S&P Global
Market Intelligence

# Arch Capital Group Ltd. NasdaqGS:ACGL

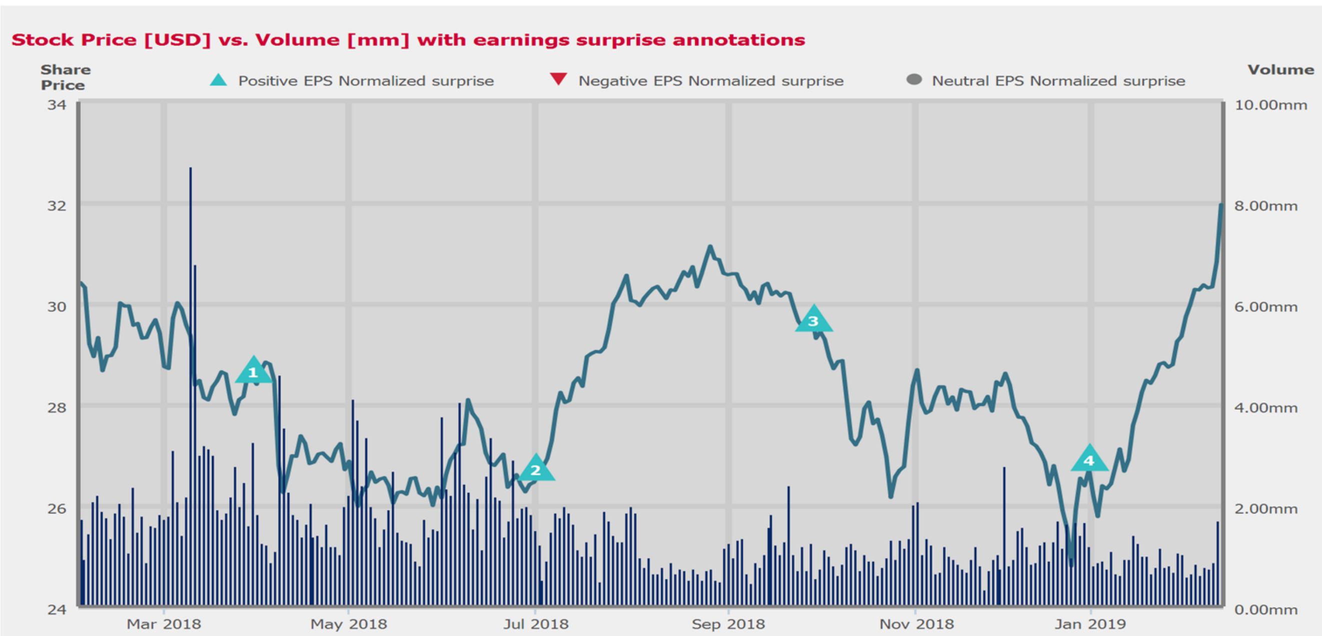
# FQ4 2018 Earnings Call Transcripts

## Wednesday, February 13, 2019 4:00 PM GMT

## S&P Global Market Intelligence Estimates

| | -FQ4 2018- | | | -FQ1 2019- | -FY 2018- | |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | ACTUAL |
| **EPS Normalized** | 0.38 | 0.46 | ▲21.05 | 0.63 | 2.12 | 2.20 |
| **Revenue (mm)** | 1028.14 | 1169.39 | ▲13.74 | 1272.00 | 4596.65 | 4742.57 |

Currency: USD
Consensus as of Feb-13-2019 11:26 AM GMT




| - EPS NORMALIZED - | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| **FQ1 2018** | 0.52 | 0.56 | ▲1 7.69 % |
| **FQ2 2018** | 0.53 | 0.59 | ▲2 11.32 % |
| **FQ3 2018** | 0.52 | 0.59 | ▲3 13.46 % |
| **FQ4 2018** | 0.38 | 0.46 | ▲4 21.05 % |

