S&P Capital IQ

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Arch Capital Group Ltd. NasdaqGS:ACGL

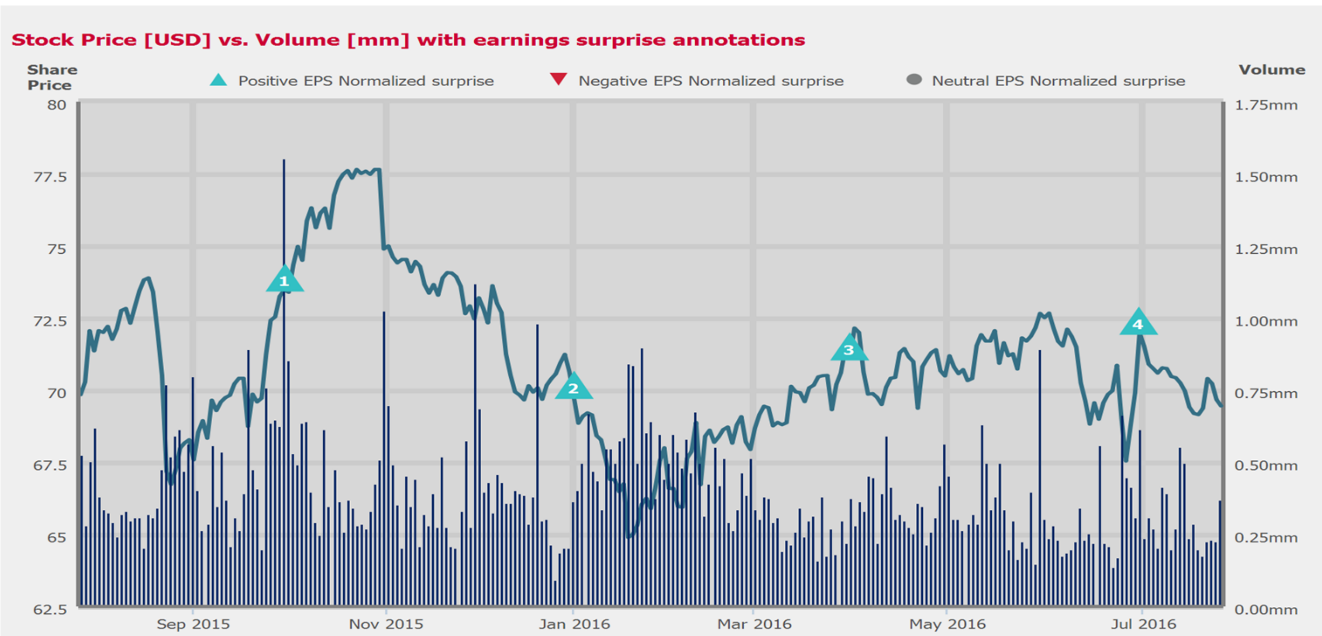
FQ3 2016 Earnings Call Transcripts

Thursday, October 27, 2016 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2016-			-FQ4 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.02	1.14	▲11.76	1.03	4.38	5.04
Revenue (mm)	1006.73	1014.28	▲0.75	870.34	4014.84	4531.20

Currency: USD
Consensus as of Oct-27-2016 1:04 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2015	0.96	1.01	▲1 5.21 %
FQ4 2015	1.06	1.15	▲2 8.49 %
FQ1 2016	1.10	1.17	▲3 6.36 %
FQ2 2016	0.97	1.13	▲4 16.49 %

Call Participants

EXECUTIVES

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Marc Grandisson
President and Chief Operating Officer

Mark D. Lyons
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Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Arch Capital Group Third Quarter 2016 Earnings Conference Call. [Operator Instructions] As a reminder, this conference call is being recorded.

Before the company gets started with its update, management wants to remind -- 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 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 will also 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 host for today's conference, Mr. Dinos Iordanou, Mr. Mark Radisson, and Mr. Mark Lyons. Sirs, you may begin

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you, Andrew. Good morning, everyone, and thank you for joining us today for our third quarter earnings call. Before I comment on the quarter's results, I wanted to note 2 items. First, this October represents the 15th year anniversary, and I would like to express my gratitude to our employees whose dedication and commitment has built this successful company over the last 15 years. Our employees are not just our most important asset, they are critical to producing the market-leading performance that we have seen these past 15 years and I would like to say thank you to all of them.

Second item I want to comment on is about our pending acquisition on United Guaranty Corporation. As you know, Arch has agreed to purchase United Guaranty for approximately $3.42 billion. Early indications from the GSEs and regulators have been positive, and we are hoping that the acquisition will close late in the fourth quarter of this year, which will to minimize the disruption to our distribution partners in the mortgage lending space as well as the employees of United Guaranty, who will benefit from this timing as they transfer to Arch benefits and healthcare coverages as of January 1, so they don't have to deal with split year deductibles and all the other complications that a different date might produce.

Now turning to this quarter results. We have a good quarter. Our reported combined ratio on a core basis, which Mark Lyons will define in a moment, improved to 86.5% for the third quarter, as catastrophe losses were light at $10.7 million. Loss reserve development continues to remain favorable in each of our segments, which, in the aggregate, reduced our combined ratio by 8.8 points in the quarter.

There were no significant changes that we see in the property casualty operating environment in the last quarter. In our insurance segment, we saw a slight deterioration in rates across some sectors, particularly in the high access and short-tail areas, but rates were generally stable in most other lines, while the mortgage insurance environment remains both stable and healthy. Marc Grandisson will give you more details on what we see in each of the markets in a few minutes.

