S&P Capital IQ

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Arch Capital Group Ltd. NasdaqGS:ACGL

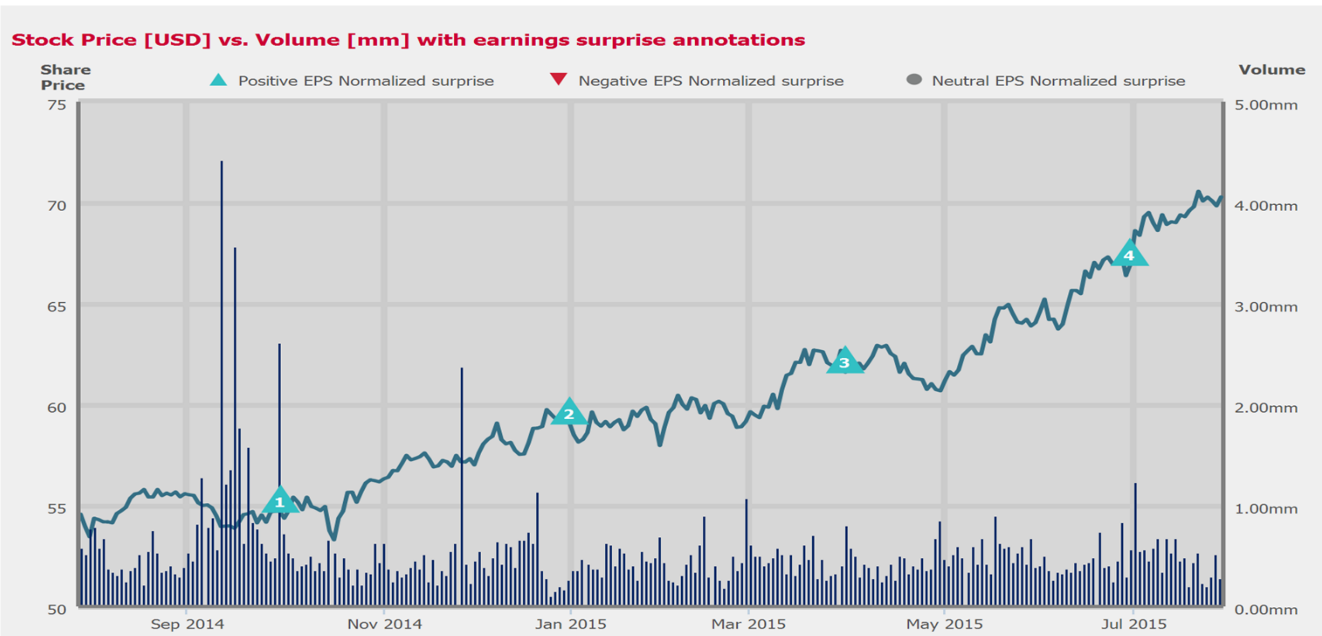
FQ3 2015 Earnings Call Transcripts

Thursday, October 29, 2015 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2015-			-FQ4 2015-	-FY 2015-	-FY 2016-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.96	1.01	▲5.21	1.03	4.36	4.10
Revenue (mm)	974.62	971.71	▼(0.30 %)	901.52	3880.34	3996.98

Currency: USD
Consensus as of Oct-29-2015 11:43 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2014	0.95	1.05	▲1 10.53 %
FQ4 2014	1.03	1.15	▲2 11.65 %
FQ1 2015	1.08	1.17	▲3 8.33 %
FQ2 2015	1.07	1.16	▲4 8.41 %

Call Participants

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Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Quarter 3 2015 Arch Capital Group Earnings Conference Call. My name is Emma, and I will be your operator for today. [Operator Instructions] As a reminder, this call is being recorded for replay purposes. And before the conference starts, the company -- before the company gets started with its update, management wants to first remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the federal securities law. These statements are based upon management's current assessments and assumptions, and are subject to a number of risks and 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 also will make reference to some non-GAAP measures of financial performance. The reconciliation to GAAP and definition of operating income can be found in the company's current report on Form 8-K furnished to the SEC yesterday, which contains the company's earnings press release and is available on the company's website.

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you, Emma. Good morning, everyone, and thank you for joining us today. Our third quarter earnings were driven by solid reported underwriting results, while investment returns were impacted by decline in the equity markets. Group-wide and on a constant dollar basis, our gross written premium increased by nearly 4% in the third quarter over the same period in 2014, while net written premium was up approximately 1% as underwriting actions in our insurance and reinsurance business were offset by growth in our mortgage business.

Changes in foreign exchange rates reduced our net written premium on a U.S. dollar basis by approximately $21 million or 2.4% of our volume in the quarter. On an operating basis, we earned $126 million or $1.01 per share for the third quarter, which produced an annualized return on equity of 8.6% for the 2015 third quarter versus a 9.7% return on equity in the third quarter of 2014.

Looking at it from a trailing 12 months ending in September 30, 2015, after-tax operating income available to Arch common shareholders produced a 9.9% return on average common equity, while net income available to common shareholders produced an 11.6% return on average common equity. On a net income basis, Arch earned $0.60 per share this quarter, which was lower than operating income primarily due to realized investment losses.

Net income movements on a quarterly basis can be more volatile as these earnings are influenced by changes in foreign exchange rates and realized gains and losses in our investment portfolio. Our reported underwriting results remain satisfactory as reflected in our combined ratio of 89.7% and were aided by a low level of catastrophe losses and continued favorable loss reserve development.

