mortgage insurance disclosure in the financial supplement to provide enhanced information by book year or underwriting year for the PC analyst. For loss reserves, insurance in-force, risk in-force and delinquency rates, as well as aggregate NIW splits between monthly and single premium policies, as well as providing our PMIER efficiency ratios on a consolidated U.S. MI entity basis.

I also want to highlight the difference between the U.S. primary mortgage division's gross versus net risk-in-force. At the end of the quarter, the gross risk-in-force is $60.6 billion, whereas the net risk-in-force is 28% lower at $43.6 billion.

As we have consistently implemented in all our segments, our ongoing mortgage strategy is to maximize profitability while simultaneously protecting the balance sheet. The existing quota shares that are in place, along with the existing and ongoing excess of loss and capital market protections provide this aggregate and tail risk balance sheet protection we see.

As for after-tax operating income EPS accretion realized in the first quarter of 2017 from the UGC acquisition, we examined our results with it and without the impact of the UGC acquisition, giving due consideration to associated debt financing interest cost, preferred stock dividend charges and intangible amortization.

The realized beneficial accretion from the transaction was nearly 25% on a reported basis. And just to remind everyone, we have previously provided long-term operating income per share run rate accretion indications over a multiyear period of being in the 35% area.

It is important to reemphasize that this long-term reportable accretion is expected to accelerate, as the 2017 and later book years become more impactful on a net basis in future quarters and as the benefits from reductions in force and other actions, such as duplicative system eliminations over time are also realized in future quarters.

On a GAAP basis, at March 31, our total debt to total capital ratio was 20.6% and total debt plus preferred to total capital is 27.7%, which is down 100 basis points from yearend 2016. This leverage reduction was due to our growth in common equity as our debt and preferred levels were unchanged from yearend.

Consolidated operating cash flows were down $111 million relative to the first quarter of 2016. The first quarter operating cash flow was generally lower on a seasonal basis and the timings of higher retrocessional and reinsurance premiums from our reinsurance and mortgage groups, respectively, drove a majority of that change. We did not purchase any shares during the first quarter of 2017 and don't anticipate repurchasing any during the balance of 2017.

As a reminder, our remaining authorization is $446.5 million, which has been extended through yearend 2019. Dinos mentioned our growth in book value per share of 4.5% from last quarter. It's important to note that this stemmed from both strong underwriting and strong investment performance.

And with these introductory comments, we're now pleased to take your questions.

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

Operator, we're ready for questions.

# Q&A

## Operator

Thank you. And our first question comes from Geoffrey Dunn of Dowling & Partners. Your line is now open.

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

Thank you. Good morning.

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

Hi. How are you doing?

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

Good. Thank you. I was hoping I could get a little bit more color on the incurred loss development in the MI side this quarter. First, can you give a better idea in terms of the improving claim rates, are you seeing that from your late stage bucket or more of the mid and early stage delinquencies?

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

I think on the U.S. side, you're going to see that – remember that's kind of a report quarter view and we're not seeing that – well, we're not recognizing it as much in the more recent report quarters as it would be for once a little more aged. But I think just part of what we might want to discuss given the size of it is that – and I've mentioned that most of it is coming from the U.S. business, about $1 million came from the reinsurance side, so it's kind of insignificant.

But there was on subrogation, on a cash receipt basis, on the establishments that normalized our accounting policies between the two consolidated entities now. So subrogation reserves put up. These are normal course, but they were scattered between first lien and second lien and other portfolios that were there and they've been there historically, they're there now. The fact that they're most of it is in run-off doesn't mean that they're going to dissipate. They'll fall off a lot more slowly over time. So hopefully that answers your question.

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

So your comment about the favorable roll rate is more on the subrogation EWOC exposure, not necessarily the primary book?

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

No. Well, the primary book, yes you're still seeing some improvement, but they're not coming from the 2016 report quarter. I believe it's 2015 and a little bit backwards.

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

Okay. So the 12-plus, all right. And then on the current period provision, can you give us an idea the incidence assumption for the new notices and how that compares to maybe the pro forma result a year ago?

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

Actually, I don't have that in front of me, so you're talking about the claim rate...

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

Yes, the initial claim rate assumption on the new notices?

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

Geoff, I think that's going to have to be something we channel back through Don Watson. Sorry I simply don't have that in front of me.

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

Okay, great. Thank you.

## Operator

Thank you. And our next question comes from the line of Kai Pan of Morgan Stanley. Your line is now open.

## Q - Kai Pan {BIO 18669701 <GO>}

Thank you, and good morning. So the MI expense saving opportunities it looks like if you look at legacy Arch as well UGC, the other operating expenses add up to about $60 million and this quarter is down to $40 million, is that the run rate going forward or there are say other opportunities or the other way to ask it is that you're targeting at 25% expense ratio over time now it's 29%, you think that improvements more coming from the absolute dollar amount of reduction were more from the top line premium growth?