On an operating basis, we produced an annualized return on equity of 8.8%, while on a net income basis, we earned an annualized return of equity of 15.3% for the quarter. As we have told you in previous quarters, net income movements can be more volatile on a quarterly basis, as these earnings are influenced by changes in foreign exchange rates and realized gains and losses our investment portfolio.

Net investment income per share for the quarter was $0.53 per share, down $0.04 sequentially from the second quarter of 2016. Despite volatility in the investment and foreign exchange markets this year, on a local currency basis, total return on our investment portfolio was a positive 88 basis points and 91 basis points, if we include the effects of foreign exchange in the quarter. Our operating cash flow was very strong at $421 million in the third quarter, as compared to $359 million in the third quarter of 2015. Our book value per common share at September 30, 2016, was $53.62 per share, a 3% increase sequentially from the second quarter of 2016 and 12.5% increase from the third quarter of a year ago. While some segments of our business have become more competitive, we believe that group-wide on an expected basis, the present value ROE on the business written in the 2016 underwriting year should produce ROEs in the range of 10% to 12% on allocated capital.

Before I turn the call over to Marc Grandisson, I would like to discuss our PMLs, which are essentially unchanged from July 1. As usual, I would like to point out that our cat PML aggregates reflect business bounds through October 1, while the premium numbers indicated in our financial statements are through September 30, and then the PMLs are reflected net of reinsurance and retrocessional covers. As of October 1, 2016, our largest 250 PML for a single event remains the northeast at $488 million or 7.4% of common shareholders' equity. I think this is the lowest percentage ever for us. Our Gulf of Mexico PML was at $418 million and our Florida Tri-County PML increased slightly to $405 million.

I will now turn it over to Marc Grandisson to comment on the operating unit and market conditions, and after that I think, Mark Lyons will share the financial returns in detail before we come back to take your questions. Marc?

Marc Grandisson
President and Chief Operating Officer

Thank you, Dinos. Good morning to all. In the third quarter, we saw continued softening of [indiscernible] particularly in the more commoditized line and as Dinos mentioned, a stable MI marketplace. Our P&C units, both insurance and reinsurance, produced acceptable combined ratios as our underwriters focused on specialty lines where knowledge and expertise differentiates risk selection. As you all are aware, we continued the build-out of our MI segment in the third quarter where returns are attractive.

Turning first to our primary P&C insurance operations, which represents about 60% of our total premium. Rate changes in our U.S. operations were relatively stable in the third quarter, at a negative 110 basis points versus a negative 120 basis points last quarter. As in previous quarters, most of what we at Arch call our controlling low volatility segments, which includes travel, A&H, contract binding, construction and program business had rate changes that were in a slightly positive range, 50 bps, while our cycle-managed segments which includes property, marine, energy and casualty, experienced single to double-digit rate decreases. Unfortunately, rate decreases are becoming widespread across more business units and have been building over the last few quarters. Increasingly our business mix is moving towards smaller specialty risks, which have historically performed better in soft markets, given that they are less exposed to the competitive pressures of the broad commercial liability in short-tail markets.

Globally, property P&C markets remain also under pressure from a rate level perspective. In the U.K., rate changes across all our product lines average negative 5% this quarter, leading us to shift further towards portfolios of smaller risks with lower volatility. Areas of opportunity within the insurance sectors were limited with modest growth recorded in the third quarter in our construction and national accounts, travel and alternative markets line. Most of the growth came because we took advantage of dislocation in those areas. Yet our executive assurance property and marine businesses are areas where rate levels lead us to a continuing defensive strategy of reducing risks.

Market conditions in our reinsurance group, which is 30% of our premium volume, remain competitive. Our teams have to be very selective given conditions in their operating environments. But Arch's history is that our underwriters have been able to find opportunities that still meet our target returns. This quarter, specialty areas such as agriculture and motor grew, while short-tailed segments such as property, cat and marine experienced significant rate decreases, and we accordingly decreased our writings in those segments. Our strategy at Arch has been to focus on niche areas of opportunities where as I said earlier, we believe that knowledge and experience gives us an edge. For that reason and given the tough market conditions in any 1 quarter, our premium mix changes, sometimes significantly.

Turning to our third leg, our MI segment, which is this quarter 9% of our premium, but a growing percentage of our premium earned. We estimate that our market share of primary NIW in the U.S. rose to about 10% or 11% in the third quarter from 9% market share in Q2. In addition, we continued our market leadership in underwriting new U.S. GSE risk-sharing transactions, which stood at $2 billion of notional limits in force and we continue to see good volume from our Australian primary insurance relationship. Notably this quarter, we elected to purchase a quarter share on our Australian business to help manage the risk profile of our global MI exposure. While returns on this business remain attractive, we believe it is prudent to manage for potential adverse results and we assess this risk much like we do in our other lines of business in the P&C sector, where we typically purchase protection to limit our aggregate exposures.

Our U.S. MI operation increased its NIW 36% to $8.75 billion during the third quarter of 2016, of which approximately 79% came through the bank channel. It should be noted that there is seasonality in the level of mortgage origination. Historically, the second and third quarter have significant higher production than the first and fourth quarters. Our return expectation across our MI segment remains in excess of our long-term ROE target, and we expect this -- we expect that for the foreseeable future.

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

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Thank you, Mark, and good morning all. As was true on previous calls, my comments to follow today are on a pure Arch basis, which excludes the other segment, that being Watford Re, unless otherwise noted. I'll continue to use the term core, as Dinos mentioned in his notes, to denote results without Watford Re and the term consolidated when discussing results including Watford Re.

As Dinos commented, we announced the UGC acquisition in August for a consideration of approximately $3.4 billion, subject to a potential dollar-for-dollar reduction for any pre-closing dividend by UGC to AIG and subject to potential fluctuation, due to the collar structure around our common equivalent preferred component. Financing and integration activities are proceeding smoothly, as we push for a year-end closing.