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

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

With respect to capital management, we continue to have capital in excess of our target levels. However, we did not find many opportunities to repurchase shares in the third quarter that would meet our previously stated criteria for share repurchases. As you may recall, our philosophy with respect to share repurchases is based on the relationship of expected returns to the premium to book value with the exception that we could earn the premium back over a reasonable period of time. Considering the underwriting environment we're operating in and the returns we're achieving, we believe that it would take more than 3 years to recover the premium paid.

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

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

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

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

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

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

Our U.S. mortgage insurance operations produced approximately half of the segment's net written premium in the third quarter with $24 million coming from the credit union channel and approximately $8 million of premium written from the bank channel. Of note this quarter, underwriting income for the U.S. operations move into the positive territory with about $2 million of underwriting income in the quarter, reflecting the slow but steady progress we're making in this area. We continue to make progress in the expansion of the bank channel as Arch MI has approved 835 master policy applications from banks, and more than 350 of these banks have submitted loans through Arch MI in -- for underwriting.

In the third quarter of 2015, we reached a modest milestone when new insurance written within the bank channel of $1.8 billion surpassed our credit union production of $1.4 billion of new insurance written. While we continue to see good opportunities in mortgage reinsurance, the GSE risk-sharing transactions issued by Fannie Mae and Freddie Mac are becoming an important component of our mortgage segment's revenues. We pioneered one of the first of these structures over 2 years ago by building upon the expertise of our mortgage team and working with the GSEs to provide insurance coverage.

Since we're talking about innovation in the sector, it might be worth a minute now to discuss the introduction of RateStar to mortgage lenders last week. We began this project approximately 5 quarters ago with a goal to develop a more robust risk-based pricing tool that in many ways will parallel what we do across our entire enterprise and is a hallmark of the Arch underwriting group approach. To us, the current rate card approach, which uses just 2 factors, FICO scores and loan-to-value ratios, while very important variables, oversimplifies the issue. Our team reviewed the very rich proprietary data that we acquired from PMI and other available industry data that would allow us to establish an appropriate price for the risk exposures assumed. RateStar will enable us to more effectively allocate capital and calculate the appropriate risk-based returns on mortgage insurance at the individual loan level. While this may be a relatively recent innovation for the mortgage insurance industry with United Guaranty the first to introduce a risk-based pricing tool, this approach has been utilized in our other lines of business within Arch for many years.

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

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

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

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

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

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

Okay. The core combined ratio for this quarter was 89.7% with 2.3 points of current accident year cat-related events net of reinsurance or reinstatement premiums compared to the 2014 third quarter combined ratio of 88.5%, which reflected a lower level of cat at 1.6 points. Losses recorded in the third quarter from 2015 catastrophic events net of reinsurance recoverables or reinstatement premiums totaled $18.8 million versus $14.2 million in the corresponding quarter last year, primarily emanating from the Chilean earthquakes and the California fires along with various smaller events.

In 2015, third quarter core combined ratio reflects 7.1 points of prior year net favorable development, net of reinsurance and related acquisition expenses, compared to 8 points even of prior period favorable development on the same basis in 2014 third quarter. This results in a core accident quarter combined ratio, excluding cats for the third quarter, of 94.5% compared to 94.9% in the third quarter of last year.

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

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

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

As we commented on last quarter, an accident quarter approach to the mortgage business is not have the same meaning it does on the PC side because of the way the business works and the way the accounting works. The insurance segment accounted for roughly 16% of the total net favorable development this quarter and was primarily driven by medium- and longer-tailed lines, predominantly from the 2007 to 2012 accident years.

The reinsurance segment accounted for approximately 78% of the total net favorable development in the quarter, excluding associated impacts on acquisition expenses, with approximately 39% of that due to net favorable development on short-tailed lines concentrated in the more recent underwriting years and the balance due to net favorable development on longer-tailed lines predominantly from underwriting year 2009 and prior. The remaining 6% of the net favorable development emanated from the mortgage segment, which reflects the continued improvement in the U.S. book delinquency rate. Approximately 2/3 of our core $7.3 billion of total net reserves for losses and loss adjustment expense are IBNR and additional case reserves, which still continues to remain fairly consistent across both reinsurance and insurance segments.

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

The insurance segment's expense ratio decreased 70 basis points to an even 31.0% for the quarter compared to 31.7% a year ago. The net acquisition ratio decreased 90 basis points, whereas the operating expense ratio increased by only 20 basis points. The insurance segment net acquisition ratio reduction continues to reflect materially improved treaty-ceding commissions on an earned basis associated with quota share contracts ceded. It's important to note, however, that on a written basis, the front-end gross commission ratio worldwide actually decreased 50 basis points, whereas the average quota share cede commission ratio improved a substantial 260 basis points, which as you will recall, is identical to the benefit achieved last quarter. These overall net acquisition improvements, however, will continue to be felt as these ceded written premiums are earned over the next few quarters.

The reinsurance segment expense ratio increased from 32.6% in the third quarter of this year to 35 -- third quarter 2014 to 35.6% this quarter primarily due to a 12.2% lower level of net earned premiums, a higher level of treaty cede commissions and a slight increase in operating expenses. Although serially, the expenses actually dropped compared to last quarter.

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

The ratio of net premium to gross premium on our core operations in the quarter was 73.1% versus 75.5% a year ago. The insurance segment had a 72.2% ratio compared to 74.2% a year earlier whereas the reinsurance segment had a net-to-gross ratio of 72% in the quarter compared to 75.8% a year ago, primarily reflecting increased sessions to Watford Re as the reinsurer. Our U.S. insurance operations saw a 60 basis point effective rate decrease this quarter, net of ceded reinsurance.

