Old Republic International Corporation

NYSE:ORI

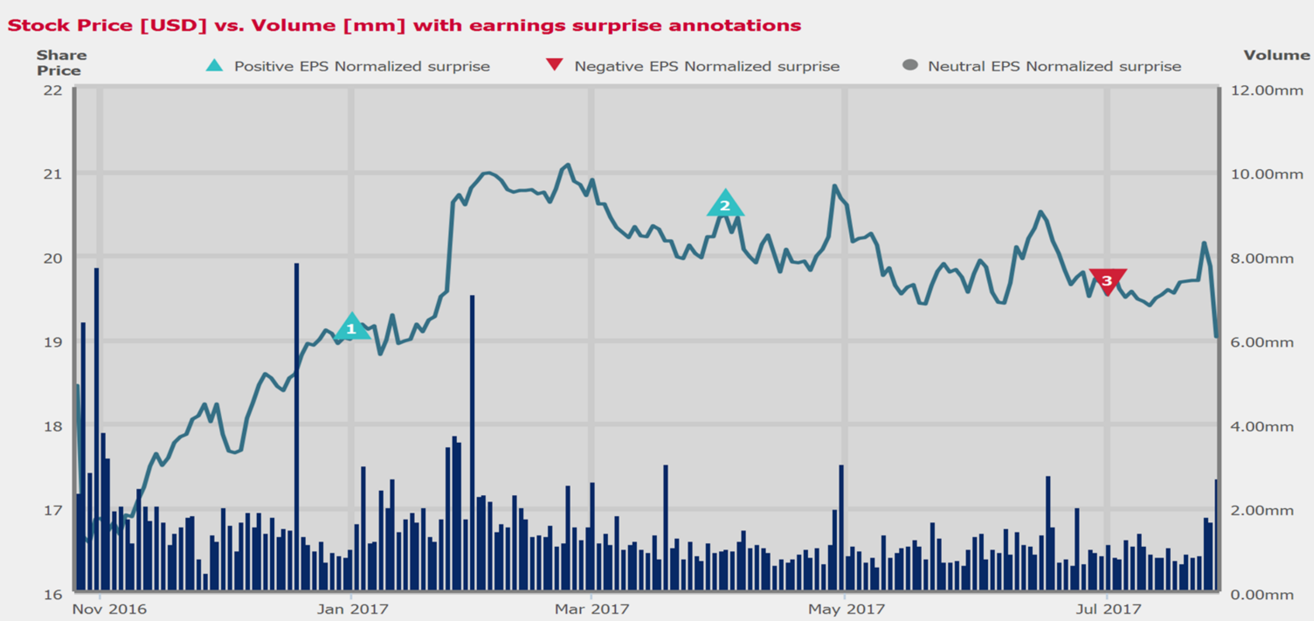
FQ4 2017 Earnings Call Transcripts

Thursday, January 25, 2018 8:00 PM GMT

S&P Capital IQ Estimates

	-FQ4 2017-			-FQ1 2018-	-FY 2017-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.28	0.33	▲17.86	0.38	1.06	1.11
Revenue (mm)	1643.00	1726.20	▲5.06	1421.00	6178.00	6263.10

Currency: USD
Consensus as of Jan-23-2018 2:03 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2016	0.31	0.43	▲1 38.71 %
FQ1 2017	0.32	0.36	▲2 12.50 %
FQ2 2017	0.36	0.34	▼3 (5.56 %)
FQ3 2017	-	0.09	-

Call Participants

EXECUTIVES

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Karl W. Mueller
Chief Financial Officer and Senior Vice President

Marilynn Meek

R. Scott Rager
President and Chief Operating Officer

Rande K. Yeager
Chief Executive Officer and President

ANALYSTS

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Gary Kent Ransom
Dowling & Partners Securities, LLC

Nicholas Karzon

Presentation

Operator

Good day, and welcome to the Old Republic International Fourth Quarter 2017 Earnings Conference Call. [Operator Instructions] I would like to remind everyone that this conference is being recorded.

I would now like to turn the conference over to Marilynn Meek with MWW Group. Please go ahead, ma'am.

Marilynn Meek

Thank you. Good afternoon, everyone, and thank you for joining us for the Old Republic conference call to discuss fourth quarter 2017 results.

This morning, we distributed a copy of the press release and posted a separate statistical supplement, which we assume you have seen and/or otherwise have access to during the call. Both the documents are available at Old Republic's website, which is www.oldrepublic.com.