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

Let me give it a shot and I'll give it to Marc to get into the details. But we didn't make projections even though internally we have certain things in mind because I want our teams as they integrate to do it in a fashion that improves our long-term opportunities to be as efficient and as effective without affecting customer service with our competitors.

Having said that, okay, a lot of it is going to come from redundancy in personnel that it will get eliminated over time. Mark gave you a number, in the first quarter we have eliminated approximately 270 positions, on April 1 there was an additional 97. We're just going to be as part of our report card, we're going to share with you in the second quarter not knowing what else is going to happen in the second quarter because I'm not putting undue pressure on (29:19) to hit certain numbers.

Our instructions, Marc and I, is do the right thing with the idea that if we don't need certain individuals see if we can reassignment into other jobs, look as we lose in attrition in other parts of the organization. And that's one of the reasons we even move our global services headquarters down there because it allows us to manage the workforce in a much more efficient basis and we're not just focusing on United Guaranty. We're looking at every operation and we do that as a matter of course independent if we made an acquisition or not. That's a prudent way of managing.

In addition to that, you've got to get into systems and back rooms and not just headcounts, but where does that head count resides and is of course differential. For example, a New York job is much more expensive than a North Carolina job and a job in the Philippines is even less expensive than a job in North Carolina and we look at that as a global organization. So there will be additional savings.

It's not that we don't know how to push the pencil and make calculations, but we don't like to promise things to influence good judgment. We'll rather report after we take the actions than trying to hit a particular number.

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

Yeah, and I think what I would add in terms of the questions, the top line is not going to change significantly just by virtue of being an MI portfolio. It's very sticky, it's very straightforward, a lot of monthlies coming in, depending on our market share. But for the remainder of the year, for foreseeable future, we don't see much change. So it's really to answer your question more directly which Dinos did it that's going to be really as a result of absolute dollar reduction as opposed to premium related ratio.

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

I'll add Kai, as Marc alluded to, wouldn't be felt as much in 2017 which is probably the model question you are asking. But on longer-term basis, as the impact of the AIG quota share, 50% quota share on 2014, 2015, 2016 underwriting years starts to lessen and we're writing 2017, 2018 towards 100% without the quota share coming in, that will start to flip and you'll see an increasing growth on a net basis for your denominator.

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

Without change in the personnel

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

Correct.

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

And you know the quota share has a 30% fee, so at some point in time that, it will revert to a benefit.

## Q - Kai Pan {BIO 18669701 <GO>}

Okay. That's very clear.

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

And the 25% is not - we think we are going to be over time below that number, but at some point in time, we say, hey, 25% is something that we're trying to achieve 25% expense ratio, but it can even be better than that over time. All I want is efficient operations with good customer service. And at the end of the day, we want to not have an un-level playing field with our competition so we monitor that.

How do they do things, are they are better than us? What things we need to do to improve? And I don't want to have a structural disadvantage. And traditionally, over the last 15 years we didn't allow that in our operations and we won't allow it in the MI space either.

## Q - Kai Pan {BIO 18669701 <GO>}

Okay. And is there a restatement in terms of the legacy like Arch MI expenses.

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

I guess there's two things (33:11) I wouldn't say there was a reclass associated with the intangible amortization where in the mortgage space and others we had it more above the line, now we have below the line. So because with our goal to be very, very transparent on the UGC tangible amortization. It only makes sense to make that a corporate wide approach. So yes, so would have been a reclass and that's why some of the prior year may look a tiny bit different than it was when you look at the numbers last year, so it's a good catch.

## Q - Kai Pan {BIO 18669701 <GO>}

Okay. Lastly, just remind us what's the lockup period for the AIG preferred shares and do you have a capital flexibility or first right to repurchase that shares?

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

It is identical to when the SPA was signed which is a third at 6 months, two-thirds cumulatively at 12 months and 100% cumulatively at 18 months.

## Q - Kai Pan {BIO 18669701 <GO>}

And do you guys have the capital flexibility to participate?

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

Yes, we do.

## Q - Kai Pan {BIO 18669701 <GO>}

All right. Thank you so much.

## Operator

Thank you. And our next question comes from the line of Elyse Greenspan of Wells Fargo. Your line is now open.

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

Hi. Good morning. When you guys announced this deal with UGC in August, you guys had said about 50% of earnings would come from P&C and mortgage. I know you have the underwriting income which shifts to about 70% in mortgage. Would you say that the mortgage market has gotten better or the P&C market has gotten worse than the view that you had I guess when you announced this deal and laid out those metrics to us in August?

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

Well, you look at it in a very short time. In the short time, your question is - and your conclusion is correct. I think the P&C, both insurance and reinsurance, has deteriorated because we're not getting rate increases to keep up with trends. So, in essence, it's eroding, so that means you're going to write a little less than what you wanted to and the profitability might not be, a little less than what you want to.