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

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

Now turning to our continuing market cycle management, the insurance group worldwide reduced gross written premiums in the highly competitive and volatile lines of E&S property and global property by 12%, and in energy and marine by 15% quarter-over-quarter. By contrast, lower volatility lines of contract binding and travel expanded north of 20% on a gross basis partially offset by a decline in program business due to purposeful underwriting actions. As stated in last quarter's call, some volume impacts were a result of underwriting actions taken on 2 programs, whereas another program administrator has been purchased by a competitor, and the premium loss impacts will be felt beginning next quarter.

Lastly, as Dinos has already stated, the insurance segment's construction business saw growth this quarter. However, much of this book has project policies and on-time policy terms, which can result in lumpy premium volume quarter-to-quarter. The reinsurance group only had 9% of its net earned premium represented by property cat this quarter. And property cat net written premiums were reduced by another 11% quarter-over-quarter, reflecting our view of that marketplace. Additionally, the property other than property cat line had a net written premium decrease of roughly 6% this quarter, and the reinsurance group also reduced net volume again in motor quota share and crop hail by approximately 20% in response to market conditions.

The mortgage segment posted a 75.2% combined ratio for the calendar quarter. The expense ratio, as expected, continues to be high as the operating ratio related to our U.S. primary operation will continue to be elevated until proper scale is achieved. The net written premium of $66.8 million in the quarter is driven by the $31.2 million from our U.S. primary operation and $35.6 million of net written premium for our reinsurance mortgage operations primarily. This segment also had $3.6 million of other underwriting income for the quarter versus approximately $1 million in the comparative quarter last year due to our GSE credit risk-sharing transactions.

This quarter marks the first time that we have reflected some mortgage risk-sharing transactions with insurance accounting rather than derivative accounting treatment. The net written premium this quarter under insurance accounting totaled $2.2 million, whereas legacy risk-sharing transactions shall continue to be accounted for as derivatives. That is reported in other underwriting income.

I want you to also note that mortgage reinsurance premium growth is driven by the fact that the Australian business is a single premium market as opposed to the United States, which is predominantly a monthly premium market.

At September 30, 2015, our total mortgage segment risk-in-force is $10.3 billion, which includes $6.5 billion from our U.S. mortgage insurance operation, $3 billion even for worldwide reinsurance operations, and approximately $800 million primarily composed of the GSE risk-sharing transactions. Our primary U.S. mortgage operation bound $3.2 billion of new insurance written during the quarter, which is approximately 57% through the bank channel and 43% via credit union clients.

The weighted average FICO score for the U.S. primary portfolio remains strong at 737 and the weighted average loan-to-value ratio held steady at 93.2%. No state's risk-in-force represents more than 9% of the portfolio, and our U.S. primary mortgage insurance company is operating at an estimated 10.2:1 risk-to-capital ratio as of the end of September.

The other segment, that being Watford Re, reported a 99.4% combined ratio for the quarter on $125 million of net written premiums and $99.2 million of net earned premiums. As a reminder, these premiums reflect 100% of the business assumed rather than simply Arch's approximate 11% common share interest. As for business sourcing, approximately 29% of the $131 million in gross written premium this quarter was written directly on Watford paper with the remainder ceded by Arch affiliates. It should be noted, however, that this sourcing mix can vary materially quarter-to-quarter.

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

Excluding foreign exchange, total return was a positive 4 bps in the quarter. On a year-to-date 9-month perspective, total return was a positive 76 bps on a U.S. dollar basis and a positive 173 bps, excluding the effects of foreign exchange.

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

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

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

Our effective tax rate on pretax operating income available to Arch shareholders for the third quarter was an expense of 5.7% compared to an expense of 2.5% in the third quarter of 2014. Approximately $1.8 million or 22% of this quarter's tax represents a true-up to bring the first half of the year to this now higher effective tax rate. Reflecting this, the 9-month -- or annualized effective tax rate is 4.5% on pretax operating income. As always, as demonstrated this quarter, fluctuations in the effective tax rate can result from variability in the relative mix of income or loss that occurs or is projected by jurisdiction.

Our total capital was $7.05 billion at the end of this quarter, which is virtually flat with total capital as of June 30, 2015, and December 31, 2014. Approximately $522 million remains under our existing buyback authorization as of the end of this quarter. Our debt-to-capital ratio remains low at 12.6%, and debt plus hybrids represents only 17.2% of our total capital, which still continues to give us significant financial flexibility. And as Dinos has mentioned, we continue to estimate having capital in excess of our targeted position.
Book value per share was $47.68 at the end of the quarter, up 4.6% relative to the end of the year of 2014. The change in book value per share this quarter primarily reflects the company's continued strong underwriting results. With that said, we're now happy to take your questions.

Question and Answer

Operator

[Operator Instructions] And your first question comes from the line of Amit Kumar from Macquarie.

Amit Kumar
Macquarie Research

Just maybe one or -- I guess 1 or 2 questions. Number one is going back to the discussion on RateStar, there was some confusion in the marketplace when the press release came out as to what it means for pricing and your competition. Can you talk a little more about it? And without obviously giving away the secret sauce, talk about the expected ROEs and maybe talk about how should we think about the adoption rate of RateStar going forward.

