Q3 2020 Earnings Call

Company Participants

- Francois Morin, Chief Financial Officer, Executive Vice President, Treasurer
- Marc Grandisson, President, Chief Executive Officer, Director
- Unidentified Speaker

Other Participants

- Brian Meredith
- Elyse Greenspan
- Geoffrey Dunn
- Jimmy Bhullar
- Josh Shanker
- Meyer Shields
- Michael Zaremski
- Phil Stefano
- Ryan Tunis
- Yaron Kinar

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Third Quarter 2020 Arch Capital Group Earnings Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will follow at that time. (Operator Instructions) As a reminder this conference call is being recorded call is being recorded.

Before the company gets started with its update, management wants to first remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the federal securities laws. These statements are based upon management's current assessments and assumptions and are subject to a number of risks and uncertainties. Consequently, actual results may differ materially from those expressed or implied. For more information on the risks and other factors that may affect future performance, investors should review periodic reports that are filed by the company with the SEC from time to time.

Additionally, certain statements contained in the call that are not based on historical facts are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The company intends the forward-looking statements in the call to be subject to the safe harbor created thereby.

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

I would now like to introduce your hosts for today's conference. Mr.Marc Grandisson, and Mr.Francois Morin. Sir, you may begin.

Marc Grandisson {BIO 4369887 <GO>}

Good morning Liz. And welcome to our third quarter earnings call on Halloween Eve. You're in for a treat. In our results, you can see tangible evidence of the advantages of the Arch model. By protecting our capital during the soft market years, we are well positioned as each of our segments leans into improving market conditions. Our underwriters are making the most of the hardening property and casualty market, while our mortgage insurance segment is benefiting from record mortgage origination activity this quarter.

This, year for the first time in nearly a decade, we've been able to grow significantly and deploy more capital in our P&C businesses that provides acceptable expected returns. And due to our strong financial position, we had accomplished this while maintaining a strong presence in MI, which continues to deliver meaningful returns.

Our ability to continually rebalance capital amongst our diverse businesses enhances our total underwriting returns. It also should decrease earnings volatility over time. Since our inception, we have believed in cycle management, and this strategy brings an added margin safety to our collective underwriting activity. Allow me to elaborate on our third quarter results by touching on three key themes: one, growth; two, margin improvement; and three, capital allocation.

First, let's talk about growth. In this quarter, net written premiums in our P&C units grew 25% in total, 17% in insurance and 38% in reinsurance over the same period a year ago. This growth was driven by rate improvements, but also reflects our ability to increase our participations where clients needed additional capacity. In the insurance segment, we continue to obtain strong rate increases in areas like property, D&O and casualty. Group-wide our rate increase for the third quarter averaged over 11%, and we believe this trend of increasing rates should continue through 2021.

At Arch, we have always followed a simple rule, our participation in the business should follow the direction of premium rates. As rates improve, we write more business. When rates decrease, as they did over the past several years, we write less. This strategy takes courage. It will often appear an outlier to the market, but being intellectually honest, disciplined and applying our cycle management techniques is what we're all about at Arch.

Obviously, the P&C market is broad and all opportunities are not created equal. There are areas such as workers' comp where premium rates or conditions are not improving to the levels we believe are needed for an adequate return and in those instances, we manage our appetite accordingly. Despite headwinds from the pandemic, our growth in insurance lines like E&S property, casualty, and professional lines are a great example of our platform's ability to flex into improved underwriting conditions.

Our reinsurance unit has been able to lean into this hardening market both earlier, and with more vigor than our primary operations. There are two main reasons for this. First, when a market transitions, needed rate increases compound up the insurance supply chain. Reinsurance is often a leading indicator of what's to come more broadly. Second, reinsurance can provide capacity quicker and in larger amounts, since it can put capital to work through clients' platforms. Of course, share growth is only one part of the equation of growing returns. Let's turn now to margin improvement.

We all know that mathematically rate increases in excess of loss trends lead to margin improvement. The marketplace seems to be supporting the momentum of continued rate increases. We are in the early stages of seeing the benefit of rate on rate increases in our operating results. Simply stated, adding the two parts, growth and margin will lead to better returns.