Having said that, I think every indication on the MI space is that things are better. Delinquencies, they're better, and in essence, the credit box has not deteriorated, is as good as it was at that time. But you got to take our comments from the long-term because in everything that we do, we have a long-term view and we make judgments as to where we're going to play, how much capital and resources we're going to allocate on the long-term view. And right now, I can tell you, green light is on MI, amber, not red, but amber lights on the P&C, both insurance and reinsurance.

Having said that, I can't predict the future. I don't know if the P&C cycle changes and at what time it's going to change. But I can tell you, don't forget, our roots, the P&C and it doesn't mean we're not going to do a lot on the P&C space, given the right market opportunity. We're not reducing the group capability from an underwriting perspective.

As a matter of fact, I think it's fair to say we have a bit of overcapacity in underwriting talent, which we're going to maintain. The course associated with that is insignificant when you weigh it versus the opportunity when the market turns. Is it going to turn two years from today, three years from today, I don't know. But I can tell you, when it does, we're going to know it, we're going to take advantage of it and we will have the people, we're not going to be chasing people to take advantage of it. Anything you want to add, guys?

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

Just one quick thing. I think it's easy to get lost in the sauce. It's a good observation. That's the underwriting gain or loss, but each of those businesses have a little different duration. So, reinsurance group may have more property, cat, so the insurance group may have longer tailed lines, at a higher proportion, they're bringing in more investible assets and so forth. So when you look at underwritings, you brought interest income and it will be skewed a little bit differently away from mortgage.

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

Okay, great. And then Dinos, following up on your comments, you mentioned loss trends on the property casualty side, do you think if we start to see a higher level inflation, which it seems like you and some of your peers are pointing to, do you think the industry will take price to combat higher inflationary levels?

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

No, you're thinking very illogically and that's a mistake in our business. The emotions that drive markets is fear and greed. And right now, I don't see greed out there, I see some concern but I don't see fear. Yes, there is some concern. As a matter of fact, I think the canary in the coal mine is being commercial auto liability, who has a short tail, and is starting to percolate and bubble up in a lot of places. You see it on the writers of commercial auto, you see it in penetrations on the umbrellas which is part of the mix when you write excess liability umbrella. You're covering that portion of the risk, too. And you're seeing a reaction in the reinsurance market. It's not easy to find auto carve-outs anymore or the pricing is going up.

So, it's not an early indication that maybe GL might be a problem in the next year or two, and then workers' comp maybe later on. It might create that environment that people, they say, we've got to adjust pricing in all three lines going forward. I don't know.

We can't predict the future but I can tell you, there is stress in the system because it requires more rate increases than we're getting. And we're not keeping up with the trend. And it sounds to me like 1998, 1999 all over again that the frog is in the happy water, but the temperature is going up.

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

I think in addition I would just add to what Dinos has said, the other dimension about fear and greed is that underwriters of companies underwrite also with some kind of – with the assumption of what the interest rates are going to be in the future. So, the inflation goes up and interest rate goes up accordingly, if not more, it generate all kinds of different behaviors.

I would argue with that even in this day and age, in the last two, three quarters, there is probably an expectation of rate increasing in the future that might explain why some of the pricing is still softening as we speak. So, there's a lot of stuff, there's a lot of things moving in the marketplace. So, there's more than one just number that would drive (40:51) everything.

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

Okay, great. Do you guys have a forecast for mortgage industry NIW for 2017 and what share that would be for Arch?

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

We have expectations and then we do follow the MBA and the Freddie and Fannie and we look at what they do, what they produce. So we would look at the same data that you're looking at. In terms of NIW, we have, of course, projections we think we're going to be accomplishing but we're not at liberty to share that. And frankly, we're going to be reacting to whatever market situation present itself in the next year or so.

So, we don't spend much time, if you will, projecting what NIW is going to be in the market. We have a good place, a good positioning with our clients and we try to do the best. And as we said before, our market share over time, we expect might decrease in the low to mid-20%s. So, that also could be something that happens by attrition. A lot of things are moving.

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

It's a pleasant surprise for us. I don't know if it's a surprise. It was basically – we didn't see much overlap between Arch MI and United Guaranty. There was only one major customer that both of us were significant participants and they reduced our combined share just slightly in the first quarter. There was no other change from any other major customer. And that's why I talk about the resilience of the customer base of United Guaranty. And basically, we are trying to do the best job possible not only to maintain the service at a very, very high quality, but also improve upon it and that's what I've been emphasizing to our staff.

That's why I said let's not focus on integration of cost savings upfront at the expense of customers. We're going to focus on excellent customer service. And over time, we're going to get very efficient in how we provide that. And I think you can do both if you're a well-managed company.

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

Okay. Thanks so much. And congrats on a great start to the year.