Constantine P. Iordanou
Chairman and Chief Executive Officer

As Coca-Cola will never reveal their formula, we won't reveal our formula either. But at the end of the day, we're in the underwriting business, and I think the more robust analytics you have in the way you allocate capital and price, risk of exposures, the better off you are as an organization. So this effort is towards that goal. We're trying to go from a more simplistic approach to pricing mortgage risk to something a bit more sophisticated that we introduced other variables in the decision-making in essence affecting the pricing. Now it doesn't mean we're going to abandon the rate card. The rate card is out there and there is some bank channels, some customers, they prefer that, and basically, they will only do business on that basis. We will continue to do that. But also there is other channels that they prefer to go to a more sophisticated pricing methodology that more appropriately allocates the right premium to the exposure, and we're going to go forward with that where appropriate. So you want to continue to see us having both the rate card and the RateStar, and only the marketplace will tell us as to how much of which is going to be used over time.

Amit Kumar
Macquarie Research

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I mean, that's the million-dollar question. At the end of the day, we always consider other avenues. Having said that, there is also the unknown that you might want to have a little bit of ammunition in case opportunities come as the market turns. And so it's more of a complicated issue for us. What was not complicated in this quarter was that we usually stick to our knitting. And when we make the calculations, we felt that it might take 4 to 5 years to earn back the premium we're going to pay when we purchase shares and we said, "hey, let's not do that. Let's see what other opportunities we have for other avenues." Having said that, we're going to have those discussions both internally as a management team and also with our board when we meet and we'll make determinations at that time.

Operator

And our next question is from the line of Michael Nannizzi from Goldman Sachs.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Just a couple of hopefully quick ones. On the U.S -- on the MI business, can you tell how much of your NIW in the quarter was singles versus monthly premium?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Mark, you have those numbers, so I...

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

Yes. It was approximately 24% that would have been singles.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

That type of business, it's exposure. Michael, it's exposure. Let me turn it over to you and you tell me the difference, right? If you have 2 loans, about 750 FICO and 90 LTV, but 1 borrower has a coverage ratio of 35 and the other one 25, which one loan would you prefer, right? And at the end, how do you reflect that in your pricing? I'm not going to get into all the algorithms that we have because it's not only you listening, our competitors are listening. But introducing additional variables, you've seen it in a lot of other P&C lines, you've seen it a lot on the selection of risk, in the automobile business. Progressive is very good and famous for it, GEICO, et cetera. And at the end, it makes a better return for shareholder and probably a fairer charge to the consumer based on their own risk characteristics.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it. I really appreciate. And then really quick, Mark, on -- I was just looking at Watford written premiums versus reinsurance ceded premiums, there's a sort of growing gap there. Is Watford -- or is the insurance sub or segment ceding business to Watford or is Watford picking up business from outside of Arch is the difference?

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

Well, as I commented on a gross basis is the way to look at it, 29% of it is coming natively on their paper. But we're continuing to get Arch Re affiliates and Arch Insurance to be sending over either retrocession or reinsurance. And I think this quarter, there was slightly more proportionally from the insurance segment.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

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

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

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Let me add something to your question from a different perspective. At the end of the day, I -- our intellectual factory that produces great results is the underwriting talent that we have within the reinsurance group. This management team, me down to Grandisson and Lyons and Papadopoulo, et cetera, we strongly believe that we have very good underwriters, talented underwriters and independents. If the market might not allow us to utilize them at a 120%, which we usually do, we're not willing to send those underwriters back into the marketplace for our competitors to hire, et cetera. So I never saw a company have problems because their expense ratio went up maybe 1 point or 2. I've seen all companies having a lot of difficulty when their loss ratio balloons by 5, 10, 15 or 20 points. So you got to understand, that's our philosophy. Yes, we expect our managers to manage expenses, and there is attrition within the organization. But we're not willing to let go good talent just because we can't utilize the factory at full capacity. That was -- the underwriting step we have is our intellectual factory that produces the profits, and I'm going to hold on to that.

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

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

Operator

Our next question is from the line of Ryan Tunis from Crédit Suisse.

Ryan James Tunis
Crédit Suisse AG, Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

I don't believe it will because the other factor you haven't factored in is what expected returns different than ours and our competitors are looking for. So if you're not -- better selection doesn't mean that you have lowered your return expectations. All you're doing is pricing more appropriately the type of exposures you're getting. This is not about reducing pricing in the marketplace. This is about assigning the right price to the right exposure and at the end of the day, our return characteristics. They're no different if we use the rate card or RateStar. So having that in mind, it would tell you that, basically, the whole effort was to improve how we think from an underwriting point of view, not to gain market share as some people -- I've heard comments to that effect. If we wanted to do market share or reduce prices, the easiest way to do it is take the rate card and you shave a few bps in each one of the category, and I don't have to be spending a lot of brainpower with a lot of our people over a number of thousands of man-hours in developing something that is more sophisticated. So I think there was a misunderstanding in the marketplace. But eventually for those who know Arch and know our underwriting approach, they will understand that at the end of the day, we're trying to be better in the way we're going to select and price risk appropriately, which is the foundation of this company.

Ryan James Tunis
Crédit Suisse AG, Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

Operator

Our next question comes from the line of Sarah DeWitt from JPMorgan.

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

The GSE growth opportunity sounds pretty interesting for you. How should we think about sizing that? And if we look out over the next 5 years, what percent of overall earnings do you think that could be?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Mark, do you want to take a shot at that? I mean, it is...

Mark D. Lyons

Chief Financial Officer, Executive Vice President and Treasurer

Over the next 5 years -- my crystal ball is only for 5 months. But still, it is we do view it as a positive opportunity. And I think one way you should think about it is that, the advent now of Fannie joining Freddie on this, and it seems that because they're expanding and looking for others to participate in this, they're going through the efforts to establish in broader market, which gives credence to the fact that they're here to stay. It's not just a transitional thing. So with Freddie continuing to do this and Fannie continuing to do this, we do think it's an exciting opportunity. And so it's definitely going to be a growing piece. Now as long as pricing stays same, we will continue to be participants in that growing marketplace. So far on the Fannie deals, they all have the same structure. They've all been 2.5 points excess of 0.5 point on the subject loans that are out there. This is why it's difficult. We don't know how those structures are going to change over time. Are they going to be higher attachment, lower attachment? So it's very difficult to put your thumb on volume, let alone how much of these are going to be pushed out into the marketplace. But it's -- we view it as an exciting opportunity for us.