# Table of Contents

# Call Participants

## EXECUTIVES

**François Morin**
*Executive VP, CFO & Treasurer*

**Marc Grandisson**
*CEO, President & Director*

## ANALYSTS

**Amit Kumar**
*The Buckingham Research Group Incorporated*

**Elyse Beth Greenspan**
*Wells Fargo Securities, LLC, Research Division*

**Geoffrey Murray Dunn**
*Dowling & Partners Securities, LLC*

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

**Kai Pan**
*Morgan Stanley, Research Division*

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

**Michael David Zaremski**
*Crédit Suisse AG, Research Division*

**Seth A. Rosenberg**
*UBS Investment Bank, Research Division*

**Yaron Joseph Kinar**
*Goldman Sachs Group Inc., Research Division*

# Presentation

**Operator**

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

Before the company gets started with this update, management wants to first remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the federal securities laws. These statements are based upon management's current assessments and assumptions and are subject to a number of risks and uncertainties. Consequently, actual results may differ materially from those expressed or implied. For more information on the risks and other factors that may affect future performance, investors should review periodic reports that are filed by the company with 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 definition of operating income can be found in the company's current report on Form 8-K furnished to the SEC yesterday, which contains the company's earnings press release and is also available on the company's website.

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

**Marc Grandisson**
*CEO, President & Director*

Thank you, Shannon, and good morning to you all.

Once again, this quarter, strong earnings from our mortgage segment offset the effects of catastrophe losses in our property and casualty segments and have produced an annualized operating return on equity of 8.8% and 10.7% for the 2018 fourth quarter and full year, respectively.

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

Given the notable catastrophe events of the past 2 years, we will begin our discussion of market conditions with the January 1 renewal market and property cat reinsurance. As you may have heard on other earnings call this quarter, on average, property cat rate increases at Jan 1 were positive but below expectations given the record level of insured cat losses that were reported in the past 2 years. Across the industry, loss-affected property accounts saw rate increases of 10% or more, while some property accounts in Europe were flat to down 5%.

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

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

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

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

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

Turning now to our mortgage segment. The underwriting environment remains very attractive, with ongoing growth in our insurance in-force producing strong increases in earned premium and will contribute to a future stream of earnings that is both stable and predictable.

For the fourth quarter, our U.S. MI new insurance written or NIW was $16.7 billion, a 16% increase over the same quarter last year, and the proportion of single premium business remained low at about 9% of NIW this quarter.

Within our U.S. primary business, the credit quality of loans insured remains excellent, and our key risk barometers are still at very healthy levels. To put this in historical context, our risk indices tell us that the current borrowers' credit characteristics are still substantially higher, in fact, by roughly a factor of 2 relative to the borrowers of the late '90s and early 2000s.

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

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

Moving to capital management. Despite our exposure to property cat in 2018, we were able to deploy some of our capital towards expanding our distribution capabilities, deleveraging our debt and repurchasing our shares. As you know, we recently closed on acquisitions in the U.S. and the U.K. that are expected to expand our distribution base. Volatility in the equity markets also gave us opportunities to repurchase approximately $100 million of our common shares in the quarter at attractive prices. As in all of our capital allocation processes, we employ a rigorous and disciplined assessment of available opportunities to deploy capital in order to generate long-term returns for our shareholders across all phases of the cycle.

Turning now briefly to risk management. For the past few years and continuing into 2019, our property cat exposures remain at historically low levels, with our 1-in-250 year peak zone at about 4.5% of tangible common equity at January 1. We have the ability and the capacity to deploy more capital to this sector if available returns improve to acceptable levels this year. For Arch clients and investors, our ability to increase our support in times of need is a significant benefit to the marketplace and a source, we believe, of long-term value creation for our shareholders.

In our mortgage segment, our issuance of insurance-linked notes known as Bellemeade securities have significantly reduced our shareholders' exposure to the tail effects on our business from economic recessions and have paved the way for a significant reduction to our risk profile despite growth in our insurance in-force.

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

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

**François Morin**
*Executive VP, CFO & Treasurer*

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

After-tax operating income for the quarter was $189.2 million, which translates to an annualized 8.8% operating return on average common equity and $0.46 per share. For the full year, our operating ROE stands at 10.7%, a solid result in light of the elevated catastrophe activity in the second half of 2018 and the pricing environment in the P&C sector that remains competitive. Book value per share was $21.52 at December 31, a 1.7% increase from last quarter and a 6% increase from 1 year ago despite the impact of higher interest rates on total returns for the quarter and the year.