Before I review our financial results, let me update you on our recent financing activities during the third quarter. The first is the issuance of 18 million, 5.25% Series E noncumulative preferred shares in late September, which raised net proceeds of approximately $435 million, which will be used primarily towards funding the UGC acquisition. Secondly, we negotiated a syndicated bridge loan facility in support of the UGC acquisition of $1.375 billion, the potential use of which has been commensurately reduced for the aforementioned preferred stock issuance.

Thirdly, we began efforts to renew our existing credit facility towards increasing the capacity to $850 million, which includes a $500 million unsecured revolving credit tranche and a $350 million secured letter of credit tranche. The new facility has been signed this week, expires in 5 years and gives us access to additional capital for the UGC acquisition and for general corporate purposes. Please refer to our publicly available SEC filings for more detail.

Okay. With that said, the core combined ratio for this quarter was 86.5% with 1.3 points of current accident year cat-related events net of reinsured to reinsurance -- excuse me, reinstatement premiums compared to the 2015 third quarter combined ratio of 89.7%, which reflected 2.3 points of cat-related events. Losses from 2016 cat events recorded in the third quarter, net of recoverables and reinstatement premiums, totaled $10.7 million versus $18.8 million in the third quarter of 2015. These third quarter cat losses stem mostly from within our reinsurance operation and reflect a series of small events around the globe, with no single event concentration. The 2016 third quarter core combined ratio reflects 8.8 points of prior year net favorable development compared to 7.1 points of prior period favorable development on the same basis in the 2015 third quarter. This resulted a core accident quarter combined ratio, excluding cat, for the third quarter of 94% even, as compared to 94.5% accident quarter combined ratio in the third quarter of 2015.

In the insurance segment, the 2016 accident quarter combined ratio, excluding cats, was 97.9% compared to an accident quarter combined ratio of 95.8% a year ago and 96.3% serially last quarter. This 210-basis-point increase between the third quarter of 2016 versus 2015 was driven by 130 basis points in the loss ratio and 80 basis points in the expense ratio. The loss ratio increase was primarily attributable to certain large attritional losses emanating from our U.S. operations. After adjusting for the incremental difference in large attritional losses, the accident quarter loss ratio this quarter is virtually flat with the prior year's quarter.

The reinsurance segment 2016 accident quarter combined ratio, exclusive of cat, was 96.5% compared to 94.6% in the third quarter of last year and 90 -- and versus 98.4% serially last quarter. The combined ratio reflected the impact of several excess property facultative losses that occurred during the quarter.

The mortgage segment 2016 accident quarter combined ratio was 60.7% compared to 82.5% for the third quarter of last year. This decrease is predominantly driven by favorable trends related to claim rates and claim sizes and the continued expense ratio improvement in our U.S. primary MI book, due mostly to growth, along with beneficial mix changes towards GSE credit risk-sharing transactions. There was, however, 1 transaction this quarter in the mortgage segment, which distorts the quarter-over-quarter comparison. Retrocessional coverage was purchased on certain Australian LMI business with loan to values greater than 90% that extended back to the inception of the underlying agreement, which was May of 2015. As a result, seeded premiums this quarter contained an additional $34 million of catch-up sessions, which served to commensurately understate net written premiums for the quarter.

Regarding prior period development, the insurance segment accounted for roughly 18% of the total net favorable development in the quarter and this was primarily driven by longer and medium-tailed lines from the 2007 through 2012 accident years, partially offset by some accident year 2015 property loss development from our U.K. operations.

The reinsurance segment accounted for approximately 79% of the total favorable development in the quarter with roughly 45% of that due to net favorable development on shorter-tailed lines, concentrated in 2012 through 2015 underwriting years and the balance due to net favorable development on longer-tailed lines emanating across most underwriting years prior to 2013. The mortgage segment contributed about 3% of the total net favorable development, which translates to a 3.2-point beneficial impact to the mortgage segment loss ratio, again resulting from continued lower-than-expected claim rates.

The overall core expense ratio for the quarter was 33.4% compared to the prior year's comparative quarter of 34.2%. This 80 point -- basis point improvement is driven mostly from approved acquisition expense in the reinsurance and mortgage segments, with the latter benefit largely being aided by a higher proportion of GSE business receiving insurance accounting treatment which has lower acquisition expense. Additionally, corporate expenses included approximately $6.8 million or about $0.055 a share of nonrecurring costs associated with the UGC transaction. These costs reflect investment banker fees, bridge loan facility fees, along with related legal, accounting, rating and SEC fees.

Core cash flow from operations was approximately $421 million in the quarter versus approximately $359 million in the third quarter of 2015. This is primarily due to a lower level of net paid losses this quarter versus last year's quarter. Core pretax investment income in the 2016, as Dinos mentioned, was $66.3 million or $0.53 per share versus $67 million or $0.54 per share quarter-over-quarter and sequentially versus $70.4 million or $0.57 per share. The decrease on a sequential basis was primarily due to the effect of low interest rates on fixed income securities available in the market and unfavorable inflation adjustments on U.S. TIPS securities. As always, we evaluate investment performance on a total return basis and not nearly by the geography of net investment income, as exemplified by the $96 million of core realized gains in the quarter. That being said, total returns was a positive 88 basis points this quarter, which reflects the impact of foreign exchange, and a positive 91 basis points on a local currency basis. This return was led by strong equity, non-investment grade fixed income and alternative investment results.

Our effective tax rate on pretax operating income available to Arch shareholders for this quarter was an expense of 6.5% compared to an expense of 5.7% in the corresponding quarter of 2015, driven by an increased proportion of U.S.-based income. This quarter's 6.5% effective tax rate includes 50 basis points or roughly $800,000 relating to a true-up of the prior 2 quarter's tax provision to the estimated annual effective tax rate reflected here. As always, fluctuations in the effective tax can result from variability in the relative mix of income or loss reported by jurisdiction.