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

That is not a consideration.

Operator

Our next question comes from the line of Vinay Misquith from Sterne Agee.

Vinay Gerard Misquith
Sterne Agee & Leach Inc., Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

Vinay Gerard Misquith
Sterne Agee & Leach Inc., Research Division

Okay. So that means this thing would take some traction to get through the book just because of larger lenders, I guess, make up a bigger portion of the total business, correct?

Constantine P. Iordanou
Chairman and Chief Executive Officer

That's correct.

Vinay Gerard Misquith
Sterne Agee & Leach Inc., Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

No. You're going in the wrong direction, Vinay. If it was just FICO scores, you don't need to go and make all these effort to create the RateStar with multiple algorithms. It's other characteristics. There is rich data in the loans being provided to us by the lenders: who is the borrower, who is co-borrower, what location is that, blah, blah, blah. I'm not going to get into all of these stuff we think. If it was purely FICO score, you don't need to make -- you have LTV and you have FICO score and then if you want to make a higher LTV -- higher FICO scores cheaper, you take a few points off your rate card and then you accomplish that. So that's not what it's all about. I'm surprised as to how much confusion is in the minds of people as to what this is all about. This is a product that it will allow us to take other characteristics of the loan and find what we believe is a more appropriate price for the exposure that we're assuming.

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

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

Vinay Gerard Misquith
Sterne Agee & Leach Inc., Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's -- the part you didn't mention is our reduction in the singles. Okay? The change in the trajectory, I would say, became 100% out of our reduction in the singles.

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

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

Vinay Gerard Misquith
Sterne Agee & Leach Inc., Research Division

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

Mark D. Lyons

Chief Financial Officer, Executive Vice President and Treasurer

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

It was the first time we did it last year. And actually, pricing on singles a year ago was more acceptable to us. I think as the last 3 full quarters emerged, it became more competitive marketplace, because we have some competitors, they're trying to gain market share through singles. We don't view that a good place to be, and we're disciplined when it comes to underwriting.

Operator

Our next question comes from the line of Jay Gelb from Barclays.

Jay H. Gelb
Barclays PLC, Research Division

I may have missed it, but did you mention your Tianjin loss?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Insignificant.

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

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

So even -- if it was anything notable, we would have put something out, but it is not notable within our numbers.

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

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

Jay H. Gelb
Barclays PLC, Research Division

Okay. Did you add some IBNR just in case?

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

Yes.

Constantine P. Iordanou
Chairman and Chief Executive Officer

We always do.

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

But it's contained within our standard attritional IBNR.

Jay H. Gelb
Barclays PLC, Research Division

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

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

Well, I think you should -- well, first off, longer term implies I know where -- what jurisdiction is going to give me profits on a go-forward basis. And that really does fluctuate from quarter-to-quarter. But you're looking at the tax rate on net income as opposed to the tax rate on operating. Just the simple arithmetic of it, you've got the tax rate on pretax operating income and to convert over to net income it's really the realized losses. So you got the same pack of dollars with the smaller denominator. I mean, that's the arithmetic [indiscernible] of it to that pushes up to 13[indiscernible] . But on a -- our current view on operating of like trailing 12-month type view on operating income is likely to be 4-ish, 4-ish percent, 5-ish percent.

Constantine P. Iordanou
Chairman and Chief Executive Officer

I would say between 4% and 5% and that's the better way to look at it. Don't look on net income in 1 quarter...

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

Because realized gains --

Constantine P. Iordanou
Chairman and Chief Executive Officer

But you look at it from a trailing 12 months. Then you got more of the net income, more of the -- and then you can add all the tax and then it would give you a better feel as to what the percentage is.

Jay H. Gelb
Barclays PLC, Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

I didn't say that. I said something different. I just said I'm not going to be the market, right?

Jay H. Gelb
Barclays PLC, Research Division

Okay. So I mean, the valuation seems to be a pretty important parameter. How should we think about it?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, valuation is very important. But you know we look at it based on the prospects of what returns we get on the business we write. And if my recovery period elongates and we're starting getting uncomfortable over 3 years, then we shy away from -- it has nothing to do with how we feel about that stock or it's just purely our approach to it, and that approach might change. I don't know what my discussions with wiser guys, that's why I got pretty wise guys on my board to give me advice and what perspective they're going to have. But based on what I said, we might sit on excess capital because there also might be opportunities for us to deploy in a different fashion in the marketplace.

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

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

Jay H. Gelb
Barclays PLC, Research Division

Of course. If the stock were valued instead, let's say, at 1.5x book, would that have been within your range of viewing it within the 3-year payback period?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It could be. It's hard for me to project into the future, right? I mean, it's like you're describing a guy who can read the obituary pages 5 years from today and he finds his name there. That's not a good place to be. But we make those decisions and we're flexible on a quarter-to-quarter basis, and we have unknowns. And when we have unknowns, sometimes we hold back a little bit. For example, the mortgage GSE opportunities, and I think Sarah is the 1 who asked the question and I couldn't answer it because I know the opportunity is big, the demand is there, but I don't know how big it's going to be. And I don't know how much of our capital we want to allocate to that. So when I have unknowns, I'd rather say I've got unknowns and here is how we're thinking but there might be opportunities. Because I know you want to build your models and project a year out, a quarter out and all that, but I don't operate on that basis. I'm trying to make sure that our underwriting unit, they make the right decisions based on the latest information they have. And if I have excess capital, it's not burning holes in my pocket. So -- unless somebody is trying to put his hand in my pocket and take it and then I will cut it, that's not a problem. It's a good problem to have.