Please be advised that this call may involve forward-looking statements as discussed in the press release and statistical supplements dated January 25, 2018. Risks associated with these segments can be found in the company's latest SEC filings.

This afternoon's conference call will be led by Al Zucaro, Chairman and CEO of Old Republic International Corporation; and several other persons, as planned for this meeting.

At this time, I would like to turn the call over to Al Zucaro. Please go ahead, sir.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Thank you. And to everyone, good morning or good afternoon or good evening, wherever you may be, and thank you for joining us.

For this visit, we've got several of our key executives. ORI's President, Scott Rager, he'll cover the General Insurance group portion of the business. He'll do that in Craig Smiddy's absence from the office; Rande Yeager, our Title business CEO, will go over that segment; and our CFO, Karl Mueller, will comment about the more important elements of our financial picture, as he usually does.

So as we discussed in this morning's release, we're assuming that, first of all, everybody has gone over it or otherwise has access to it on the Internet. And as in past conference calls, we'll also be referring to some additional statistical information that we include in the financial supplement that we post on the Old Republic website.

So to begin, let me just say that the latest quarter's results were affected by quite a bit of noise, as we like to say. And all of that noise makes it stand out from the norm. The noise specific to Old Republic relates primarily to the additional incentive costs and an adjustment of cost assumptions applicable to small life and health business we have. But the other noise pertains to all of American industry, and I suspect that everyone on the call is familiar with this. And I'm referring, of course, to the changes in federal income tax rates, which took effect on January 1 of this year. And like everybody else, we've had to reflect in our fourth quarter and year-end results the impact of those rate changes on the accumulated deferred income tax balances that rest on our balance sheet or rested on our balance sheet before this event. And those are the deferred income taxes amounts that usually run through our periodic income statements and shareholders' equity insofar as unrealized gains and losses are concerned.

So the combination of these factors, as well as the effect on all of 2017's results of the very sizable litigation costs that we booked in last year's third quarter, has made the year-over-year comparisons relatively unclear. So it's for these reasons that in the news release we put out this morning, we expanded it by 3 pages, namely pages 2, 3 and 4, to show the impact of these factors on our results for both the last quarter of 2017 and the entire year as a whole. So if you are willing and able to sift through those 3 pages, we think that you will see the effect of each of these factors on the earnings report, both the net operating earnings as well as net income for both the fourth quarter and the full year. Karl in his discussion will cover all of that or at least the key points relative to those factors, so I won't bother spending much time initially in guiding you through them.

So now, why don't we just go ahead and turn the meeting to you, Scott, and let's have a discussion of our General Insurance business, okay?

R. Scott Rager
President and Chief Operating Officer

Okay. Well, as the release indicates, the General Insurance group reflected year-over-year increases of 7.2% net premiums earned in the fourth quarter. For all of 2017, the increase came to 5.9% when compared to 2016. We experienced greater writings for most insurance coverages, especially in commercial auto, where rate increases over the past 2 years or so continue to earn through. Workers' compensation writings were down slightly for the fourth quarter and were down 2.5% for the year as a whole. As to workers' compensation, competitive forces are still driving pricing lower in most regards.

Our business retention ratios continue steady on renewal business. We're writing new business pretty much across the General Insurance group and most notably in our newest underwriting operation, which we started in early 2015, as well as in our trucking, large account risk management and home and auto warranty businesses.

Our various markets remain very competitive. While top line growth is always an objective of our operations, our focus remains on risk selection and rate adequacy. We won't forsake the bottom line expectations for top line growth at what we deem to be unreasonably low rate levels.

The General Insurance group's overall composite ratio improved materially in fourth quarter. Year-to-date, the composite ratio was down 0.5 point compared to last year at 97.3% versus 97.8%.

Last year's hurricane costs turned out to have been a nonevent for us. At this stage, we think we are progressing in the right direction, and we believe improving results are sustainable.

The group's expense ratio of 26.8% for the fourth quarter was up a bit, contrasted to the same quarter of 2016, due in part to the additional charges registered for incentive awards. We might note that expense ratios going forward are expected to be in line with the past 10 years' average, which is in line with our long-term expectations for the existing mix of business.