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

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

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

The insurance segment's accident quarter combined ratio excluding cats was 98.3%, slightly lower than for the same period 1 year ago. Most of the improvements came from lower levels of attritional losses and acquisition expenses.

The reinsurance segment accident quarter combined ratio excluding cats stood at 96.2% compared to 103.2% on the same basis 1 year ago. As we mentioned on prior calls, we tend to look at trailing 12-month analyses in order to assess the ongoing performance of our segments given the inherent volatility in the business that can emerge from quarter to quarter. The year-over-year comparison for the reinsurance segment is affected by a few notable items. First, as we mentioned on the previous call, our acquisition expense ratio last year reflected the federal excise taxes associated with a large internal loss portfolio transfer. Second, our loss experience this quarter was impacted by a large attritional casualty loss arising from the California wildfires. And third, we had a noticeable amount of reinstatement premiums and premium adjustments this quarter that benefited our combined ratio. Once we adjust for these variations, the underlying performance of our reinsurance segment remained strong this quarter.

The mortgage segment's accident quarter combined ratio improved by 1,410 basis points from the fourth quarter of last year as a result of the continued strong underlying performance of the book, particularly within our U.S. primary MI operations. The calendar quarter loss ratio of 2.1% in the fourth quarter of 2018 compares favorably to the 17.8% in the same quarter of 2017 due to substantially lower delinquency rates. Part of the difference is attributable to increased favorable prior year development, which was approximately 320 basis points higher than last year. In addition, there was approximately $13 million or 410 basis points of favorable development on 2018 delinquencies due to very strong cure activity in the period. The expense ratio was 20.5%, lower by 160 basis points than in the same period 1 year ago as a result of expense savings achieved.

I'd like to remind everyone that due to the nuances of purchase accounting, the amortization of our debt asset should continue to increase in 2019 by an amount that is approximately $8 million higher on an annual basis than 2018 levels, increasing acquisition expenses. These results highlight the contribution to our pretax underwriting income from the mortgage segment, which remained strong this quarter. After allocating corporate items such as investment income, interest expense and income taxes to each segment, the mortgage segment's contribution to our 2018 net income decreases to approximately 75% of the total after normalizing our results for catastrophic activity.

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

During the quarter, we continued to move away from municipal bonds and into corporate and government bonds due to relative valuations. The repositioning of our portfolio during 2018, combined with the reinvestment of shorter-maturity bonds and other swap activity at higher yields, generated higher investment income year-over-year. We extended the duration of our investment portfolio in the quarter to 3.38 years, up from 2.94 years on a sequential basis as global economies weakened. Operating cash flow on a core basis was a strong $384 million in the quarter, reflecting the solid performance of our units.

The corporate effective tax rate in the quarter on pretax operating income was 16.8% and reflects the benefit of the U.S. -- of the lower U.S. tax rate, the geographic mix of our pretax income and a 210 basis point expense from discrete tax items in the quarter. As a result, the effective tax rate on pretax operating income excluding discrete items was 14.7% this quarter, higher than the 9.9% rate last quarter. The difference from this rate to the numbers noted in our recent prerelease is primarily attributable to discrete items and a higher level of U.S.-based income, which triggered a true-up of tax accruals for the first 3 quarters of the year.

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

With respect to capital management, we paid down the remaining $125 million of our revolving credit facility during the quarter, and we also repurchased 3.6 million shares at an average price of $27.11 per share and an aggregate cost of $98.2 million under our Rule 10b-5 plan that we implemented during this quarter's closed-window period. Our remaining authorization, which expires in December 2019, stood at $164 million at December 31, 2018. Our debt-to-total capital ratio stood at 15.5% at year-end and debt plus preferred to total capital ratio was 22.5%, down 390 basis points from year-end 2017 and a full 620 basis points from year-end 2016, when we closed the UGC acquisition.

Finally, I would like to bring to your attention a change we are introducing in 2019 regarding our incentive compensation practices. As you know, equity grants made to employees had historically been awarded in May of each year. Starting this year, equity grants are expected to be awarded in the first quarter, subject to board approval. As a result, we would expect a small distortion in the timing of our operating expenses. The impact of this change, based on 2018 equity grants, is an expected shift of approximately $11 million to $13 million in operating expenses from the second quarter to the first quarter of 2019. 2/3 of that expense is expected to be reflected within our operating segments, with the remainder in corporate expenses and investment expenses.
With these introductory comments, we are now prepared to take your questions.