Operator

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

Kai Pan
Morgan Stanley, Research Division

So first, on the -- do you have any --

Constantine P. Iordanou
Chairman and Chief Executive Officer

[indiscernible] sandwich is on the grill.

Kai Pan
Morgan Stanley, Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Insignificant. Insignificant.

Kai Pan
Morgan Stanley, Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, listen, our hallmark is putting the right price based on the recent exposures we underwrite. If the market improves, we're going to write more. Our appetite has not disappeared. There were times that we were committing 20%, 21%, 22% of equity capital to that line on a PML basis and it was down to now 9 and actually, for Florida and the Gulf of Mexico which is less than that. So our appetite will depend on the market pricing. Now predicting what's going to happen in January 1, who knows. If I had to guess, it will probably be a stable where it is today because I think even for those that they participate, the new capital that comes in, even with no real cat, their returns are not super juicy. And that's a sad statement to say when there is no cat, you don't have super juicy because what do you do when you have the cat, right?

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

Kai, I would also add: you used the term "if it stabilizes." Depends what you mean by "stabilizes." If -- improving doesn't mean stabilizing to me. And if the rate cuts stay, there's no more rate cuts and stays at 0% change, we've been shedding volume given that relative level. So I wouldn't expect our business to increase if it stays at the levels. They would have to improve, not merely stabilize.

Kai Pan
Morgan Stanley, Research Division

Okay. And so you're not expecting any sort of meaningful price increases from current levels?

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

Kai Pan
Morgan Stanley, Research Division

Okay. That's great. Then on sort of the management succession, Dinos, you've been running -- have a great track record since founding the company and I'm sure you're at the society [ph] running the business as it is today. But I don't know if the company has mandatory requirement age, but is the board considering a succession planning? And how do you think about it?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We have succession planning in everyone, every senior position we have with -- is part of our process within the comp committee and their responsibility is -- and my responsibility as CEO is not only preparing my successor but also each 1 of our key positions has 1 or 2 successors ready from within. And that process is not new, it's been in place now for over 10 years. Having said that, if you're at my contract, it goes all the way to the end of '17, actually, March 1, '18. So I can't sign the 10-K if I decide to just become the chairman. But no decisions have been made. But there is an existing succession plan within the company that is part of the responsibility of our board and they take it seriously and they -- and we talk about it at least once a year in the comp committee.

Operator

Our next question comes from the line of Meyer Shields from KBW.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

If you allow them to have both, yes. But basically, what we're telling lenders, you can either have 1 or the other. You can't have the rate card and then price it that way and then price it on the other way and go back and forth. It's either you choose to participate with us on the rate card or you choose to participate with us on the RateStar.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

What is the loss trend in the insurance segment that corresponds to the 60 basis points sort of premium or rate decline?

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

I'm sorry, could you --

Constantine P. Iordanou
Chairman and Chief Executive Officer

The 60 bps rate decline.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Right. I'm just trying to get the corresponding loss happened there [ph].

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's probably short lines outweighing the increases we get on longer-tailed lines.

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

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

And our volume on the short-tailed lines is it's small, so you got to do weighted average, right?

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Right. I'm just trying to understand -- to get the sort of weighted average loss cost trend that corresponds to that.

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

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

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

So the 4.4% was - I'm sorry, I'm probably more dense [indiscernible].

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

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

Operator

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

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Maybe a bigger picture question on the mortgage business. I believe, Dinos, in the past you've said that when this business gets to scale that I think the segment earnings could be as much as 1/3 of the overall company's earnings. Is that still a view that you believe is accurate?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, it's an accurate view. But I also said that it will take 3 to 5 years to get to that point. So we believe that, yes, we have potential to be earning $150 million, $200 million annually from the mortgage business, but it's got to get to maturity and we are not there yet.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

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

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

That should improve. Because of -- on the U.S. mortgage side, it's really a sales force. It's there. So you're going to have those fixed costs and you write more volume as you drop.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Our sales force is constant, right? I mean, we're not adding -- once you get to a steady state on the sales force, maybe you add 1 person here and there. And then there is a little bit of increased cost-of-living adjustment, et cetera, incentive compensation. But -- so that's more of a steady number. And then as you're building volume, your expense structure on a percentage rate basis is going to improve.

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

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

Jay Adam Cohen
BofA Merrill Lynch, Research Division

It was the segment. That's what I figured.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Right, right.

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

Fair enough.

Operator

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

Brian Robert Meredith
UBS Investment Bank, Research Division

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

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

Yes, on the quota share treaty is that dominate the sessions. It was a 260 basis point spread of -- or actually, let me restate that. Improvement in the ceded commission by 260 basis points 3Q to 3Q? And last quarter 2Q to 2Q has exactly the same improved spread difference.

Constantine P. Iordanou
Chairman and Chief Executive Officer

And at some point in time that would disappear because once we cycle over 4 quarters, it's over until, in comparison quarter-to-quarter. Right.

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

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

Brian Robert Meredith
UBS Investment Bank, Research Division

Right, right. So therefore your acquisition expense ratios should probably continue to come down in the insurance space, year-over-year for at least the next couple of quarters?

Constantine P. Iordanou
Chairman and Chief Executive Officer

On the earnings, yes.