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

Thank you.

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

Thank you.

## Operator

Thank you. And our next question comes from the line of Sarah DeWitt of JPMorgan. Your line is now open.

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

Hi. Good morning. Just first to follow up on the share buyback. I think you said you wouldn't buy back any stock in 2017. So, just to clarify, if AIG did sell, you would not participate?

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

Well, there's optionality in there. It's a decision tree, basically. But it's as I stated, but we're not going to be buy – overtly, other than those possibilities, we're not going to be going out and buying back shares.

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

Yeah. Our theme there, Sarah is, we always want to have flexibility on the balance sheet. Right now, our debt and hybrid is at about 27-point-something-percent, of which about 4.5% or so is short-term revolving facility. That doesn't give us a lot of capital credit with the rating agencies. So, at some point in time, my first action with excess capital, maybe I can reduce that down and then we'll revisit the share repurchase in 2018 and beyond.

Don't forget, I don't know when AIG is going to decide to sell, so I can't answer that question. If they're selling in 2017, we probably could likely we will not participate, but if it's 2018, it's an open question.

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

Okay, great. Thank you. And then separately, I wanted to get your thoughts on some of the practices of the insurance brokers. Chubb was critical at some of their practices, particularly in London and so there could be regulatory or customer backlash and now they're being investigated by the FCA. So, just trying to get your thoughts on some of the practices and do you see any regulatory risk with your current distribution channel?

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

Listen, at the end of the day, distribution cost is part of the business, been always part of the business. Some people view it as transactional. I think it's more than that. Some of it is transactional, some of it is advice and counsel, et cetera, and it's all buried into some number.

The ultimate arbiter of if that's fair or unfair or sustainable is the customers themselves. They know that both our revenue and the broker's revenue comes from only one source, it's out of premium they pay. So, if they don't like what's going on, they have ways to change that. But at the end, that's a customer decision.

Now you asked the regulatory question. We believe, at the end of the day, that the insurance and reinsurance business is highly competitive and we're strong believers in the free market. So, at the end of the day, if the customer is satisfied and nobody is doing anything that is illegal which the regulator has a say in it, let the market decide if it's fair compensation or unfair compensation and the buyer of the product is the person who counts the most.

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

Okay, great. Thank you.

## Operator

Thank you. And our next question comes from the line of Nicholas Mezick of KBW. Your line is now open.

## Q - Nicholas Mezick {BIO 20223149 <GO>}

Hi. Good morning, guys.

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

Good morning.

## Q - Nicholas Mezick {BIO 20223149 <GO>}

So last year, you discussed the way to think about mortgage, earnings volatility as the micro or underwriting decision and the macro changes. Now you assigned two-thirds of the volatility on the micro and one-third on the macro. Given the different composition of the book today with the UGC acquisition, how would you expect a change in either of those sensitivities?

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

Actually, what I said last year, it was 70%/30%, not 66% and two-thirds, and 33% and one-thirds.

## Q - Nicholas Mezick {BIO 20223149 <GO>}

My apologies on that (47:46).

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

And I'm sticking to that 70%/30% because we did analyze a lot of back data through the financial crisis as to what was causing defaults and we compare it with other environments.

For example, what happened in Canada where all day no verification loans, et cetera. They were not allowed and there was a minimum of 5% downpayment requirement and if you go historically and you see the performance of the Canadian book of business, it was much different even with the same economic conditions not only affecting the U.S., but affecting Canada and what the outcome of that business.

So, the 70%/30% hasn't changed and what I'm saying – what we're seeing, I think, the ability of MI companies to go back to the very loose underwriting standards that were common during the financial crisis in 2006, 2007, 2008. In the future, they would be much more difficult. First of all, managements, they saw companies go bust, so they're more resilient on the risk management side of the business. And more importantly, I think the technology is much better today in analyzing individual mortgages and attributes that affect that.

And also, more importantly, the GSEs, both Fannie and Freddie, with the PMIER approach and as regulators of the MI companies, they're a lot more resilient in their approach on maintaining stability on the balance sheets of the companies that they provide them the counterparty risk.

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

But right now, exactly what's going on, there's no change from last year, because really what drives the losses and we've seen historically is the products that were offered in the marketplace. And we've seen no change in the products offering. And to echo what Dinos just said about the GSEs being really wary or at least very attentive to what's happening in the marketplace, they had an increase in the sort of discounted LPMI business as of last years, recognizing that, that might represent a bit more risk to the system. So there's really a heightened level and still high level of scrutiny and attention paid to the product that are delivered in the business. So no change from last year.

## Q - Nicholas Mezick {BIO 20223149 <GO>}

Okay. Thank you both, and Dinos apologies for misquoting you.

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

Well, no, I just like – it's my test as I'm getting old, I'm 67 that I'm still sane.

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

67, that's two-thirds, one-third.