Our total capital was $8.24 billion at the end of 2016 third quarter, up 8.5% relative to last quarter and up 2.6% when excluding the recent $450 million preferred stock issuance discussed earlier. Our debt-to-capital ratio this quarter remains low at 10.8% and debt plus hybrids represents 20.2% of our total capital, which continues to give us significant financial flexibility. We continue to estimate having capital in excess of our targeted position. We did not purchase any shares this quarter under our authorized share buyback program, which has remaining authorization of $446 million at quarter's end. Dinos mentioned book value, so I will not.
And with these introductory comments, we're now pleased to take your questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Elyse Greenspan of Wells Fargo.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

You have just any kind of initial insight into what your potential fourth quarter losses would be from Hurricane Matthew?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, early estimates, and is quite early, is that it would be within our cat load. And let me remind everybody our cat load is about $40 million a quarter. So what we see on a model basis, we get a number close to the cat, but when we see the actual claim reporting activity is much lower. So it's too early for us to narrow that number, but it looks to us like it's within the cat load.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

Okay. And then would that be more of a spilt insurance versus reinsurance? Or is that too early to say?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It -- right now, it looks like is a 50-50 allocation between the 2. About half of it coming from our insurance operation and half of it coming from our reinsurance operation.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

Okay. And then just in terms of the cat load, that $40 million, I believe, has been fairly consistent, and you did reference your PMLs have been coming down at the lowest level, I guess, that you guys have ever been at. So why -- I guess, why overall do you think your cat load, I guess, for the company isn't coming down when you think about it that way?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I don't think the PMLs came out dramatically. I mean, they have been the lowest. But if you look at last quarter versus this quarter, the PMLs, they came down by a few million bucks on $450 million or $500 million. It's a rounding error. So I don't -- we estimate the cat load based on 2 parameters: what is the aggregate PMLs; and also what kind of pricing we're getting.

Marc Grandisson
President and Chief Operating Officer

And in addition to this, as a result of deemphasizing high excess and then reshaping the portfolio, you could still have an average that's somewhat more stable, but the PML could change dramatically. So the shape of our curve has changed as we have gotten away from the high risk excess area, on -- specifically on the cat reinsurance.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

Okay. And then 1 question. In terms of the UGC financials that you guys disclosed with the deal, the accretion double digits in the first year and then 35% about or so in '17. Are you guys planning on taking in the intangible amortization through earnings? So are those accretion figures including intangibles?

Marc Grandisson
President and Chief Operating Officer

That reflects -- yes, that reflected an estimate of the mix between goodwill and intangibles at the time as we work through towards closing and getting much more clarity on what's goodwill versus amortizable intangibles that will modify it. In fact, I think, you can see some of that in the respective supplements that we had for the preferred offering, some accounting rules around it, but there was more refinement on the intangibles. And whenever we go to the markets next and that will have -- of course, you might see an adjustment there. What matters is what is it at the closing and we're working with our auditors to fine-tune that.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

Okay, great. And then one last question. We're couple of weeks away from the Presidential election. Dinos, I was just hoping if you could just give some high level views on the potential impact of the election overall just on the insurance industry?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I mean, I don't know. I guess it depends on what happens with -- who the President's going to be, Congress and are they friendly to the business environment or unfriendly. Without knowing that, I-- the big issue for the insurance business is going to be on appointment of judges, how the Supreme Court, it will be and it's a slow process. But if we continue in the past, over the last 8 years, I can tell you that the future is going to be more challenging for the business and we got to adjust to it. Because at the end of the day, that's what awards get determined in not only in the cases that they get litigated but also in the cases that they get settled, because the settlement values go up based on the attitude of the court. So not knowing what's going to happen, hard to predict.

Operator

Our next question comes from the line of Kai Pan from Morgan Stanley.

Kai Pan
Morgan Stanley, Research Division

First question on UGC. Now you have like 2 months after deal announcement, speak with sort of external clients, with the banks. And is there any indication in term of a potential market share loss because of concentration issue? How does that compare with your initial thought? And any others -- any offsetting factor internally on the expense savings side you can offset some of those?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, let me answer the first one. I'll get Marc Grandisson to get on the second part of your question. But on the first one, first and foremost you got to understand that we're running independent of each other. We're still 2 independent companies. We're going to come together after closing. So our discussions with the market and the clients is separate from the UGC discussions with the market and the clients. No indications yet that there is any discomfort about what they do with us or what they do with them. Once we close and we become one company, we'll revisit that issue, but nothing so far that indicates any significant overlap that it might be problematic.

Marc Grandisson
President and Chief Operating Officer

Actually -- yes, this is Marc. Actually part of the due diligence sort of highlight to us that there's not as much overlap as we might think, but again, the proof is going to be in the pudding after we close the books, and we go represent some of those that are -- that have -- that we may have overlap on. It's too early to tell right now. In terms of the expense savings or working through the operations, we have teams that are dedicating working very, very diligently to try to assess and first and foremost try to understand what both sides have in terms of system and operations and structure to see how we can make something that would be unique and cohesive as we go forward after the closing. We're making good progress in the direction. At that point in time, we're not so focused on, to address your question specifically, on the expense savings or what not if they are there. We are, as we said in August, not doing that transaction for that reason, first and foremost. We think there will be some, we don't know how much it's going to be. Our team are also going through that process and the savings might come not necessarily on a linear basis. And we'll have to integrate and get things together. So it's very hard for us to tell you anything more than this at this point in time.