As shown in the financial supplement on the ORI website, the commercial automobile trucking claim ratio was 63.4% this quarter compared to 76.8% last year. In a similar vein, the ratio for the year-to-date came in at 76.8% this year compared to 79.4% last year. The liability component of that ratio was down 6 points year-to-date, again, a good trend that we think is sustainable, given the greater strength of our claims reserves.

We also believe that the rate increases we've obtained in the commercial auto coverages will further offset the loss cost trends we've experienced in more recent years. Our objective is to maintain claims ratios at historically experienced levels in the low to mid-70s.

2017's fourth quarter workers' compensation claim ratio improved to 73.5%. This is down from 80.4% in the same quarter last year and down from third quarter of 74%. Year-to-date, it landed at 75.5% compared to 76.1% at year-end 2016. We're also aiming for this ratio to range between 70% and 75% over time.

Our general liability writings are much less than workers' compensation or commercial auto, and as such, we can experience greater volatility in this -- in its underwriting results.

As we've also shown in the financial supplement, our results in the latest quarter reflect a claim ratio of 88.5% compared to 79.5% in the fourth quarter last year. Year-to-date results reflect a lower claim ratio of 73.1% compared to 77.5% in 2016.

Other than the lower than originally anticipated hurricane-related impacts on our aviation and guaranteed asset protection books, the remaining coverages performed within expectations. As we have reported on prior occasions, all of the claim ratios we post are inclusive of any favorable or unfavorable claim developments. Unlike 2016, we experienced small favorable developments in 2017. We believe that the reserving judgments of recent years should restore greater long-term stability to our claim reserve base.

In summary, operations within the General Insurance group remain focused on underwriting discipline, and we believe our current mix of business can produce a 95% composite ratio over 5- to 10-year cycles, and we believe our results are trending in that direction.

So that's the extent of the comments we wanted to make on this particular group. We'll answer any questions anyone may have during the Q&A period.

And on that note, I'll turn the discussion over to Rande Yeager, who leads our Title group.

Rande K. Yeager
Chief Executive Officer and President

Great. Thank you, Scott. Once again, I'm pleased to report on the Title group success exclusive of the previously announced charges discussed in the release this morning. Group came in with a 2017 result that surpassed the all-time record of 2016. According to the Mortgage Bankers Association, mortgage originations in the fourth quarter are predicted to be about -- off by about 12%. And all of that reduction likely came from refinance transactions, which were down about 36%. By contrast, purchase transactions were up nearly 13%. And in spite of these market fluctuations, our operating revenues of $626 million were off only 0.5% from the $629 million that were posted in the final quarter of 2016.

Net of the aforementioned charges of $21.2 million, as discussed this morning in the release, fourth quarter 2017 Title group pretax operating income totaled $64.2 million.

For the full year, records were once again set for total premium and fees of almost $2.3 billion. That was an increase of 3.6% over 2016; and for pretax operating income of $237.1 million, an increase of 12.8% over 2016.

As pointed out in the release, our claims from the prior year policies continue to develop favorably. Certainly, there is no guarantee that this trend is going to continue indefinitely, but we're optimistic for the near term. The hurricanes and fires that affected transactions late in the third quarter were not much of a factor by the end of 2017.

For 2017, agency and direct premiums were up 3.6%, and commercial business was up 4.9%. National market share hovered around 15% all year, and the final numbers are not yet available for 2017. We expect to see a slight market share increase over 2016.

So in summary, 2017 was a record-setting year in many ways and, most importantly, in revenues and profits. We're approaching 2018 with cautious optimism. Real estate market by most accounts will hold steady on the purchase side of the equation while refinances will continue to decline relative to the total origination market. While projections for the commercial market are flat, we believe we'll continue to gain market share based on our expertise and an expanding customer base. In all, we remain optimistic about the near term and the future success of Old Republic's Title business. Much like Scott had mentioned, we'll be happy to answer any questions anyone has during the question-and-answer period.

And with that, I'm going to turn it back over to Al Zucaro.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Okay. So let me just say a few words about the RFIG run-off business. As the release shows, the mortgage insurance portion of this segment continues in what we think is a very stable mode now that we have gotten rid of whatever lingering litigation applied to that business, and it's running along the run-off model that we've had since 2011 when the business was first placed in run-off operating mode, as they say.

In planning the -- for the future now, the decks are cleared for this business. We're anticipating a fairly decent housing and mortgage banking market, just as Rande noted in his discussion just now of the Title segment. We very much believe that the business will most likely run off positively until the policies that are currently in force normally drop out of the inventory. And we think that, that probably takes place by 2022, 2023 or thereabouts.