Many factors are driving today's P&C markets. These include, elevated natural CAT loss activity in each of the past four years, weakened reserve positions from soft market years, lower investment yield and a rising claim inflation. Add in a global pandemic that is still ongoing and it's not surprising that market conditions are changing.

Now pivoting to MI. Our $33 billion of NIW in the U.S. in the quarter was a record for Arch. Low interest rates are producing huge refinance activity and unsurprisingly some churn in our in-force business. However, MI premium rates remain above pre-COVID levels and the continued high credit quality of borrowers is generally better than it was pre-pandemic. We continue to face uncertainties such as the economy's health and how the pandemic may ultimately affect individual borrowers. However, we are optimistic that among other positive factors, recent trends in the U.S. housing market will mitigate the effects of the pandemic.

Finally, Arch's ability and willingness to allocate and manage capital remains a key competitive advantage. We always think about balancing our capital deployment over five pillars; into the insurance, reinsurance, MI, into our investment portfolio and lastly into our stock repurchase. Our job is to optimize risk-adjusted returns through capital allocation across these pillars. We see managing the five pillars, being similar to coaching a basketball team. We're constantly looking at how we can distribute the ball i.e., our capital to the right players.

For the past several years, we've been able to feed the big seven-foot seven MI guy down low and rely on him to get easy dunks. Now as a playing field i.e. the market changes, we've adjusted our tactics slightly and are increasingly relying on our two hot shooters, reinsurance and insurance. MI will still score its fair share of points but the P&C players are getting more open three point looks and lay ups. In short, our game is becoming more complete and diversified. Our ability to adapt to the new conditions is what makes us stronger as a team.

The market dynamics take me back in time. We have talked about Paul Ingrey's underwriting clock that helps track and measure the phases of the insurance cycle. It's been central to our management philosophy since the beginning and is a helpful reference to understand the underwriting lifecycle and assist us in gauging our risk appetite.

I recently asked our underwriting teams where we were on the Ingrey clock and the most common response was around 8:00. If you take a look at the clock in our most recent annual report, you'll see that it's a very nice time to be at Arch. There's a buzz among our underwriters because we've become the first call for so many of our clients. They know that we have the capacity, the expertise and the desire to serve them.

Now I'll turn the coach's whistle over to Franois, as he goes into more detail on our quarterly results. And I look forward to responding to your questions afterwards. Francois?

Francois Morin {BIO 17410715 <GO>}

Thank you, Marc and good morning to all. We at Arch hope that you are in good health. Onto the third quarter results. As a reminder and consistent with prior practice, the following comments are on a core basis which corresponds to Arch's financial results, excluding the other segment i.e. the operations of Watford Holdings Limited. In our filings the term consolidated includes Watford.

After-tax operating income for the quarter was $120.3 million, which translates to an annualized 4.2% operating return on average common equity and $0.29 per share. Book value per share increased to $28.75 at September 30, up 4.1% from last quarter and 12.2% from one year ago. The increase in the quarter was fueled by the continued strong performance of our investment portfolio and good underwriting results, taking into consideration the elevated catastrophe activity in the quarter, and the uncertainty surrounding the current pandemic.

Our property casualty teams continued on their path of solid growth and improved performance as we continue to see strong positive pricing momentum in their markets.

Losses from 2020 catastrophic events in the quarter including COVID-19, net of reinsurance recoverables and reinstatement premiums stood at $203.3 million or 12.5 combined ratio points compared to 5.2 combined ratio points in the third quarter of 2019. The losses impacted both our insurance and reinsurance segments and include $191.4 million from a series of natural catastrophes in the quarter including hurricanes Isaias, Laura and Sally, the Midwestern derecho, California wildfires and other smaller events as well as $11.9 million for losses related to the COVID-19 pandemic.

The COVID-19 losses we recorded in the quarter were small, reflecting additional information that became available during the quarter and represent our current assessment and best estimate of the ultimate losses for occurrences through September 30, based on policy terms and conditions including limits, sub-limits and deductibles. As of September 30, the vast majority of our COVID-19 claims are yet to be settled or paid with close to 80% of the inception to date incurred loss amount recorded as incurred but not reported i.e. IBNR reserves or as additional case reserves within our insurance and reinsurance segments.