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

And Kai, it's Mark Lyons. Let me just add that, when we were doing our economic analysis of this deal and when we -- and we communicated on our call in August about this transaction, we actually anticipate some fall-off of market share. So to the extent that there is some marginal fall-off, it wouldn't surprise us and it was actually contemplated.

Kai Pan
Morgan Stanley, Research Division

Okay. Mark, any estimates on sort of like additional interest expense for the fourth quarter?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Well, I think you can -- what you call interest expense. You can take your 5.25 times the $450 million and add that in. As far as -- we're really not in a position yet to discuss timing or expense of any additional offering. But we are striving towards closing at year-end, so there's 2 months to accomplish quite a bit.

Kai Pan
Morgan Stanley, Research Division

That's great. And then my second question is really on the core loss ratio, the deterioration year-over-year. You explained that with some higher level of attrition losses in both insurance and reinsurance segments. I just wonder, do you consider this year's large attrition losses sort of normal? And -- or just higher than sort of like exceptionally sort of good results from last year?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No. On the insurance group it was the surety loss that we have accounted for it to its full extent. Surety is a line of business by nature, occasionally it would give you that volatility, 1 quarter you have a big loss, then 2, 3 quarters, no losses. So I don't -- we look at the book and the composition of the book and the long-term performance in making judgments as to how healthy or unhealthy that book is. So 1 quarter of event doesn't really gives you a trend, so to speak. On -- similar case with the reinsurance. This is excess of loss property backed transactions, and occasionally that's where you're in business. You will -- you take in the volatility from your clients, so when it happens, it comes through your books. But that particular unit has been a big, big moneymaker for us and it continues to be. So I don't attribute that as a trend.

Marc Grandisson
President and Chief Operating Officer

In fact we looked at the last trailing 12 months accident combined ratio adjusted for all these large losses and it's actually very, very stable, which is what we care for. Like to Dinos's point, 1 quarter does not make a trend and where we're right now, we're very comfortable and very happy with the stability actually of the accident year combined ratio.

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Kai, just one more thing to add. Dinos just noted about the reinsurance side. The facultative group has been enormously profitable by its nature, shorter-tailed excess position, it's going to be volatile, any given quarter could be volatile. In our view, there was roughly 2.5, a little more, of long-term loss ratio points that may have been excess of what you normally would see, which translates -- if you go back and do the arithmetic, it pushes you to about a 60 or a 59.9 on the adjustment for the loss ratio for the reinsurance group in totality versus 59 the prior year. So it's a 90-basis-point movement.

Operator

Our next question comes from the line of Quentin McMillan from KBW.

Quentin John McMillan
Keefe, Bruyette, & Woods, Inc., Research Division

I just wanted to touch on the UGC acquisition. You have a footnote in here that it's dependent on closing the execution of an excess of loss agreement between AIG and UGC. I just wanted to ask if you guys have any clarity at this point on that reinsurance transaction. Sort of maybe what it will be protecting you guys against in the future? This is not the Bellamy Re 1 or Bellamy Re 2. I'm talking about the third excess of loss agreement. What it's going to protect in the future? And maybe if you've gotten that in place at this point?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

A couple layers there. First layer of answer is that between AIG and Arch, we have agreed on terms and conditions of it. It is not yet signed because we need approval of the GSEs. That's a requirement and that's part of our discussion with them now. So that's the first point. So I would say significant progress on that aspect. Secondly, it's an aggregate excess of loss that there's couple layers involved, but it is effectively 2009 through year-end 2016 coverages. It's an out of the money cover that in the aggregate provides quite a bit of capital relief from the viewpoint of S&P.

Quentin John McMillan
Keefe, Bruyette, & Woods, Inc., Research Division

And who is going to bear the original cost for that? Is that going to be paid for by Arch, by AIG or combination?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

It's effectively paid by UGC at closing. So it's an applied book value reduction for the seeded premium.

Michael Zaremski
Crédit Suisse AG, Research Division

Okay, great. And then can you help us in terms of the investment yield of the portfolio, when UGC is added in maybe what is sort of the current yield and/or duration of the UGC portfolio? And how much uplift might that have on the overall Arch portfolio? And will you be using the extended duration of the UGC premiums to extend your own duration or change anything in the overall investment portfolio going forward, maybe starting in Q1 '17?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Well, let me start and I'll ask Dinos to say a few words, too. First off, once the closing occurs, the management of that will transfer, of course, to AIM, which is our internal Arch Investment Management. The coupons on that book is higher. It's about 3.3, I think, maybe 3.5 as the average coupon. It's on a lot of credit book in there, which could be reshaped. So I think some of is timing, I would expect it to conform more towards Arch's approach of total return and not just getting lost on the thoughts of coupon income. That will morph over time, probably throughout the course of 2017.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. It will probably take at least 2 or 3 quarters for our investment professionals to make whatever changes we feel that are appropriate. But at the end of the day, it's going to be -- it's going to look more like the Arch duration and credit quality than what exists today.

Quentin John McMillan
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And just a quick follow-up. The coupon in the UGC book you said is about 3.3 average. What is the Arch current kind of average coupon?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

It's closer to 2.

Operator

Our next question comes from the line of Michael Nannizzi of Goldman Sachs.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Just a couple quick ones. Mark, maybe on the investment portfolio, just the yield or the investment income sort of ticked down sequentially. Looks like there was some seasonality last year sort of consistent with that. Is the -- is there anything that we should think about that's not sort of run rate from third quarter, maybe some mortgage backed security payouts or something along those lines, that would cause it not to be consistent?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Every quarter, there is -- it's always a new story. So I wouldn't look at it in a trend sense. Back to my total return comment. I mean clearly, our investment group harvested some gains, hence the approximate $100 million of realized gains I noted, so again based upon our total return approach. So you get those gains and you put some of that back into -- the extent of which is put back into fixed income, you got to deal with new money rates there.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it. Okay. So you got some harvesting there. Okay. That helps. And then the -- how should we be thinking about the tax rate? Looks like – so guessing the MI impact has caused you to lift here over the last few quarters. How should we be thinking about that longer term, once you integrate UGC?