In the meantime, we're working and thinking about what to do with this business, and we're certain that we'll figure out an appropriate way for arranging the most beneficial long-term outcome for all the key stakeholders in what we consider to be a most valuable and very viable franchise in the mortgage guaranty field.

As to the consumer credit indemnity or the CCI portion of the run-off, as we refer to it, this book also is beginning to perform as we had anticipated, and this is particularly so since the event in the third quarter of last year when we resolved substantially any and all litigation worth anything that had been lingering in that business for almost a decade since the beginning or near the beginning of The Great Recession. The business is much smaller in terms of its footprint relative to MI, so we do expect a little bit more volatility in it. But all in all, we think that the business now has been stabilized and should perform without being exposed to any significant litigation costs certainly and, therefore, should not be a cause of adversity of any significance in the overall scheme of things for Old Republic's business.

So RFIG is going to mosey along, and we are going to be able to fairly soon or certainly in the foreseeable future come up with a resolution that favorably affects all the stakeholders of that business.

So let me now turn it to you, Karl, and -- for your additional comments.

Karl W. Mueller
Chief Financial Officer and Senior Vice President

Okay. Thank you. As usual, I will address a few of the key elements of Old Republic's financial condition. And then as Al mentioned earlier, I plan to comment briefly on the new schedules included on Pages 2 through 4 of this morning's news release, which describe the effect of both tax reform as well as previously announced charges on reported results for 2017.

I would say, overall, the makeup and strength of Old Republic's balance sheet remains substantially unchanged at year-end in relationship to both year-end 2016 as well as earlier 2017 periods. Total investments grew to $13.3 billion at the end of 2017, up a little more than 4% from the prior year-end. The growth resulted from the investment of positive consolidated operating cash flows, which totaled $453 million for the year, along with further increases in the portfolio's unrealized market appreciation. That market -- our unrealized market appreciation grew to $754 million by the end of 2017, which further increases Old Republic's ending book value per share.

The composition of the portfolio remains relatively consistent with earlier periods of 2017. The fixed maturity and short-term investments make up approximately 75% of total investments. The fixed maturity portfolio retains its overall A credit quality rating with an average maturity of slightly in excess of 4 years. Equity securities make up the remaining 25% of the total portfolio.

On a year-to-date basis, net investment income grew by almost 6%, due primarily to higher investment balances in a relatively flat yield environment.

Consolidated claim reserves continue the trend of favorable development during the final quarter of 2017 and on a full year basis. This morning's release, along with the financial supplement shown on Pages 4 and 5, disclosed the effect of prior year favorable or unfavorable claim reserve development on the reported claims ratios for the past several periods.

Each of our 3 principal operating segments, and as Scott and Rande have already mentioned relative to General and Title, along with our RFIG run-off business, all 3 reported favorable claim reserve development for the fourth quarter of the year.

For the full year, the General Insurance group did experience modest unfavorable claims development, and that was largely concentrated in the workers' comp and general liability coverages, while Title and RFIG reported favorable development resulting from the continuation of positive loss development trends that we've been experiencing in recent periods.

Old Republic's book value per share increased for the year to $17.72 or by 3.3% since the prior year ended. This does take into consideration a special cash dividend of $1 per share declared by the Board of Directors this past December and payable at the end of this month. 2017's total return on book value amounted to 13.6%, and by comparison, the total market return for the year totaled 16.6%. The main elements of the growth in book value per share are shown on Page 10 of the release as usual.

The lower debt capitalization ratio at the end of 2017 shown in the table on Page 10 is reflective of the $79 million of notes that converted into 5.1 million common shares through year-end. We continue to see modest amounts of conversion activity in the early part of 2018 and have every expectation that the majority of these notes will convert to common equity prior to the upcoming March 15 maturity date.

So now as mentioned at the outset, I'd like to spend a couple of minutes discussing the new tables included on Pages 2 through 4 of the release. The objective of Pages 3 and 4 is really to provide a detailed analysis of, one, the effect of previously announced charges on segmented pretax operating income; and two, the effect of revaluing deferred tax assets and liabilities to reflect the lower 21% U.S. federal income tax rate that became effective the first of this year under the tax reform act that was signed into law on December 22 of last year.