As regards the potential impact of COVID-19 on our mortgage segment, we note that the delinquency rate at the end of the quarter was 4.69%, down from 5.14% at June 30. Our current expectation is that the delinquency rate should be in the 5% to 5.5% range at year end 2020. While we have seen many positive signs over the last few months that point us to a more favorable view of the ultimate performance of the U.S. MI book, many of the uncertainties we identified on our last call remain.

In particular, the potential impact from a second wave of infections, potential lockdowns, and the lack of an additional fiscal stimulus package are risk factors that we continue to monitor and evaluate on an ongoing basis. For these reasons and consistent with our corporate reserving philosophy, we believe it is prudent to take a cautious approach in setting loss reserves across our MI book.

In the insurance segment, net written premium grew 17.1% over the same quarter one year ago, a strong result demonstrating our ability to achieve profitable growth in this environment. Adjusting for the net written premium decrease observed in our travel, accident and health unit, the year-over-year growth in net written premium would have been 26.5%.

The insurance segment's accident quarter combined ratio excluding CATs was 94.1%, lower by 620 basis points from the same period one year-ago. Approximately 300 basis points of the difference is due to a lower expense ratio primarily from the growth in the premium base from one year ago and reduced levels of travel and entertainment expenses this quarter.

The lower ex-CAT accident quarter loss ratio reflects mix change and the benefits of rate increases achieved over the last 12 months. Prior period net loss reserve development, net of related adjustments was favorable at $1.1 million generally consistent with the level recorded in the third quarter of 2019.

As for our reinsurance operations, we had strong growth of 38.4% in net written premiums on a year-over-year basis which was observed across most of our lines and includes a combination of new business opportunities, rate increases, and the integration of the Barbican reinsurance business. The segment's accident quarter combined ratio, excluding CATs stood at 83.1% compared to 92.8% on the same basis one year ago.

The year-over-year movement is primarily driven by a more normal level of large attritional losses compared to a year-ago and rate change activity over the last 12 months. Most of the remaining difference is explained by operating expense ratio improvements, primarily resulting from the growth in earned premium.

Favorable prior period net loss reserve development, net of related adjustments was $40.8 million or 7.4 combined ratio points compared to 4.0 combined ratio points in the third quarter of 2019. The development was mostly in short tail lines.

The mortgage industry had a record-breaking quarter in terms of NIW and we certainly followed suit with this quarter's NIW of 38 -- $32.8 billion, a full 30 % higher than our prior high watermark. Offsetting this record level of production was the high level of refinancing activity across our portfolio with the net result being a slight reduction in our insurance in force. The combined ratio was 64.2%, reflecting the lower delinquency rate observed during the quarter.

The trends we saw this quarter were favorable relative to last quarter, but the game is far from over. The expense ratio was slightly lower over the same quarter one year ago and prior period net loss reserve development was favorable at $4.5 million this quarter.

Total investment return for the quarter was positive 230 basis points on a U.S. dollar basis as the strong recovery in the capital markets produced healthy returns across our entire portfolio. Returns in our equity and alternative investments contributed approximately 40% of the total return for the quarter. The duration of our investment portfolio remained basically unchanged from the prior quarter at 3.21 years.

The effective tax rate on pre-tax operating income was 4.8% in the quarter, reflecting a change in the full year estimated tax rate, the geographic mix of our pre-tax income and a 10 basis point benefit from discrete tax items in the quarter. 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. We currently estimate the full year tax rate to be in the 8% to 10% range for 2020.

Turning briefly to risk management. Our natural CAT PML on a net basis increased to $918 million as of October 1 which at approximately 8.4% of tangible common equity remains well below our internal limits at the single event one in 250-year return level. The growth in the PML this quarter is attributable to our E&S property unit within the insurance segment which increased its writings in an improving marketplace.

On the capital front, the increase in interest expense this quarter was mainly the result of the issuance of the $1 billion senior notes we issued in June 2020. So far, we have been able to fund our recent growth with our existing capital base. And our balance sheet remains strong with a debt plus preferred leverage ratio of 23.1% that remains well within a reasonable range.