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

That's age.

## Q - Nicholas Mezick {BIO 20223149 <GO>}

All right. Just one follow-up. Last quarter, you referenced your door being broken down by people wanting to get a piece of your business through reinsurance. Just wanted to check on the status of the door and in turn demand for the reinsurance of your portfolio, in particular the MI book?

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

It hasn't changed, but like I said, we're here to feed our shareholders first. And then if we have extra, we can be charitable to others. This is a good business. Within our risk management limitations, we will continue to have our shareholders in mind first and then our reinsurance partners and other segment.

## Q - Nicholas Mezick {BIO 20223149 <GO>}

Okay. Thanks. And enjoy your lunch.

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

Thank you.

## Operator

Thank you. And our next question comes from the line of Josh Shanker of Deutsche Bank. Your line is now open.

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

Yes. Good morning, everybody or almost end of the morning.

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

Good morning. Hi, Josh.

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

Hi, Josh.

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

Hi there. Following up on the last question, I wonder why it does or does not make sense to think about MI the same way we think about cat. Is there a PML that you have and maybe you're not going to tell us what it is, but do you calculate something like that?

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

Yes, we do. You've got to think on the concept of what is (52:32) event, right? A severe recession, housing prices collapsing, et cetera. And we build these models that we model and then we calculate based on the book that we have what the macroeconomic effect of those events. They don't happen like a hurricane that happens in one day and the next day, it's going to be more gradual. But at the end of the day, if you're writing the business, you got to be cognizant of that. But we model that and we have a tolerance and the tolerance is no different that we don't want to commit on these, what I would call catastrophic events more than a probability of us of losing 25% of our common equity capital.

So that limitation is still there. It's a board (53:29) limitation. Myself and the rest of the management team in our discussions with our board, they say we want to know what is the maximum loss that you're willing to have on a stress scenario. And we want to understand what that stress scenario is all about. And that's how we build our model around it. Marc, do you want to elaborate...

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

The only thing I want to add, Josh, it's not exactly like a cat book of business because you're going to have future (54:00) coming in so you have to factor in an S&P type of PML. So this is what Dinos is alluding to. We have to factor that in because it's part and parcel of what we're assuming as part of the policies. The policies, those that don't default continue paying premium for the future and we've taken credit for that as well. So, just want to make sure it's not one event, one-off event, like Dinos said, that happens overnight. It's an over two- or three-year period development and we take an S&P type of approach.

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

And Josh, I think one other thing. It's a good question, especially given the relative size of its origin (54:34). But thinking wise, you got to learn from the past. I mean anything that erupts that can cut across underwriting years, we learned from asbestos and the GL, we learned from environmental and the GL, we learned from D&O, anything that could signal it, you can break it down, these lines have at least a component of cat. I think more so in the mortgage space but we think about that in every line of business.

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

So, let's just take a scenario. I look at the business right now as not only well underwritten but also well priced. And even if pricing works, the clients still might be well underwritten on the mortgage by mortgage level, therefore, avoiding the risk of "catastrophe". To what extent...

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

Well, you're not avoiding the risk totally, the risk of catastrophe. Because even well underwritten business, if you have higher unemployment, you're going to have hardships, your default rate is going to go up. If you're going to have house prices collapse, that means the claims that you're going to have, they're going to cost you more.

So, at the end of the day, those you can avoid. And I put that a round number of 30% on the problem in the past crisis was macroeconomic events. Who is the affected, for example, the Canadian book of business but it didn't cost companies, their profitability suffer, but there were still profitable and they didn't go out of business.

What caused collapses in the U.S., it was all these crazy stuff like how do you underwrite an old verification law (56:19). You don't know the information you're getting is correct. How do you factor in these old days? Or 110% LTV stuff. And there was a lot of craziness that went into the mortgage space at that time.

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

So, when the cat market gets irrational, Arch can say, look, someone else can underwrite this business, there's a hundred other companies who know how to write property cat, let them chase the market down.

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

Exactly right.

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

When you're only one of six or seven participants, what does that mean when the market gets irrational?

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

When the market gets irrational, that means you got to maintain your discipline. Our hallmark as a company is that we have been disciplined underwriters. And as long as I breathe, this team which I have 1000% confidence is, they're going to be disciplined underwriters. It's our DNA. For better or worse, it's our DNA. The Arch DNA is disciplined underwriting. Be patient, disciplined and at the end of it.

And thank God, we got a board who understands that. I never, never had a discussion with my board that says, oh, your volume is suffering or – they never talk about volume. They do talk about profit and margin and are you taking undue risk. That we talk all the time.

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

Josh, it's unfair to really compare it to a cat, because a cat in January 1, I don't know that there's going to be a hurricane in September that hits Florida. But it's underwriting mortgage and we have indeed, our company have the proper early warning systems in terms of risk quality. We're going to have actually take actions way ahead of things percolating up.