# Question and Answer

**Operator**

[Operator Instructions] Our first question comes from Kai Pan with Morgan Stanley.

**Kai Pan**
*Morgan Stanley, Research Division*

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

**Marc Grandisson**
*CEO, President & Director*

The loss ratio has been very good and, actually, better than we had anticipated probably a year, 1.5 years ago. So we have ongoing improvement in notice of default and [ cure ] rates. So right now, everything we're pointing to is much less than the long-term average, which will be 20%, I would think, overall cycle. So yes, you could pick your number, Kai. It's very hard to predict the future, but certainly, we are in a very benign loss environment.

**Kai Pan**
*Morgan Stanley, Research Division*

That's great. But if you take out, I mean, the large amount of reserve releases, the reported loss ratio is below 10%, had been around 10% or less for the last several years. At what point the regulator, would you say, the result is too good? And would -- be more focused on either pricing or competition could start to come in?

**Marc Grandisson**
*CEO, President & Director*

Well, I think -- I'm not sure what the regulators would do, but from our perspective, this is still a risky insurance product, like everything else is out there. And what matters is really about the return. And I would argue that even if you have a little bit higher-than-average return in the current environment, that probably more than makes up for some of the bad years that have occurred in the industry. So we're not losing sleep over this. There's no commentary to the effect that the loss ratio is too high or too low. In fact, I would even argue that the new capital framework from the GSEs are leading us to a directive -- in the direction of still appropriate level of capital and return in the industry to make sure it's a solid framework for how they finance.

**Kai Pan**
*Morgan Stanley, Research Division*

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

**Marc Grandisson**
*CEO, President & Director*

Yes. So the growth year-on-year is a little bit distorted. If you look at the last 4 quarters, it's more consistent. The growth that we've seen over the last 12 months is -- continues to be areas that we've talked about before, international motor quota share, some -- actually, some commercial auto, we have some opportunities in there, and some workers' comp opportunities, of all things. So there's a lot -- and some property -- specific property cat-related exposure in the reinsurance group as well. So the growth we're -- that we're seeing in reinsurance is consistent with our fishing and looking around in the world for good returns, better risk-adjusted return, if we can, and away from probably the more traditional commoditized reinsurance business. So it's a little bit more bespoke than the rest of the things you would hear about in the marketplace.

**Kai Pan**
*Morgan Stanley, Research Division*

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

**Marc Grandisson**
*CEO, President & Director*

Yes. So on the liability side, it's a little bit easier to answer because these things are most -- there's a lot of questions in the market and the industry as to whether these are insurable and at what level and at what price. And as you know, it's kind of a big market. And currently, the player that's been tagged or had been identified as being liable for that loss is going through a lot of difficult times. So we'll see how that develops, so it's currently developing as we speak. This is still a very small market, right, in the broader scheme of things. As far as the property is concerned, it's really uncertain. As I said in my opening remarks, the capital supply is still plentiful. There were talks at the beginning, Kai. Maybe that's what you alluded to, to the fact that there might be some changes to the modeling of California wildfires, but it's still very early. People are still trying to figure out what they have and what it means in their modeling. And as you know, it's more -- it's a little bit isolated, in fact, right? It's isolated to one area of the country and people have a way to manage their portfolio and deploy capital in other areas. So it's a very hard question to answer because we don't know what the supply of capital is going to be by midyear. But logic would dictate it should go up to some extent, but we'll see what happens.

**Operator**

Our next question comes from Geoffrey Dunn with Dowling & Partners.

**Geoffrey Murray Dunn**
*Dowling & Partners Securities, LLC*

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

**François Morin**
*Executive VP, CFO & Treasurer*

No. What we've seen, there's actually no indication that it's weakening. We see tremendous investor appetite for the product. As you know, the [ GCs ] really started, that we were in there as well as the sole MI that was accessing that market in the last year. Most of the others have jumped into, I'd call it, on the bandwagon. And it just makes it for -- I mean, investors now have the ability to -- when they do the research, they do analysis, they feel it's something that's repeatable. They can access that type of product not only through us but also through some of our competitors. So as far as we can tell, there's still tremendous appetite for the product. It's expanding a little bit. Getting some of our instruments rated has also helped. But we see that as something that -- there's nothing in the horizon that suggests that we won't be able to execute on it.