As for our U.S. MI operations, the mortgage insurance linked notes market has recovered to a great extent from the lows we saw at the onset of the pandemic. Earlier this week we priced our third Bellemeade transaction of the year at terms that are getting closer to what we saw in 2019, both in structure and price. Our latest transaction will provide 6.5% of coverage in excess of a 2.5% attachment point, both expressed as a percentage of the risk in force.

Including this transaction, the Bellemeade structures currently provide approximately $3.9 billion of aggregate reinsurance coverage. The fact that this market has recovered as extensively as it has in just over seven months with investors more and more comfortable with the exposure they are assuming is quite telling and provide support to our current assessment of the health of the using -- of the U.S. housing market.

With these introductory comments we are now prepared to take your questions.

Questions And Answers

Operator

(Question And Answer)

Thank you. (Operator Instructions) Our first question comes from Elyse Greenspan with Wells Fargo. Your line is now open.

Q - Elyse Greenspan {BIO 17263315 <GO>}

Hi. Thank you. Good morning.

A - Unidentified Speaker

Good morning.

Q - Elyse Greenspan {BIO 17263315 <GO>}

My first question is on the capital allocation. So Marc, you laid out five pillars. I just want to confirm I guess based off of how you were talking, it sounds like share repurchase is left kind of on the chain right now. And I guess, because it seems like you have such good growth opportunities that you could put your capital to use to basically to incrementally add to your insurance and reinsurance writings? Am I understanding that correct?

A - Marc Grandisson {BIO 4369887 <GO>}

So yes. I didn't mean to put them in ranking order. I think that they are probably all very equally, attractive at this point in time. I think that we're investigating as you know on a quarterly basis as to what the opportunities are in various signs of business. I didn't mean to name stock repurchase as the last one, as a rank ordering mechanism. I think that is also part and parcel of the discussion.

I think that for the first time in a while I would argue that the five players actually are actively making the point for receiving ball, the ball and play and be part of the game. So I would definitely say that. And we're evaluating but certainly our game number one, our focus number one is to allocate capital to the underwriting units if the returns are there. And that certainly is a relatively easier place to deploy and easier what you see it at this point in time. But everything is up, everything is -- every guy -- everybody is playing on the field, on the court.

Q - Elyse Greenspan {BIO 17263315 <GO>}

Okay. That's helpful. And then my second question, your insurance, underlying margin 94% in the quarter. Arch had targeted to get to kind of a mid-90s. Yet you guys are kind of there but there's more -- you mentioned a lot of rate. I think 11% that you're getting in your book of business which means you haven't even earned that in yet. So as we think about the earning in of the rate you're getting today, plus what seems like incremental rate you could get into 2021, do you have a new target for that business? Or is there a way that we can think about the margin profile there, especially since you've kind of hit that target that you laid out for the street?

A - Marc Grandisson {BIO 4369887 <GO>}

Yes. So let me go back to the 95% combined which I mentioned, I think three years ago now I think it was meant to be there as an aspirational target and to shoot for at that point in time based on the mix of business and the opportunities that we had in the marketplace. I think this has changed, right? I think that now that we're obviously going in that direction and very nicely, and the market is certainly, helping us, I think we still look very heavily into line by line and ROE by line of business.

And I would argue, Elyse, that some lines of business would be less than a 95% combined and some might be still okay at above 95. But certainly, what I would tell you is that combined ratio was aspirational. We have to keep in mind that there's still COVID-19 is still ongoing. And secondly, interest rates have also been decreased -- have decreased significantly since 3 years ago. So rate increase might be needed beyond the combined ratio just to make the returns equivalent to what they should be or would have been at the 95% historically.

So it's really an ongoing process of reflecting current investment yield. So there are no targets on the combined ratio, but certainly target on a return basis . And I would agree with the 140 to 150 bps decrease in interest rate that the combined ratio would presumably mathematically need to go down to make an equivalent return.

Q - Elyse Greenspan {BIO 17263315 <GO>}

Okay. That's helpful. And then last question, you mentioned taking a cautious approach to reserving within your mortgage book. And then I think you also laid out that default rate to get to 5% to 5.5% by the end of the year. And so I'm just trying to understand like as the default rate I guess, your expectations is it will go up a little bit from where it sits today. And I'm assuming that you'll continue with the same conservative approach that we saw in the third quarter. So how should we think about kind of the combined ratio? You've been giving some metrics for how that business could trend. And you've obviously come in better than expected in the second and the third quarter. Do you have an expectation for how that could ultimately trend into Q4? And I'm not sure if you want to provide initial color on 2021.