The revaluation of deferred tax asset is split into its separate operating and unrealized gain on investment securities components in the schedule that are shown on Pages 3 and 4. The dollar effect of the revaluation on operating results is shown on line D1 of the schedules. So for example, the General Insurance group recorded a $70.5 million additional tax charge; RFIG, a $51.1 million tax benefit; and on a consolidated basis, a $41.8 million additional tax charge. The effects of the charges on operating income per share can be seen on line D2 of both schedules.

The revaluation of deferred taxes on unrealized gains shown on line F4 reflects $104.9 million tax benefit or $0.35 per share. In total, the full effect of deferred tax revaluation resulted in a $63.1 million tax benefit, which added $0.22 to net income per share for both the fourth quarter and full year period.

The tables on Page 2 summarize information from the tables on Pages 3 and 4 to simply eliminate the effect of deferred tax revaluation and present segmented operating income and consolidated net income, along with corresponding per share amounts on a consistent basis with the 2016 presentation. And on this basis, we believe the 2017 results compare, on balance, favorably with those of 2016.

A lot to cover, but at this point, that concludes my remarks. And I'll turn things back to Al.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Okay. So when we put everything together, we feel very, very good about Old Republic's situation today. System-wide, our focus on the core underwriting and related services disciplines of our business, all of that remains unchanged. And as Page 8 of the release shows, the consolidated composite ratio of claims and expenses to premiums and fees of 96.7% for the entire book of business: Title, mortgage guaranty, General Insurance, et cetera. That ratio is close to our 95% long-term bogey for Old Republic's long-tailed business mix. And if on top of that we eliminate the $150 million hit to claim costs in the third quarter of last year, which represented mostly costs associated with terminated litigation, the ratio of 96.7% drops to 94%, so again, within that 95% bogey range.

So we think that this is reasonably good in the context of the underwriting and overall economic cycles in which all of our business is and most likely will continue to be operating for the foreseeable future. For our part, we continue to believe that the North American economy in which we're focused exclusively is likely to remain in a very moderate growth mode for the foreseeable future. We're guessing that GDP growth will range within 2.5% to 3% or so average configuration, again, for the foreseeable future. And we think that in that context, that our services in some of the more important industry sectors that we service throughout the Old Republic system should enable us to grow the consolidated business at a faster clip than the economy at large. And we think we can do this on the strength of the -- of very high-quality intellectual talent. And we think that we can do this on the strength of a very strong balance sheet, which enables us to consistently compete on a level playing field with all comers in our areas of chosen underwriting and related services.

So with all of that, we believe we're in great shape to drive our business to greater success, particularly in light of the fact that we are no longer, by any means, inhibited by the remnants of The Great Recession and its aftermath.
So on this note, we'll turn it to the planned question-and-answer period for this visit.

Question and Answer

Operator

[Operator Instructions] And we'll take our first question from Greg Peters of Raymond James.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

This call, I guess, in the context of previous calls, stands out because we didn't have the opportunity to listen to the firetrucks on their way back from lunch.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

It's early, Greg.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Okay. Well, we'll cross our fingers for that. So if I can just go through the 3 segments briefly. I guess, starting with General Insurance, the commercial auto and general liability premium is growing much faster than I suspect you're getting rate increases, so you're obviously gaining some market share. Can you give us some color behind the levers that are driving -- if I look at the fourth quarter results, the growth in 2 of the 3 areas of those main coverages?

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Scott, do you want to take that?

R. Scott Rager
President and Chief Operating Officer

Sure. Our growth in general, Greg, I would say, in general, as most coverages, with respect to the operations that we have, new business actually makes up the lion's share; to a lesser degree, rate increases and organic growth within the existing customer book. However, as to the commercial auto liability coverage line, I would attribute the greatest share of that growth demonstrated to rate increases.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

And can you give us some perspective on what kind of rate action you're taking? Or, I guess, what you've taken is already in the books. Can you talk about what you expect to look for in 2018?

R. Scott Rager
President and Chief Operating Officer

Well, in 2018, I think it's reasonable to assume that what we would plan to do is continue to get rate increases as necessary. As you know, we have specialty underwriting operations. We not only underwrite them as to the specific industry they serve, but also on an account-by-account basis for the most part. And I would anticipate that there will still be rate increases within the commercial auto line to follow, and those might be mid-single digits. At this point in time, as you know, we've been -- in our trucking operations, we've been operating on the basis that we're getting rate increases for the last 3 years, smaller rate increases, not necessarily double-digit, but low to mid-single-digit increases in the trucking business. I would anticipate that would continue. As to our general liability book, we'd like to get low single digits there as well; and workers' compensation, flat to low single digits to mid-single digits there as well. I mean, costs continue to go up. And so that's basically where I think the outlook might be, Greg. Any other specific questions you might have?