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

Barring no change on the front-end direct commission.

Brian Robert Meredith
UBS Investment Bank, Research Division

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it's a difficult question to answer because it depends on the volume. But 2 things I got to tell you: don't underestimate how good our reinsurance guys are. They're finding other avenues, not all of their business is these, what I would say, large client under a lot of pressure business. They're finding niches here and there to still be relevant and have good returns. So -- and at the end of the day, yes, if our mortgage business continues to grow, it might offset it. But I don't know that because I can't project volumes. We don't spend time thinking about volumes and that's why we're not trying to be avoiding the questions. But to us, future projections are not -- we don't spend a lot of time on those. What we spend a lot of time is to analyze what we have and how we're going to behave quarter-to-quarter based on the market conditions that we see every quarter.

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

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

Operator

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

Ryan J. Byrnes
Janney Montgomery Scott LLC, Research Division

Just 1 question for me. Just trying to figure out why your Tianjin loss was immaterial. It seemed to kind of effect of most of your competitors. Just wanted to see if you guys avoided certain risks or coverages that kept you away from these losses or if that were just simply luck. I'm imagining it's more the former?

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

Operator

And your next question comes from the line of Rob Half [ph] from Wells Fargo Securities.

Unknown Analyst

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

You found it.

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

I love it when you answer your own question. It was exactly right. It was $239 million increase in borrowing from revolver on Watford. But since we consolidate, of course, we have to reflect that on our balance sheet. You're also correct that our capital composition exhibit is for non-Watford. So you hit it exactly.

Unknown Analyst

Okay. And I don't know if you can discuss what they need the money for? And if these borrowings are nonrecourse to Arch?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Nonrecourse to Arch. Is their borrowings and they're using them for investments. Their business plan always included, I think 1.5x leverage, up to 1.5x. So it's a company with over $1 billion of capital, so they would probably borrow up to $400 million, $500 million and use it in their investment strategy. We're not responsible for the investments, we're only responsible for the underwriting side, so.

Operator

And your next question comes from the line of Ian Gutterman from Balyasny.

Ian Gutterman
Balyasny Asset Management L.P.

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

Ian Gutterman
Balyasny Asset Management L.P.

I hope you burned it. But that's a different discussion. Just a follow-up to that last question. Is the reason Watford needs -- not needs or chooses to use debt to get to their asset leverage because they're behind plan on float and they thought they would have been better on float and they're replacing it with straight debt or?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, I don't -- listen, these are questions for Watford. But what I'm telling you is that they believe there might have been opportunities now based on what they see in the market and they say, hey, we can put some leverage on it and buy some stuff.

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

And Ian, just to add to that, use of leverage was there from day 1 on the initial business plan.

Constantine P. Iordanou
Chairman and Chief Executive Officer

No need to go out and borrow when you haven't even deployed your own capital yet. And [indiscernible] generate rate float for them. I mean, our premium plans we have been hitting based on the original plan. So there is float coming in from our underwriting activities.

Ian Gutterman
Balyasny Asset Management L.P.

Exactly. That's what I wanted to make sure about. Okay, good. So my -- the first question I was going to ask before that was on the capital discussion, can you remind me -- you guys have obviously never paid a dividend whether it be ordinary or special. Sort of remind me sort of why you guys are adverse to dividends? Is it a tax thing? is it just...[indiscernible]

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I mean you're making -- you're forcing a tax bill to your shareholders, right? And once you give the money, if the next day you got an opportunity, then you got to go and borrow to take advantage of it. We always like to have a little bit of excess capital. Maybe we have a lot of excess capital, but right now it's not at the level that is really giving me a lot of angst. Even though excess capital is only earning 2.5%, 3% or thereabouts, it is what it is. But like I said, they -- we talk to our investors and some of our investors, they're opposed to a special dividend. They think that over time, we might not be in the next few quarters, it might be in the next year or 2, we'll find the right opportunity and deploy capital. Don't forget, we were talking about excess capital, et cetera. Our mortgage business is a new business for us. We only started it about 4, 5 years ago and it really is getting scaled now. So if I didn't find that opportunity with our guys, it was predominantly, Mark Granderson, who discovered it based on our discussions with our investment department and me, et cetera, we wouldn't have that opportunity to deploy today in excess of $0.5 billion of capital into that business. So it's everybody tries to say oh, if I have this magic balance sheet that is always in balance that will be utopia but I am a realist. There is no such a thing as utopia. We're trying to do the best we can.

Ian Gutterman
Balyasny Asset Management L.P.

No, very fair. I just want to make sure I was remembering correctly. Then on MI, just a couple of quick things. One, I don't think this has come up yet. Is that -- I believe there is a lot to talk about just pricing changing in the bank channel. I think it's more in the community bank channel, if I'm correct. That, that's a -- sort of some of the banks are sort of, I guess, jealous of the credit unions' success, right, and saying since the crisis, things have changed and the credit union is not necessarily a better channel than a regional bank anymore, given changes in lending standards and why are we charging so much more for MI in the bank channel? And therefore, we should cut rates to bring it more in line with the credit union experience. Is that happening or is that being discussed? And if so, just what are your thoughts on that?

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

Ian Gutterman
Balyasny Asset Management L.P.