**Marc Grandisson**
*CEO, President & Director*

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

**François Morin**
*Executive VP, CFO & Treasurer*

Recognizing there's volatility here and there, but in the long term, we think, yes, spreads have been very stable. Yes.

**Geoffrey Murray Dunn**
*Dowling & Partners Securities, LLC*

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

**François Morin**
*Executive VP, CFO & Treasurer*

Absolutely. I mean, we argue it's even better than traditional reinsurance because we have the cash on hand, so it's collateralized. And from that point of view, they...

**Marc Grandisson**
*CEO, President & Director*

If they [ were to ] accept it, they should have you being -- happier than just other forms of capital, I mean, aside from just traditional equity.

**Geoffrey Murray Dunn**
*Dowling & Partners Securities, LLC*

Okay. And then a follow-up on new notice development. Is the company's book reaching an inflection point where, even though the newer vintages are very high-quality and outperforming, but the book size is obviously -- and the [ seizing ] is going to drive decent new notice levels. Are the more recent vintages now exceeding the benefit of the runoff of the '08, meaning that we should see, on average, new notice growth going forward?

**Marc Grandisson**
*CEO, President & Director*

I think we will at some point. I'm not sure that we've crossed it yet. It's very hard for us to see and to predict that. But you're right. Over time, we would expect as the '09 and prior -- or the '08 and prior is going up. Yes, we would expect that. I'm not sure that we are there yet.

**Operator**

Our next question comes from Josh Shanker with Deutsche Bank.

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

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

**Marc Grandisson**
*CEO, President & Director*

Yes. Clearly, there tends to be at the margins, better quality for the refinance market, but it's clearly not a target market for the MI market, right? So broadly, you are right, but in terms of what pertains to the MI market, our penetration for origination of MI, of mortgages in the refinance is 5% to 6%, so it's very, very small. The market that we are targeting that is really our bread and butter, if you will, is the purchase market, and that's still pretty healthy. And that's really what we've been focusing on. So having said all this, if you look at, historically, at the blend of the cycle, the blend of the DTI, it's been fairly consistent, and I think that speaks to -- there's not that much of a difference between the credit requirements, whether you refinance or whether you purchase.

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

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

**Marc Grandisson**
*CEO, President & Director*

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

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

Okay. And switching gears on the wildfire liability. Look, obviously, that was a difficult loss 2 years in a row, but the pricing might have been adequate to take that. A lot of times, though, in certain markets, the market really isn't big enough to give you a payback no matter how good the pricing is. Do you think you'll get a chance to write wildfire liability this year? And is the market sizable and attractive enough to make it a worthwhile business to write on a multiyear basis?

**Marc Grandisson**
*CEO, President & Director*

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

**Joshua David Shanker**
*Deutsche Bank AG, Research Division*

And is that a midyear renewal?

**Marc Grandisson**
*CEO, President & Director*

I believe so. I believe so.

**François Morin**
*Executive VP, CFO & Treasurer*

Well, that one's -- it's a multiyear policy.

**Marc Grandisson**
*CEO, President & Director*

Yes, yes. That one's -- [ that one's ] a multiyear, yes. Correct. Sorry. Yes.

**Operator**

Our next question comes from Mike Zaremski with Crédit Suisse.

**Michael David Zaremski**
*Crédit Suisse AG, Research Division*

First off, François, in the prepared remarks, you made comments about actions you'd take on the expense side to improve the ratio, and the trend has been an improvement over the last year or so. This quarter came in, I think, better than expected. Is any onetime items in there? Or is that improvement somewhat sustainable?

**François Morin**
*Executive VP, CFO & Treasurer*

Well, are you referring specifically to mortgage?

**Michael David Zaremski**
*Crédit Suisse AG, Research Division*

Yes, yes.

**François Morin**
*Executive VP, CFO & Treasurer*

Yes. Well, mortgage, right, we acknowledge internally that it's been 2 years since the acquisition, and we're basically complete with the integration. And we told -- hopefully, you guys all remember that we told you it'd be a journey. It would take a couple of years to fully integrate the 2 operations. And we're at this stage now when you compare, obviously, year-over-year, Q4 '17 to Q4 '18, we just realized more savings in technology, in people, et cetera. So I think we're kind of there. There's also a bit of seasonality that comes into play, but we're truly in a good spot in terms of where we want to -- where we think our expense base and, especially, operating expenses will be going forward.