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Well, I guess -- then if, I guess, I just get to the -- sort of the targeted claim ratio for the business. I think in the past, Al, you've cited the high 60s, getting back down to the high 60s, if possible, for General Insurance. And I'm wondering if that's still in the cards or if you have a view on that.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

No. That's very much where we expect to be in that business. Really, we're looking to hopefully get our expense ratio down to a 23%, 24% range as the business blossoms from a top line standpoint. But loss ratio-wise, I think the high 60s, 68%, 69%; and up to the 72%, 73% area for the current mix of business is very achievable, we think. And that's particularly so since as reflected in the periodic reserve, unfavorable reserve developments we've had, that once those -- once we're over the hump with respect to those, and I think we are. I think it was Karl that mentioned that in this latest quarter, both Karl and Scott mentioned that we had very low unfavorable to speak of. That's going to help drive that loss ratio to those levels.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Right. And I think that's a good segue. I noted Karl's comments and Scott's comments about favorable reserve development in General Insurance in the fourth quarter. Did that come mostly from case? Or was it case and IBNR? Or could you give us some added perspective about it? Because that was somewhat of a surprise.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Yes. It's been a combination of both. I mean, one of the difficulties we've had, and I don't think -- I think those difficulties are shared industry-wide by any P&C company that's operating in with longtail business. One of the challenges we've had has been in the so-called allocated loss adjustment expense reserve portion. And you might call that IBNR, I suspect, but it is really tied to case reserves when you come right down to it. And that's been, as I say, a challenge for us. But we think we've gradually gotten our arms around it. It's a combination of legal fees to defend claims, et cetera, even though they may be old claims relative to which we have no exposure to the indemnity portion of the claim. We still have to defend, and those defense costs have been going up and up and up. But as I say, I think an answer to your question, it's been mostly in those areas that you might refer to as IBNR. Although from time to time, we do get some claims, some case reserves that go south on us. But as those have lapsed away from the inventory gradually, the older cases, we feel more comfortable now that case reserves are much stronger than they've ever been.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Great. I wanted to switch gears. Rande, I always have the obligatory question or 2 in your direction. I'm not going to disappoint. So I noted your comments about title activity, both new and refinancing, and I was struck by your commentary around refinance-related activity being down some 36%. Can you give us a sense -- when we look at your total revenue, I think it was almost $2.3 billion in 2017. Can you give us a sense of what the mix is between new and refinance?

Rande K. Yeager
Chief Executive Officer and President

It kind of changed all year. So you started off with a little bit heavier percentage of refinance relative to the entire mortgage origination market. But -- and it's tough to say, okay, you got to -- you started with a 60-40 and you ended with a 30-70 refinance to purchase money ratio. But then you got to throw in what was going on in the cash portion of the market. There's alternative ways of financing properties, so it's difficult to put a number on refinances and what's really going on in the marketplace out there. More cash transactions, of course, affects the total origination market, so -- but overall, when you look at it, I mean, interest rates were up a little bit over the year when you look at the trend. And so there's just not as much refinance activity because a lot of people have refinanced. As we get more and more equity and properties, people will refinance cash out for home improvements. People aren't moving around as much. Prices of homes are up. People are settling in. And so the market kind of changes, but it's very, very steady. And the purchase market is really a whole lot better for our business, as you can see by the results that are generated by the title company.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Right. I guess, the last area of questioning would be around capital and just the tax rate -- consolidated tax rate assumption going forward. Can you just give us a perspective and update on capital? With the run-off RFIG business, what was the amount of capital on that unit at the end of the year? And then segue that, and any other comments you might have about capital, into provide some guidance, if you will. I know there's a lot of moving pieces to the tax reform, including expenses that were previously deductible that are no longer. Can you give us some guideposts that we might be able to use in terms of a tax rate assumption for your consolidated operations in 2018?