It's a decision as to where we put the red line or the yellow line as to when we start de-emphasizing it. We do have access that information. And frankly, and Dinos has said this in prior calls, if the people that were in (58:19) the business in 2006, 2007, 2008 had heeded those calls and those points and those clear indication signals in the marketplace, they wouldn't have put themselves in the position.

So, it's not like you wake up one day and the risk quality was as good as it gets and overnight, it everything goes down by 20% and the unemployment goes from 5% to 25%. You have a lot of products, (58:43) you have time to react.

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

PMI was recognizing segments of their business into what we will call the red line, all the way back in 2004. And they did not take action. As a matter of fact, they increased their participation in everything that they are monitoring systems were showing red. Meaning all-day no ver loans, they became 28% of their book of business because a lot of the customers, especially, countrywide, et cetera, it was threatening them. You don't write all of that, you're not going to get the good.

Well, I said this before, you give me three glasses of Kool-Aid and one has cyanide in it, I'm not drinking it. So, even though the other two they're very refreshing and I'm very thirsty, I'm not drinking it. And basically, that's what the industry did. They were given three glasses, one had cyanide in it, and they down all three of them.

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

I appreciate the goofy image.

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

I don't want to be graphic, but I tell you, when you're running a company and you got your shareholders capital and you've got 3,500 employees in your hands, you got to feel like I feel. You got to be very responsible, not only for the capital, but also for the welfare of the employees.

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

And Josh, that was three Kool-Aids, not three bourbons.

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

The bourbon will neutralize it, I'm sure.

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

But one other thing, if I could, Josh, Dinos and Marc have talked about this before, but the history was that the MIs took all the risk on their balance sheet, 100% in, 100% retained. That's clearly not part of our strategy. That's the strength of the PC side. We can't think any other way than simultaneously managing balance sheet. And maybe, Dinos, I'll kick it to you but the benefit of going to capital markets and reinsurance as a leading indicator unto itself.

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

You always have to have a loop to the market. So, by purchasing reinsurance and capital markets products, you always have a compass as to how other people think about the product, are you pricing it well or not. If you can't shed risk in an effective way that tells you you're the patsy. So, you better start shutting the doors because you're not doing the right thing.

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

Thanks for all the answers. And I came in very unfair to Ian, so, appreciate the time.

## Operator

Thank you. And our next question comes from the line of Brian Meredith of UBS. Your line is now open.

## Q - Brian Meredith {BIO 3108204 <GO>}

Yes, thanks. A couple of quick ones here. First, Mark, can you tell us what was the impact of the AIG quota share on your premium this quarter? And just kind of trying to figure out kind of going forward how that's kind of play out?

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

We have that. Okay, hang on.

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

Well, you want to know the cession to the AIG?

## Q - Brian Meredith {BIO 3108204 <GO>}

Yes, the cession to the AIG quota share. Were there anything unusual in this quarter that would have elevated it versus what it would look like going forward?

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

No.

## Q - Brian Meredith {BIO 3108204 <GO>}

Okay.

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

I'm trying to give you a ratio, because I think that's what you're after. So, bear with me.

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

Oh, you don't want to give him the amount?

## Q - Brian Meredith {BIO 3108204 <GO>}

Could you give me the dollar?

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

All that SOV, very good (01:02:29). Okay, so...

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

Brian, he doesn't want to give you the amount. He has it in front of him.

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

About 20%, let me go up here.

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

Yes, it's about 70% of the ceded premium. I was going to give to you of the net, but that's easier.

## Q - Brian Meredith {BIO 3108204 <GO>}

Oh, so, about 70% of the ceded premium was AIG. Okay.

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

Yeah.

## Q - Brian Meredith {BIO 3108204 <GO>}

I'm just trying to figure out looks going forward. So, that's kind of – generally think about it just gradually trending downwards over the next...

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

No. I would think that, that would, over the next three to five quarters, could be trending up and then trail down because of the nature of the monthlies and...

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

Don't forget, the quota shares covers 2015...

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

2014.

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

...2014, 2015 and 2016. So, the United Guaranty book goes all the way to 2007, 2008. We still have mortgages all the way back from the 2007, 2008. They're still paying premium. So, it's not as easy to calculate it, but a lot of the old stuff will be coming off more of the newer stuff. There is not going to be a lot of – depends on the persistency of those years, the 2014, 2015 and 2016. We think that calculation is going to probably increase it a little bit and then it will come down later.

## Q - Brian Meredith {BIO 3108204 <GO>}

Got you. Okay, helpful. And then second question (01:04:04), I'm just curious, when you talked about the expense savings, could we expect some in some of the other areas, reinsurance, insurance, also just given your relocation of the services of business operation?

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

Well, the relocation, it's not that – we're not going to just take a lot of people and relocate. We have attrition, right? Attrition usually is around 10% in our operations worldwide. So, basically, we lose roughly about 300 positions every year.