**Michael David Zaremski**
*Crédit Suisse AG, Research Division*

Okay, got it. And sticking with the mortgage segment. Marc, you made an -- interesting stat you made in the prepared remarks about mortgage credit quality being approximately -- I think you said 2x better than precrisis levels. Maybe you can further elaborate on what's behind that viewpoint.

**Marc Grandisson**
*CEO, President & Director*

We have internal proprietary credit analysis evaluation, and you could also look at some things that are published by us -- such as the Urban Institute, and you will look at the relative credit quality, based on an index, looking at the late '90s, early 2000s, factor in income, credit score and all these various aspects of the creditworthiness of a borrower, and when you run it through the grinder, if you will, and you come up with a number at the end, that number is half of what it was back in the late '90s and 2000. So it is made on a comparable basis, [ long-standing ] to be apples-to-apples as can be.

**Michael David Zaremski**
*Crédit Suisse AG, Research Division*

Okay. It's interesting because, yes, we know qualitatively, there's other reasons why credit quality is most likely better, so it's interesting that you're trying to quantify it. That's helpful.

**Marc Grandisson**
*CEO, President & Director*

Yes, very, very much so. Yes.

**Michael David Zaremski**
*Crédit Suisse AG, Research Division*

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

**François Morin**

*Executive VP, CFO & Treasurer*

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

**Marc Grandisson**
*CEO, President & Director*

A couple of things. 50% quota share with AIG for '14 through '16. Then you have Bellemeade. We have about $1.1 billion of outstanding limits on the Bellemeade that covers...

**François Morin**
*Executive VP, CFO & Treasurer*

2/3.

**Marc Grandisson**
*CEO, President & Director*

2/3. 2/3 of our portfolio has reinsurance against it. Thank you.

**Michael David Zaremski**
*Crédit Suisse AG, Research Division*

Okay. And the duration of the Bellemeade transactions, roughly?

**François Morin**
*Executive VP, CFO & Treasurer*

Well, they're 10-year transactions, right? So they're all a bit different. Some have features where we try to have the coverage be in-force for a bit longer. But I would say about 5 years is probably something where we -- and as we keep rolling off, we're adding new ones. So I think that should remain pretty stable as we move forward.

**Operator**

Our next question comes from Elyse Greenspan with Wells Fargo.

**Elyse Beth Greenspan**
*Wells Fargo Securities, LLC, Research Division*

Yes, my first question, so you guys said, if you normalize for cats, that your C mortgage, I think you said about 75% of earnings, I guess. What do you guys view as your normal cat load since your P&Ls have come down, right, but we're coming off of 2 years of pretty high cat losses?

**François Morin**
*Executive VP, CFO & Treasurer*

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

**Elyse Beth Greenspan**
*Wells Fargo Securities, LLC, Research Division*

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

**François Morin**
*Executive VP, CFO & Treasurer*

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

**Elyse Beth Greenspan**
*Wells Fargo Securities, LLC, Research Division*

Okay. And then on reinsurance, you guys seemed to kind of be cautious and balanced in terms of what might happen at the midyear renewals. Marc, how much would you say you need rates to go up for Arch to want to materially write more cat business if you want to talk separately about what you might want to see at April 1 versus 6/1 and 7/1 in [ Florida? ]

**Marc Grandisson**
*CEO, President & Director*

I guess I could tell you a lot more, but that's not going to get you what you want. So I think if you look back, Elyse, to one of my comments about 6 quarters ago, looking back at the characteristics of the -- at the time, the numbers were 35% to 40%, to really start getting us to the risk-adjusted return that we believe is appropriate. We've had since maybe 10% to 12% rate increase, so that tells you we're probably 25% to 30% still short of rate change to really get there. And again, I want to caution everyone that's listening to this saying that, that 20%, 25% is not going to come across the board all at once. There's some pockets that need a bit more than this, some that need a little bit less than this. But that gives you a flavor for how much more we believe we need to get us to start going the path of deploying more capital.