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Well, as a general commentary, Greg, the rate is going to come down. To some degree, it's going to be affected by the amount of underwriting and service income we get which, as you know, is taxed at full rates. So to the extent that, that improves, more of our tax number is going to be driven by the 21% rate. To counter that, though, a lot is happening with respect to our investments and where they get directed. We're having to reconfigure or rethink, I should say, our investments, for example, in tax exempts, okay? Because the field is changing there. We're having to rethink, therefore, also our investments in corporates and our investments in dividend-paying stocks, and that's also going to have an impact. But I would say that the biggest driver, which would tend to drive our tax rate down, will be the amount of underwriting income we get throughout the system. And speaking of that, we -- from that standpoint, we are well positioned at Old Republic. Given our mix of business, we -- where title delivers typically more underwriting service income than it does investment income. And in General Insurance, to the extent we succeed, as I believe we will, to have greater stability in the loss ratio and not have it be affected by any significant amount of unfavorable development, that also will help drive the tax rate down. As to our capitalization, as Karl mentioned before, we're in very good shape. We think that the remaining non-converted notes will convert by -- certainly by March 15. But there, if they do not, for some ungodly reason, we've got the money in place to honor that obligation. But we think it will convert. And when it does convert, the leverage on our balance sheet will obviously go down because some $550 million, if all of it converts, will be diverted towards the shareholders' equity account and be eliminated, obviously, from the debt account. So we'll have a lot more balance sheet flexibility if we should need it. At this point in time, we don't think we need it. We think we've got enough capital to meet our obligations and to keep some powder dry in the event that it is needed for whatever reason. One of those reasons may not be a cash acquisition. We don't believe in doing that. But other acquisitions for small amounts of cash, we might consider. So I think we're in good shape on all of our metrics in terms of how we manage our balance sheet in very good shape, in the greatest shape, I would say, that they've been in years. And that, again, gives us a lot of firepower to grow our business. So from the standpoint of capitalization, cash flow, ability to upstream dividend, ability to pay dividends to our shareholders, ability to honor our obligations, we're in very good shape at Old Republic.

Operator

[Operator Instructions] And we'll take our next question from Gary Ransom of Dowling & Partners.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Greg already hit a lot of my questions, but I wanted to zero back in on commercial auto a little bit. The loss ratio was an improvement year-over-year and sequentially. And you talked about rates, there's some favorable development in there as well. But I wonder, is there an accident you'll true up in there also, meaning you looked at the whole year, the whole year looked better and that resulted in a better number in the fourth quarter?

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Better numbers from the standpoint of what, [indiscernible]?

Gary Kent Ransom
Dowling & Partners Securities, LLC

Meaning sort of as if it was favorable development from the first 3 quarters of the year. They wouldn't be prior year development, they'd be prior quarter development.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Yes. We typically -- we change our loss picks once a year at budget time. And we basically -- unless some adversity comes out of the woodwork, we typically don't change them. So current year loss ratios do not cause that. Really, what causes the change in the loss ratio is the premium input, i.e., as Scott mentioned before, the accumulation of rate changes, which are working their way through the system and becoming earned premiums and the fact that, again, our reserves are panning out -- panned out last year a lot better than they have for a while. And I would say those are the main reasons why the loss ratio in trucking or commercial automobile is improving sequentially, as you have noted.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Just one other aspect of it. Can you comment at all on what you're seeing on frequency and severity of loss in commercial auto? Obviously, that was going up before, probably up in '14, '15, '16, you're taking rate. Has it moderated at all for you?

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Scott, you've got a better handle on that than I do.