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Okay. Good question. First a slight correction to what you said. Mortgage was contributory to that. But remember, our mortgage segment is very broad and some of that is out of Bermuda and other jurisdictions. And the U.S. MI operation, clearly was contributing positive underwriting gain, at this point. So they were contributory. But let's not overlook the facultative unit we talked about on the property side, the insurance group and the onshore reinsurance group all were profitable and contributing income. So it's really the composite of those, Michael, that actually inched up the effective tax rate. The second part of your question with UGC, we talked about it on our call, about UGC. We plan on having it subject to approval, of course, with the GSEs, a core to share facility in place. So only roughly half of those exposures and gains will be resident in the U.S. jurisdictions. So it's going to have an uplift but probably not the slope of uplift that your -- you might be contemplating.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Okay. How can you tell that I was contemplating? Did you look inside my...

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

I reverse engineered the first part of your question.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

I thought. That felt invasive.

Constantine P. Iordanou
Chairman and Chief Executive Officer

It was in the tone of your voice.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

And then last really a quick one. The Australia quota share, can you talk about sort of just how you're thinking about like that on the forward? Is that sort of notionally the right amount that we should be covering in? I just love to get a little bit more color on the thought process there [indiscernible].

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. The thought process is more important than the actual specific transactions. When -- with everything we do, we have an overlay of the risk management. We look at our capital, we need -- how much risk we -- is prudent for us to carry and at the end of the day, we look for ways to manage that and reinsurance is one way to do it. So we look at it from a global perspective. How much MI business we have, how much we will retain that to our books and then the rest of it, we reinsure out. And that's the attitude with everything that we do. It's not only on the MI side, it's also on the P&C side, both reinsurance and insurance. And as we said in prior calls, going forward after the acquisition is completed with United Guaranty, we'll be looking at the MI book including the U.S. book and buying the appropriate aggregate protection to make sure that we have, from a risk management point a few, the profit parameters. We always think about PMLs. We think about PMLs also not on the P&C side only, but also on the mortgage side and that will drive a lot of our decisions. Doing a Bellamy 3 [ph], doing an aggregate excess of loss for different years. As Mark told you, the transaction we have with AIG will cover '16 and prior, '09 to '16. So all those years are taken care of, so to speak. And then for us is what we do for '17, '18, and '19, as we go forward. But that's the philosophy and is no different than what -- how we run the group for the last 15 years. Measure approach to pricing properly and then also making sure we don't take too much of the meal independent, how profitable that meal is.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Right before lunchtime comment, I think that's totally fair.

Operator

Our next question comes from the line of Sarah DeWitt from JP Morgan.

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

Wanted to get your latest outlook for the mortgage insurance market conditions. One area of concern I hear sometimes that we're late in the credit and economic cycle. So how much longer do you think mortgage insurance returns will be good for?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We don't see anything that clouds the horizon. I think it's pretty clear. All the indications is that it's a stable market. Pricing has been stable. The environment is good. We're projecting housing prices to be going up somewhere between 3% and 5%, next year. Yes, there is certain states, especially the energy states, that there might be some issues. But that's what RateStar is all about. We look at and adjusting pricing on the basis of what the risk components are. But long term, we view the market to be very healthy and there is no indication for us that is going to change in the next few years.

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

Okay, great. And then additionally, do you expect any FHA rate cut before the election? And what would be the implications of that for you?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I have no idea what FHA will do and I don't like to guess, at the end of the day. A lot will depend on the actuarial work that is going to be done to see what their capital requirements, if they are meeting the minimum standard. That report usually comes out in mid-November or so forth so on. But we don't anticipate it before the election but you never know after the election. Once they take an action, then we can gauge what that might mean. But without them doing something is very hard to predict.

Operator

Our next question comes from the line of Charles Sebaski from BMO Capital Markets.

Charles Joseph Sebaski
BMO Capital Markets Equity Research

First is on, there was a report recently regarding the GSE and some of the risk-sharing and regarding some bondholders that are raising issue regarding credit quality from reinsurance and the GSEs offloading that. Any thoughts or had any conversations with the GSE? Is there any real legitimacy to the amount of risk transfer change going on? Appreciate your thoughts.

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, I -- we don't -- basically the GSEs are interested in having 2 avenues, the cash market and also the reinsurance market. Their allocation has been pretty constant, so to speak, about 25% to 35% depending on the quarter to their reinsurance market and then the rest of it, 65% to 75% in the cash market, and they've been consistent with that approach. Now I don't believe they have any concerns about the creditworthiness of reinsurers because at the end of the day they make the selection as to whom they're going to allocate these transactions to. So as a matter of fact, for the GSEs is terrific by looking at the credit quality of the reinsurance and allocate what portion of the deal they want to allocate to any particular individual, so.