We decided that North Carolina is a better place for some of these back rooms that – premium audit, some clearance system, some booking things, et cetera. So, gradually, we'll be moving – we lose a job here, instead of replacing it in, I don't know, high cost environment, we go into a lower cost environment.

And that process has been with us all along. We have operations in Nebraska. We have operations overseas in other parts of the world. So that's ongoing. The reason I mentioned it is because North Carolina, based on our statistics, it has about a 30% cost advantage over other – from New York, New Jersey, California, let's say.

So, over time, and we're not trying to displace people, but as we lose people, we'll be moving that. So gradually, you're going to see the benefit coming through. But we do that on our day-to-day operations, as a matter of course, we do that all the time. That's what our managers are getting paid to do, make sure that we're cost effective.

## Q - Brian Meredith {BIO 3108204 <GO>}

Got you. And then last question. I wonder if you can give us your perspective right now on the political landscape with respect to mortgage insurance business and particularly related to the FHA. And if you get some changes going on there, what do you think the potential is for market share kind of shift back to the private MI and what do you think UGC or Arch should get?

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

Well, it's very hard to predict, very hard to predict. Clearly, the FHA has more market share that they need. So, you're not going to hear that only for me, for everyone, MI CEO will say that. It should be in the private sector not on the taxpayer.

Having said that, I don't know what they're going to do. The share of VA, FHA in combination is probably a little north of 55%. So, that's way too much, in my view, to be on the public back.

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

I think what I would add to this is there are a lot of things that we also have available to us in terms of providing MI insurance, not only to primary, but there's clearly still an ongoing focus on deleveraging the GSEs and the MI to the third-party to private capital. That is not stopping. It's actually most likely going to be accelerating over the next year or two.

The one thing that we are thinking about collectively is we're agnostic as to, in general, how we would allocate the capital in terms of primary MI or CRTs to the extent that it shifts to that direction. But we're essentially more than willing to provide the risk on a private basis, either which way the FHA decided to go.

But right now, we don't see any cause to be concerned in terms of the existence of the MI industry as it is. And we believe that the CRTs that we've been participating on are going to grow in size. And it's not going to be most likely instead of the MI primary, it's going to be in addition to the MI market.

## Q - Brian Meredith {BIO 3108204 <GO>}

Got you. Great. Thank you.

## Operator

Thank you. And our next question comes from the line of Ian Gutterman of Balyasny. Your line is now open.

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

So Dinos, my first question is when you're planning this move to North Carolina.

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

What's for lunch? Let me...

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

No.

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

Okay.

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

Okay, well, tell me.

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

At the request of Marc Grandisson, it will be grilled halloumi cheese from Cyprus with tomato, cucumber on pita bread and that's the sandwich for today and he's salivating already. So, get to your question so he can go and eat.

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

Well, my first question was when you made this decision to move all these people in North Carolina, did you make sure there was a good Greek restaurant in the neighborhood for them?

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

I have a few cousins who might be interested in going down to open a Greek diner down there, but I'll leave it up to them.

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

Okay. I actually had a couple of questions on the P&C business, but just on MI quickly first to maybe ask a little bit of a take-up on Josh's question and your response about the crazy conditions in the U.S. 10 years ago. Australia, it sounds like it's kind of getting to that point and I know you've obviously bought some reinsurance to help manage your exposure there. But, how concerned are you about the Australian market right now and the HPA just seems crazy and you hear all these anecdotes about things going on to get loans to get houses and so forth.

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

Well, let me – you're always concerned of everything you do. But I'm not fearful of the Australian business for two reasons. First and foremost, there seems to be a little frothy housing prices in two major cities, right?

Having said that, the frothiness is on loans that they're larger than what we insure. These are in the 0.75 million and up market. So, when you look at it from an exposure point of view, the things that we insure, the more on the lower size of homes.

And the Australian market is also a full recourse market which is different than the U.S. So, in essence, the individual is responsible for repaying the loan, beyond the ability of the residual value of the house to make up for the loan over time. So, there is a different characteristic to the market.

In addition to that, I think, the APRA which is their regulator, who regulates both insurance and also the banks, they have some strict rules about what loans get approved. And the stress test they put them to be able to qualify for the loan. It's a 200 basis point stress test on every loan, on interest rates movement because a lot of the loans in Australia, they're adjustable. So they don't have these 15 and 30-year fixed rate mortgages. So Marc, you want to elaborate further on it, or...



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

I would agree with that. I think the portfolio as a result as well, Ian, of the current, we're also looking at the same presses, do we have an economist who spend a lot of time reviewing and he confirms exactly what Dinos said, which is, there is a couple of areas, spot of frothiness, but it's confined to the larger dwellings or larger condominiums and also a lot of investors coming from outside which is...