R. Scott Rager
President and Chief Operating Officer

Yes. I would say the frequency is relatively stable. They're not in unexpected levels by any means. Severity still continues to be the issue, not only with us but with the markets in whole, in general. And so yes, it's more a severity-driven book than perhaps frequency.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Okay. And I had a few questions on the taxes, and maybe these are more forward-looking kinds of questions. But you do mention in the press release this morning about possible changes in the investment portfolio as you look through and work through the new tax law. And I wonder if you could add a little more color to that, whether this is just you'll think about as new money comes in. Will you look at what you have and maybe sell something, buy something else? I just wondered if you could outline a little bit what the strategy might be.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Yes. I think I alluded at least to parts of your question, Gary. Really, we're looking at the entire portfolio. And the big portion of the portfolio, which is about -- as I recall, about $1 billion of tax exempts, we're focused on that. We're not going to do anything stupid or foolish by having a mass exit from any part of the portfolio. We're going to nickel or even dime our way to making changes. I mean, one of the issues also applies to most of our stock portfolio is driven by dividend income considerations, yield considerations, and maybe the changes in the tax rates also affect some of that. So it's really in a state of flux. Don't forget, as you know, it's only been, what, 4 weeks since the new rates or the new code became actuality. So we're still looking at all of the elements in it, and we're going to approach it in a very gingerly manner. We don't expect major changes right away. They will be incremental and gradual, I believe.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Okay. And one more question on -- this is maybe just an opinion on economics, but who do you think will ultimately keep the benefits of the tax change? Will it be the shareholders, the -- your customers, possibly your employees? I wondered if you had a view on that.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Well, the basic view that we've always had is that when it comes to the insurance industry, when we get lots of money thrown at us and it starts burning a hole in our pocket, we start doing foolish things like cutting prices. There's always -- there's already a move afoot by one of the industry or regulatory groups that I saw the other day to the effect that, "Okay, you guys. Now that you have this big tax change coming your way and your profits are going to increase, isn't it time for you to change your rate structure, particularly with respect to the American consumer since the rates, the tax rates that were baked into the pricing equation were much higher, obviously, than they are going to be going forward?" So I think the -- our view is that the market in the insurance business is very efficient. And one way or the other, whether it takes place at the board level because there's reduced expectations for return on equity or in light of the greater tax credit we're all going to get or whether it's from a regulatory standpoint or whether it is from pure -- from the pure competitive juices flowing through the system, a lot of it will get sapped. And -- so -- but I do think some of it will stick. And I think whatever sticks will be additive to the capital base and require us and, I think, the rest of the industry to be less demanding of the capital markets because the business, to some larger degree, will be self-funding, so to speak. That's a long-winded answer to your question and probably not as much on target as you would have liked it to be.

Gary Kent Ransom
Dowling & Partners Securities, LLC

No. That's -- I was looking for your opinion. You gave it to me. So it was perfect. I think that's all I have.

Operator

At this time, we have one question remaining in the queue. [Operator Instructions] We'll take our next question from Nick Karzon from Franklin and Teplin (sic) [Franklin Templeton].

Nicholas Karzon

In December, you announced that the North Carolina Department of Insurance had terminated supervision of the mortgage guaranty subsidiaries and [indiscernible] ability to advance on strategic alternatives. Can you provide us with some additional context for your optimism about the strategic alternatives now and how that might differ from prior attempts to recapitalize the business?

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Well, we're not prepared to let the cat out of the bag as to what we're thinking of doing with respect to that operation. We've got several options. They're all very good options. And as I tried to say before, we're going to do our level best in directing that business to achieve the greater value for all of the key stakeholders in it. And as you know, those stakeholders are the shareholders, the employees who provide the intellectual talent, the regulators and the existing -- most importantly, the existing policyholders whose policies are still in force and are still being serviced by our people to their best advantage.

Nicholas Karzon

I guess, we'll stay tuned on that.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

I beg your pardon?

Nicholas Karzon

I guess, we'll stay tuned for that then.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

Yes.

Nicholas Karzon

And if I could -- one last one in. On the Title business, there've been some industry headlines regarding new technologies, including distributed ledger with potential long-term implications for the business. Can you discuss your view on these and any potential implications they could have over the long term for the business?

Rande K. Yeager
Chief Executive Officer and President

Yes. This is Rande. Yes. And there certainly are a lot of technology initiatives we're heavily involved through a number of our subsidiaries in the Title business. One of the most exciting to me is a company called Pavaso, which is deeply involved in the digital closing market and has signed a number of contracts with large national lenders to provide digital services and some other things we're working on that go beyond that. And there's a lot of talk about where block chains and cryptocurrencies fit into the mortgage origination markets. As much as it almost looks like [Flash Gordon's] in charge, those things aren't that far down the road. And I think we're really well prepared. I think that units like Pavaso put us certainly at the head of the pack to service those customers' needs.

Operator

And that concludes today's question-and-answer session. At this time, I would like to turn the conference back to the speakers for any additional or closing remarks.

Aldo Charles Zucaro
Chairman and Chief Executive Officer

No, we have none. And again, we appreciate very much everybody's participation and the opportunity to have this discussion about our great company. And now we look forward to our next visit, which will, according to schedule, take place in July of this year, following the midyear earnings release. So on that note, we bid you farewell. You all have a good day.

Operator
This concludes today's call. Thank you for your participation. You may now disconnect.