Charles Joseph Sebaski
BMO Capital Markets Equity Research

All right. Then I guess, on the insurance business, on the low vol, you guys had pretty nice growth in some of the travel and accident and some of the other products. And it seems to be marketplaces that there's lots of interest in the low vol business today. Just curious if you've seen any additional increase in competition and whether or not your growth is coming from new programs coming out or just kind of grinding it out, doing good work with the existing business and any color on that?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, these are product lines that -- don't forget, when we built Arch, we got into product lines that nobody wanted to do back in '02, '03, '04. Because some of them, they can be slow growth. Unless you may a major purchase, these things, it requires patience and perseverance to make the meaningful all the time. Yes, depending on the cycle, there is more competition or less competition. But more importantly, with this kind of products, you have to have a long-term view and a long-term commitment. And it will take time to build volume. It doesn't fit with the thesis of instant gratification. You don't get that with these kind of products. So we've been very patient. And we have grown some businesses from nothing to a reasonable size. I mean our lenders business grew over the years from some $20 million to over $100 million in premium. And we try to find these little nuggets that we work all the time to give us more control of our portfolio. And as Marc Grandisson said and I'll turn it over to him for his comments, that low volatile business is what we like to build most of our insurance group. Not abandoning the other segments and because the other segments, even though they are volatile in certain market conditions you can make a lot of money. If the market is very hard, we'll write a lot of the covers that we're not willing to do today. It's not bad business, it's just bad price business. When the price improves, a good business.

Marc Grandisson
President and Chief Operating Officer

On travel side, I think I would echo what Dinos had said, obviously, but in addition we have a couple of new transactions that we've entered into programs and had been very, very nice going so far. But we also are investing – it's also a very intense technology play and we are always on the look to build that aspect of the book of business, because to your point, it's low volatility, it's also -- it drives, it's sticky, a lot stickier than other business could be. So we are definitely focusing evermore. And this -- and I think a reflection of the premium and our effort -- this is sort of a reflection of our efforts in this space, and I think you should expect more in the future.

Operator

Our next question comes from the line of Ryan Byrnes from Janney.

Ryan J. Byrnes
Janney Montgomery Scott LLC, Research Division

I just had one question. I guess, post-UGC deal, does your PML tolerance change at all? Essentially are you still willing to risk 25% of the total capital? Or is that just the property capital -- I'm sorry -- property casualty capital, going forward?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, no. It's total capital. It hasn't changed.

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

No change. There's no change really.

Operator

Our next question comes from the line of Brian Meredith from UBS.

Brian Robert Meredith

UBS Investment Bank, Research Division

A couple of quick questions here for you. First one, I'm just curious, there was a big transaction that was announced of another MI company. What do you think the possibilities are of kind of market share shifts as a result of that? Could that be positive for you all?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I don't know. The -- you're talking about a transaction with a Chinese ownership. So I think that's an appropriate question to ask to the distributors of the product. I mean, this is for banks to determine if they want to continue to do business or not, but not for us. So I wouldn't know. I have no -- I have the faintest idea if their reaction would be positive or negative.

Brian Robert Meredith
UBS Investment Bank, Research Division

Okay, great. And then just my second question, in the news there's been a couple of articles that you guys have hired some pretty high profile people in the legacy business. Can you guys talk to me about your views on that -- on the legacy business and opportunities?

Marc Grandisson
President and Chief Operating Officer

Yes. I think that we have a -- certainly 1 individual that joined us and that was obviously publicly discussed. We're exploring at this point, and we're really looking around and try to see whether there is something to be done there, whether it's Arch or not. I mean, we have all the things on the table. We're exploring what is out there. But certainly we had -- we did an LPT last quarter, as you remember. We do think this phase has – lends itself to a level of heightened interest at this point in time. I think we're certainly in a place where rates have been going down in certain sectors and some clients may have – may be running out of patience and tolerance for some books of business. And certainly we are always -- Dinos and I are always looking to provide services and products to the marketplace that would help the industry, and that's certainly one area. But it's -- we're still -- we're working through it and when we have something, we'll obviously let you know.

Constantine P. Iordanou
Chairman and Chief Executive Officer

We'll announce the details. Listen, the theme here is, every time you come out of a soft market, and eventually, we will come out of a soft market, there is repair work that needs to be done, and we want to participate in the repairing.

Brian Robert Meredith
UBS Investment Bank, Research Division

Makes sense. And then just lastly, I know you talked a fair amount of the retro you bought on the Australian book. I know you guys have great analytics and stuff. Was there anything behind it that you kind of looked at the housing prices in Australia and there's a lot of talk about people think they're kind of really peaking out here. Any concerns there?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, no concern whatsoever. This is more from an aggregation point of view, how much you want to have from an overall MI book of business, because the reinsurance that they participated on the deal, they got pretty good return characteristics. They're going to make some good money on it. At the end of the day, either you add a lot of capital to your balance sheet and you might have maybe a little over-commitment to one line of business versus others, or you try to keep the balance and this was more balancing from our perspective.

Operator

Our next question comes from the line of Josh Shanker from Deutsche.

Joshua David Shanker
Deutsche Bank AG, Research Division

You mentioned U.K. pricing is down 5%. I sort of associate U.K. with a lot of specialty markets. Is that experience leading the market down? Or is that lagging the market? And do we need to be worried about another sort of step downward in pricing for the market in general? Most of your competitors have not been so grim about pricing conditions.

Marc Grandisson
President and Chief Operating Officer

The U.K. market is extremely competitive and has been for a long time, especially the traditional Lloyd's placement and the international business and open brokerage. So that's going on -- that's been going on for a little while. So it's not new to us. But in terms of leading where it's going to go, unfortunately, we -- I'm afraid that we'll have to experience further rate decreases going forward and a lot of competition ahead in the London -- in U.K. market more broadly. So but again, things may change and some of that happen, it may change things overnight, but there certainly is a lot of competition out there. We don't see anything happening at this point in time.

Constantine P. Iordanou
Chairman and Chief Executive Officer

If you don't measure correctly, you can't make good pricing judgments going forward. And we rather say what we see and you guys make the judgment, if others are not willing to talk about it.

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

Josh, I would add and there's publicly available information. By their own account, Lloyd's has about a 3% on the current underwriting, about 3% to 4% return on expectation, return on capacity. So that tells you something about the absolute rate level.