Got it. Very fair. And then just lastly, on the RateStar thing is, I guess, what's interesting to me I'm not asking you to give us the secret sauce here, but just -- I always thought about FICO being -- again I know it had, it maybe had some missteps in the crisis, but that arguably was because of the lending standards maybe more than FICO itself, right? And when you look at auto insurance that FICO is the best predictor of whether you're going to get into an auto accident. It seems like it's pretty powerful variable. I mean, what do you see as the flaws in [indiscernible]

Constantine P. Iordanou
Chairman and Chief Executive Officer

Absolutely, it's there. But we're not eliminating FICO. FICO is a very powerful [indiscernible] is very powerful, but there is other attributes that they have predictive ability and value. So by ignoring them, is it 2 borrowers or 1 co-borrowing? Is it coverage ratio? Is it 30, 40 or 50? And I can go on and on and on into the other things that what territory you're in, what do you think about the housing market in that territory, et cetera, et cetera, et cetera. These are --- and I'm not going to go and tell everybody as to what we've done with this, but we've done a lot of work. We believe that it's a -- I wouldn't say it's smarter because that's arrogant. I think it's a different way of looking, but I think it's a better way in our view to assign the right price to mortgage risk.

Ian Gutterman
Balyasny Asset Management L.P.

That makes sense. I guess, maybe if I ask it in a slightly different way. Is your sense that FICO is maybe explaining, I'm just going to make up numbers here right, but is FICO so good that it was explaining 90% of the difference in borrowers and this gives you the last 10%? Or was it maybe 2/3 and this gives you a whole another 1/3? You know what I mean? I'm just trying to get a sense of how significant the improvement is.

Constantine P. Iordanou
Chairman and Chief Executive Officer

I don't know because -- I don't know from the work. I've seen some of their work, and I participated in some of their discussions. So I can't put a percentage of predictability on any 1 attribute. But I can tell you FICO is a very important piece. LTV for some risk is very important. For other risks, it might not be. Like a young couple, 2 MBA students that they -- college sweethearts, they both have pretty good jobs and they can only scrap together a 5% payment because they're living in a bigger house because they have a lot of income. So the LTV might not be as critical and they might have super FICO scores, and these other attributes and that might -- you might price that loan differently than a simple rate card.

Operator

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

Charles Joseph Sebaski
BMO Capital Markets Equity Research

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's 2 issues. It's 2 issues you got to think about this. It's the willingness of the -- the number one issue is the GSE is, they're going to put this in the market. That's known, there's a lot of pressure by Congress to de-risk and not be their credit providers for loans beyond the mandatory 20% down payment and maybe all the way down to 40%. Now that's why we've been hesitant on volumes. A lot of these goes to the capital markets, and it depends what pricing they're getting from the capital markets. What the both GSEs, Fannie and Freddie, are doing, they're developing 2 parallel markets. They're developing the insurance/reinsurance market that -- and it fluctuates. Sometimes, they allocate 20% to 30% and up and then the rest of it goes to the capital market. But we have no control as to what those allocations. If the capital markets become expensive, maybe they would start allocating 30%, 40% to the insurance markets. And believe me, what happens in the capital markets, is also affect the pricing that comes to the insurance/reinsurance market. The reason they're doing that, they believe that by creating 2 avenues and 2 different source of capital responding to these credit risks is good in the long run, and it might create more stability for them because they have 2 different paths to shed credit risk into the private domain instead of the government taking it. So I don't know which way it's going to go. But right now, we believe that with insurance accounting being introduced and the innovations that we have worked very closely with the GSEs there and their willingness and they're talking to a lot of others within the insurance and reinsurance business, I don't know how many they have the expertise to do it, but some do, I think this is going to be a new market for the insurance/reinsurance business, and it can be substantial over time.

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

And, Chuck, the other thing that makes it difficult to predict, as Dinos said, Dinos was describing more how Freddie Mac has done it where it's the same notional base of loans and capital markets and the insurance/reinsurance industry share on that same same set. Fannie has done it a little bit differently, but they're using capital markets and the reinsurance market, but it's a different pool. So what's gone out to the Fannie deals has been exclusively a pool that went to the reinsurance industry and a separate pool may have gone to the capital market. So they may not continue doing that way. They may wind up doing it similar to Freddie. So there's a lot of different parameters that make the projections difficult.

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's a young emerging market and a lot of it is because the Congress in general, they want Fannie and Freddie to de-risk. And for that reason, we feel optimistic that this is going to -- the demand is always going to be there. Now is it going to go 100% to the capital market? I doubt it. Now what percentage comes to insurance/reinsurance versus the capital markets is in their hands and you got 2 big customers here and they hold all the cards. So, yes.

Charles Joseph Sebaski
BMO Capital Markets Equity Research

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

As we do with every line of business that we have, we have a, think of it as a PML and how much of our equity capital we want to risk. So there is a constraint, and we have developed. Actually, maybe, we're the only ones. I don't know if our competitors do that or not. I have no idea. I'm sure from a risk management point of view, they do something of that sort, but we do calculate on a quarterly basis what the PML values we have for the mortgage business. And we have -- that will be a constraint at some point in time. When we reach the upper limit of the available PML, that would be a constraint for us, but we got other vehicles. We might create a cycle at that time. We might use our knowledge and ability and underwriting ability and the systems we have. Don't forget, we got to have good systems to price loan by loan, et cetera, to introduce other capital providers into the sector with us as we've done with Watford, we can do mortgage Watford, so to speak. So we have a lot of flexibility. We're nowhere near yet or passing that constraint. So for the time being is we've got freedom to operate and we got plenty of capital to deploy and is not violating any of our PML criteria that the board sets as to how much risk you're going to take in any particular. I don't care if it's cat risk or mortgage risk or D&O risk we have. In our risk management principles, we have limits that we want to take.

Charles Joseph Sebaski
BMO Capital Markets Equity Research

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

Operator

Now I'd like to turn the call over to Dinos Iordanou for closing remarks.

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

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