**Elyse Beth Greenspan**
*Wells Fargo Securities, LLC, Research Division*

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

**Marc Grandisson**
*CEO, President & Director*

Nothing yet. It's still very, very early. So we'll have to wait and see how it's rolled out, how it's actually developing in the marketplace. And I would say that, for everybody's benefit, that our risk-based pricing was created back in 2011. This is our UG -- well, now our U.S. MI operation, and there's a lot of things that need to happen to have a run rate. So we're going to have, most likely, some bumps along the way. Our competitors are going to be trying things and figuring out things that work and don't work out as well. So we're bracing for it, but keeping from our perspective is we're keeping steady in our grid in our risk-based pricing, and we're going to take whatever market -- however they react, we'll be the beneficiary or we'll lose some business because it's mispriced based on our own. But it's too early to tell, Elyse. It's going to take a while.

**Elyse Beth Greenspan**
*Wells Fargo Securities, LLC, Research Division*

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

**Marc Grandisson**
*CEO, President & Director*

Right now, I think if you look historically what went wrong, it really did not -- I mean, certainly, the credit quality or the credit worthiness of the borrower is extremely important, right? But what happened historically that really created the issue is the product development. If the product like the -- like low doc, no doc, [ all day ], all this stuff comes back to the market. This is what we'd be worried -- we'll be worried about. Of course, the macro thing that could impact everything is the housing price depreciation across the economy. So one thing that we're not worried about -- the reason why we're not so worried about right now is because there is a shortfall on housing supply, and it's been there for quite a while. So everybody is predicting smaller price increase in house prices but still positive for the next 2, 3 years. So a recession could probably put a bump on this. So if you look at it historically, in some recessions in the past, we had times when house price increased by 1%. The only time it went down, guys, for your benefit, and it's actually very useful to know, is only in the '07, '08 crisis. And for the last 45 years, it never -- the house price index, despite having gone through 5, I think, different recessions, only came down once. The price index came down once. So the product is really the problem, Elyse, and we don't see anything yet.

**Operator**

Our next question comes from Meyer Shields with KBW.

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

Marc, in your introductory comments, you noted not just that loss tends to get worse, but they could resume sort of above-average levels. So I was hoping you could sort of clarify why that is the concern right now.

**Marc Grandisson**
*CEO, President & Director*

Because we're seeing some changes in some of our submissions and some of our data, it's still very early signs and it's really anecdotal. Sometimes, anecdotal, sometimes actually real. So we're seeing price -- seeing loss trend ticking up in certain areas, and it's -- we believe it's only a matter of time before it starts spreading to other lines of business. And Meyer, as you know, we're students as well of the industry, and the CPI is about 1.8%, 1.7%, as I've mentioned that in prior calls. The inflation -- or the insurance inflation is typically running ahead of it by 1.50% to 2.50%. So I would expect the trend could be recapturing, having a very vibrant economy, exposure growth and more friction in the marketplace. We would expect those to generate more losses. And the reason we're putting that out, Meyer, is because I want to put that into perspective of the price increase that we talk about on average, being 200 or 250 or 300 bps. It just doesn't make for a lot margin of safety as you go about in analyzing how you allocate capital between lines of business. And as you know, more probably than I do, when you write a business in insurance policy, it takes years for you to really find out how bad or how good it's going to be, so we tend to take a more cautious approach to it.

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

Okay. That's very helpful. Quick modeling question. With the recent U.S. and U.K. acquisitions, are those going to produce any appreciable change in the expense ratio?

**François Morin**
*Executive VP, CFO & Treasurer*

Well, I mean, both acquisitions were in the [ important ] segment, so I would say that the expense ratio, yes, no question that in one of our acquisitions in the U.K., maybe a bit of integration expenses that we'll have that will be reflected. But all in all, given that the U.S. one was something that we -- it's a partner, it's a business that we've done business with for many, many years, that should not really impact the expense ratio. And the final thing, which you'll see in the 10-K, is that will certainly trigger a bit -- slightly higher intangible amortization expenses that start coming through in 2019.

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

Okay. And that's segment or corporate?

**François Morin**
*Executive VP, CFO & Treasurer*

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

**Operator**

Our next question comes from Brian Meredith with UBS.