Joshua David Shanker
Deutsche Bank AG, Research Division

If we put on our '97 to '01 hats, how hard is it to keep the team together in a soft market? And how do you keep everybody content when you can't make money in the business?

Marc Grandisson
President and Chief Operating Officer

Well, I think there's shifting in our book of business. I mean people are working extremely hard to transform or to just gradually over the cycle as we try to do as we've been working on for the last 10 years to shift towards low vol controllable business, takes a lot of work and lot of effort. So I would just say that it's a just a shifting and realigning our expertise and assets for our people towards different lines of business. Things are transportable across lines of business, it's not like an excess D&O, can only do excess D&O. There is a lot of stuff that, that person can and has the culture and the understanding as to how we do cycle management, so we try very hard to keep those people and keep them busy doing other things. This is on the insurance and on the reinsurance, it's across the P&C units.

Joshua David Shanker
Deutsche Bank AG, Research Division

And there's still a lot of deferred comp they have to earn that they would lose if they left, I would imagine?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, there is a big component of that. But that's only that is. At the end of the day, they know over their career with us, they're going to have good years and they're going to have some not so good years, but overall, if they produce for our shareholders, they're going to make very good money. And for those who have been here and we have a pretty stable management, they have done extremely well.

Operator

Our next question comes from the line of Jay Cohen from Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Let's be quick, my questions were answered.

Operator

Our next question comes from the line of Ian Gutterman from Balyasny.

Ian Gutterman
Balyasny Asset Management L.P.

So I actually wanted to follow up on Ryan's question about the PML limits and obviously, you are so far away, it's not really an issue. But if the market did get better, I guess, I'm surprised you would say 25% of the whole balance sheet because that essentially would suggest you're using 25% of PMIER's capital to write cat, if you ever got to that point.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, you're talking about PMLs in the MI business or the PMLs on the property cat business [indiscernible]...

Ian Gutterman
Balyasny Asset Management L.P.

On the property cat when you answered Ryan, that the limits were 25% for everything.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, our property cat – well, no, the 25% is what our board allows us to risk, assuming we like the pricing and risk relationships right? The fact that we're at 7.4% today is an underwriting judgment the management team is making, is not a restriction by book. But if rates quadruple tomorrow, I can go to 50% of capital exposure on PML without going back to my board and say, "Hey, that 25% is too low and you got to change it." And if we change it, we're going to come and tell you. Because I think shareholders need to know what kind of exposure you take. Don't forget, and I don't know what other MI companies do, but we do PML calculations on the MI business also. And it's a requirement by our risk committee and -- of the Board. Every quarter we'll talk about how much is our PML on our MI business. And that's the reason we had all these discussions about how much reinsurance both total share or aggregate excess of loss or transactions like Bellamy 1 [ph], Bellamy 2 [ph] or similar type of transactions we might do in the future. So all of that is around understanding that we have one simple principle that drives our risk management philosophy, they're independent of what even happens. We have to not injure the balance sheet to the point that we're not in a very strong competitive position the day after.

Ian Gutterman
Balyasny Asset Management L.P.

Exactly. That's what I was trying to get at. Because I guess, when I heard 25% of everything as the limit, I guess I thought that that's essentially the P&C capital would be -- whatever that would be 35% or 40% or something like that. So see what I was going at?

Constantine P. Iordanou

Chairman and Chief Executive Officer

Not quite. I mean, 25% -- at 25% of equity capital is a limit, it's a pretty safe limit, for adverse conditions, if you're talking about in 1 in a 250-type of events. So, the PML calculations that we do for our MI business is somewhat even worse than the recent financial crisis we have passed. We have gone back all of the way to the Depression era and factoring a lot of available -- and skimpy available statistical information to come up with some reasonable assumptions as to what -- how things might look like if we have events of that nature. And we still want this company not only to survive but to be in a strong competitive position the day after.

Ian Gutterman
Balyasny Asset Management L.P.

Fair enough. The other thing I was going to ask is I think you mentioned some surety losses are part of the attritional. Can you just remind me sort of how you approach that business? Is it sort of vanilla construction bonds? Does it tend to be some of the commercial surety?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, it was a construction bond, it is a surety. One of our contractors messed up, and we had to step in and you saw a lot of crisis, some steady or maybe in Connecticut [ph].

Ian Gutterman
Balyasny Asset Management L.P.

Got it. And is it residential or commercial?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's commercial. Commercial surety.

Ian Gutterman
Balyasny Asset Management L.P.

Okay, so there's [indiscernible]...

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's a building of a baseball stadium.

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

It's contract surety but for Commercial [indiscernible].

Constantine P. Iordanou
Chairman and Chief Executive Officer

Commercial exploit, right.

Ian Gutterman
Balyasny Asset Management L.P.

Where I was going with is, how do you think about clash with MI? I know there's not a direct clash but it's something that...

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, surety and MI, there is no clash there because these are construction projects...

Ian Gutterman
Balyasny Asset Management L.P.

Well, bad credit cycle, right? If you had a bad credit cycle, construction...

Constantine P. Iordanou
Chairman and Chief Executive Officer

I think the full clash [ph] between the investment portfolio and that. And that's why we don't do -- our MBS is -- will clash with what we...

Mark D. Lyons
Chief Financial Officer, Executive Vice President and Treasurer

MI.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Do in mortgage. And we consider that in part of our mix, how we manage the company.

Operator

Ladies and gentlemen, this now concludes our question-and-answer. I'd like to turn the call back to management for closing remarks.

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

Operator
Ladies and gentlemen, thank you, again, for your participation in today's conference call. This now concludes the program. And you may all now disconnect at this time. Everyone have a great day.