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

They pay cash, they don't buy insurance.

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

Exactly. And even if they were to – what we tend to focus on are the lower risk and we don't do the investors loan as much. So we curtailed and shifted the portfolio towards the more single dwelling, owner-occupied house down under.

And to your point, we still, despite all this went on and bought a quota share and we got partners there to help us in case we would be a bit too optimistic. We don't think we are, but just to be prudent in terms of rightsizing the whole portfolio. So, we're cautiously optimistic or comfortable.

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

All right. Got it. That makes a lot of sense. On the P&C business, Marc, the insurance segment, the reserve releases were pretty de minimis this quarter. Was that less sort of gross releases, or is it just sort of the normal amount of releases and there were some adverse in pockets offsetting it?

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

I think the latter. I think we are seeing, as I said in my comments and as Dinos and Mark both alluded to, the market, we're seeing pick up in severity in the markets across lines of business. Certainly, it started in the commercial auto. And you've heard that story more than once.

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

And the auto component in umbrellas as well.

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

Exactly. So, there's a lot more coming. We're of the mind that it's going to get a bit more, a bit worse before it gets better again. So, we tend to take, as usual, a prudent approach to reserving. So, we might take a bit more long to recognize what looks like good news, because frankly, a lot of people around our clients, we've seen it. Some of them have, we believe, recognized too early good news and are in a position to having to redirect or recorrect that and we would like to avoid that at all cost.

So, there's a little bit of - some activity in severity, some activity and some losses coming through but certainly holistically, corporately, more prudent view on the ultimate reserve development.

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

And Ian that's a direct benefit from the multiplatform we have that the holding company guys see. So you can see other ceding companies and fear on the insurance by the way.

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

Yes.

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

Understood. And then sort of similar to that is the higher accident years in both the insurance and the reinsurance. Other than, I guess, probably the elevated (01:14:43) losses, is this sort of a reasonable run rate given where rate and mix is, unless the mix changes pretty dramatically?

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

It's the best guess for the current accident year. Listen, the first year (1:14:56) is a self-grading exam and we try to do the best we can. But I can tell you, things are not as good as they were a year ago. And I think the reason you got to recognize them on the current accident year.

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

Ian, again, that what I just talked about the reserve development, what transpired over the last quarter informs us going forward as to what we think the ultimate underlying fundamentals of the business is. And as you heard, we're losing margin and it's being eroded as we speak. So, it behooves us to do the right thing, which is to be, again, that much more prudent on the current accident year. That's what you're seeing right now.

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

Got it. And then just finally on that. Dinos, I think you mentioned earlier, some may be rhyming with parts of the late 1990s. And the one thing I guess, I noticed looking at reserves across the industry, I'm assuming you guys have looked at these sort of trends.

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

Oh, yeah.

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

It looks like there's – the initial IBNR has been coming down every year for the past three, four, five years and it's now getting to a pretty low point. Do you agree with that trend? Does that concern you that even the loss trend has been benign the last five years, it seems to be now reflected in IBNR? I'm asking from an industry standpoint (01:16:11)

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

Give me another month or two, we're going to finish our study. I do these macro study with Don Watson about the industry reserve levels and all that, I look at cash flows, underwriting cash flows, et cetera. Give me a little time and then we'll share that study with you.

Maybe that might be my five minute in Investor Day because the guys want me to only have five minutes with you guys. They want to put me with the chef, so I'll be grilling halloumi. But at the end of the day, I think it's an interesting question. Yes, it feels to me, from other indications – let me give you an example. I won't mention names because it's embarrassing. But we lost an account, right? That it was a high deductible account that, in essence, it was about $10 million in premium and we lost it to a competitor for $3 million, to me, is the definition of insanity. Either you're totally naive, you don't know what you're doing or you can beat me by going to $9 million. You don't have to go from $10 million to $3 million to get the account. So, that means they're uninformed, don't understand what they're doing and the brokers are taking advantage of them because I can tell you, they knew that the expiring premium was probably $10 million.

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

And the other thing, Ian, on that, that will be in their renewal pricing monitor. Next year, when they raise to $4 million, a 33% increase.

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

Of course. Exactly. It's funny how that works. All right. Thank you, guys. Appreciate it.

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

Thank you.

## Operator

Thank you. And our next question comes from the line of Jay Cohen of Bank of America Merrill Lynch. Your line is now open.

## Q - Jay A. Cohen {BIO 1498813 <GO>}

Actually my questions were answered. I tried to hit the right button to remove myself but I failed. So, thanks for all the information. Great call, guys.

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

Thank you, Jay. We'll continue to try to perform for the shareholder.

## Operator

Thank you. And I would now like to turn the conference over to Mr. Dinos Iordanou.

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

Well, thank you all for your attention and looking forward to talking with you next quarter. Have a wonderful afternoon.

## Operator

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