**Seth A. Rosenberg**
*UBS Investment Bank, Research Division*

It's Seth Rosenberg here for Brian. I've got one for you. So if you look at the insurance segment, large losses improved versus last year. But if you look back at last year, I think you had called out 2.2 points, which was elevated at the time. So if you kind of just take this quarter in a vacuum and not the comparison, will you say that large losses were better or worse in line with expectations? And I ask because so many companies are calling out a higher frequency and severity of large losses. So just trying to get a feel if there's something in loss cost there that concerns you.

**Marc Grandisson**
*CEO, President & Director*

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

**Seth A. Rosenberg**
*UBS Investment Bank, Research Division*

Got it. So nothing in particular to construction cost or labor that really stuck out in terms of severity?

**Marc Grandisson**
*CEO, President & Director*

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

**Seth A. Rosenberg**
*UBS Investment Bank, Research Division*

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

**François Morin**
*Executive VP, CFO & Treasurer*

No. We looked at this and we also thought about the government shutdown, which was on the horizon, but there's certainly GSE rulings that prevent us from these potential delinquencies developing into claims. And going back to the hurricanes, 2017 was slightly different in the sense that both -- in particular Harvey, where flooding was persistent for a number of weeks and it was more damaging than Michael that came in and through and didn't really have an elongated time frame to the event. So at this time, we don't think there will be any spike in our delinquency just -- from the cats.

**Marc Grandisson**
*CEO, President & Director*

Right. As far as the government shutdown, Trump signed up something at the end of January just releasing backpay. So that should be -- should go a long way to alleviate any of our concerns there.

**Operator**

Our next question comes from Amit Kumar with Buckingham Research.

**Amit Kumar**
*The Buckingham Research Group Incorporated*

Just 2 quick follow-ups, if I may. The first question goes back to the discussion on wildfire casualty losses. I just wanted to understand a bit better if the utilities numbers change or if there is any other development, does your current number remain static? Or how is that reserve -- maybe just help me just explain that a bit more.

**François Morin**
*Executive VP, CFO & Treasurer*

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

**Amit Kumar**
*The Buckingham Research Group Incorporated*

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

**François Morin**
*Executive VP, CFO & Treasurer*

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

**Marc Grandisson**
*CEO, President & Director*

And Amit, the one thing that's interesting with this one because it's such in a high [ press, you get out the press. ] You don't hear about the 98 others that are actually -- that work out to our favor, but let's leave it at that.

**Amit Kumar**
*The Buckingham Research Group Incorporated*

No, that's a very fair point. Then I guess the only other question I had was going back to the discussion on buyback. And I think in your opening remarks, you talked about the volatility in the market is kind of giving you an opportunity. The buyback, obviously, was higher than my numbers and The Street's numbers. In the past, we used to talk about a matrix, and there used to be a matrix on your website, which I was having trouble finding. Are we still utilizing that payback matrix? Or how should we think about future buybacks?

**François Morin**
*Executive VP, CFO & Treasurer*

Well, yes. The matrix that you're referring to is still the starting point of our analysis. And the question that comes up often from many of you on the phone is, with the growth in the mortgage segment, does that matrix or that view change. And the answer is it does, but it's not black and white. What we like and we told everyone before about the mortgage segment is that we like the visibility and the predictability of the earnings stream that it gives us. So the 3-year payback that we've targeted in the past, we have a view that, yes, maybe we'd be willing to extend it to 4 years, to 5 years, who knows. But that's always considering all the options that are available to us. We talked about acquisitions. We talked about reducing our leverage. So there's all these aspects of capital management that come into play. I mean, so hopefully, that answers your question. So the grid is still there, but it has -- we have some flexibility around it.

**Operator**

Our next question comes from Yaron Kinar with Goldman Sachs.

**Yaron Joseph Kinar**
*Goldman Sachs Group Inc., Research Division*

Just one quick one. Could you break out the cat losses by event?

**François Morin**
*Executive VP, CFO & Treasurer*

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

**Yaron Joseph Kinar**
*Goldman Sachs Group Inc., Research Division*

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

**Marc Grandisson**
*CEO, President & Director*

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

**Operator**

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

**Marc Grandisson**
*CEO, President & Director*

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

**François Morin**
*Executive VP, CFO & Treasurer*

Thank you.

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