A - Francois Morin {BIO 17410715 <GO>}

Yes. I'll take that Elyse. I mean just to be pretty clear, I think I've -- as you guys all know I'll take the blame. I did a pretty poor job of forecasting combined ratios or delinquency rates over the last two calls. So I think we're trying to minimize those kind of bad forecasts.

But listen, there's -- as we know there's a lot of uncertainty out there. Yes, we're extremely pleased that the delinquency rates have come down, right? We had talked about even just last quarter, we had said like somewhere around 8% by the end of the year. It doesn't look like we're going to -- it's going to be as bad as that based on what we know today. Still a few months to go but definitely saw some encouraging signs this quarter.

So that's all well and good. Does it translate to -- what kind of combined ratio does it translate to? I mean it's hard to know because again what we're facing is really we just don't know how long this pandemic is going to last. And the fact that the forbearance programs are at this point scheduled to end, but who knows if they get extended or not? And how do people convert from forbearance to a regular delinquency? There's a lot of unknowns at this point that we feel are extremely hard to predict and estimate.

So listen, we're taking it one quarter at a time. We're happy with where things are at right now. Again, it's reassuring but we're not -- as I said, we're -- the game's far from over. And who knows maybe hopefully even my 5% to 5.5% forecast or expectation for delinquency ends up being a bit high. But we'll find out in a few months and we'll reassess at that point.

Q - Elyse Greenspan {BIO 17263315 <GO>}

Okay. Thank you very much. I appreciate all the color.

A - Francois Morin {BIO 17410715 <GO>}

Sure.

Operator

Our next question comes from Jimmy Bhullar with JP Morgan.

Q - Jimmy Bhullar {BIO 4278955 <GO>}

Hi, good morning. First, I just had a question on how you're thinking about pricing reinsurance pricing as a buyer of reinsurance? And how should we think about your sort of overall exposure, especially to cats as you're entering 2021? Are you, given better pricing, you can hold more exposure? Or maybe should we assume that you'll keep your retention sort of a similar and be a buyer of record regardless of prices?

A - Marc Grandisson {BIO 4369887 <GO>}

Short answer is we don't know yet, right? I think we'll have to see what the one-one brings to our reinsurance folks on the inward side and certainly on our E&S property. We'll have to evaluate and assess what kind of exposure and what kind of margins we're getting there and then look back and say, okay now what is the -- because buying reinsurance as you know is like, raising, it's like using capital. It's like we have to pay for that. So we're going to go through a very straightforward analysis of capital usage and what we pay for it.

And we take a very, very first economic view of the whole world, and specifically, as it relates to the insurance exposure, we take on a property CAT exposure specifically. But having said all this, we also have -- balancing it or adding to that information process is that we also are careful and not over stretching the capital. So we'll always be buying reinsurance to some extent. The question is what level and how much and at what price. But clearly we are -- we like stability and we're always trading stability for sometimes lesser margin, and that's going to be part of the mix.

But clearly, both markets where we can be on the advantage, we can gain both sides, but we can actually get rate increases on the insurance side, find a way to buy reinsurance in a good way. And on the assumed basis, we actually are benefiting from the improvement in the market there as well. So it's really a holistic view of the CAT exposure. Too early to tell what exactly is going to transpire, but everything is always up for discussion.

Q - Jimmy Bhullar {BIO 4278955 <GO>}

Okay. And then on Watford you raised the price. There's pressure on yield to raise it again. And at what point does the deal become sort of uneconomic? And/or are you already there? Or any comments on how you're thinking about that situation?

A - Francois Morin {BIO 17410715 <GO>}

Well, I mean we didn't raise the price -- we did not raise the price, right? We have an agreement, we have a signed agreement with Watford that we're starting the process to get regulatory approvals et cetera. But yes, I mean there's another party that has come in that Watford feels they have to look into their potential offer and what it all means to them. But at this point what's been announced is what is still valid. Depending on what they end up deciding, we may choose to do something different . But at this point we can't really say much more than that

Q - Jimmy Bhullar {BIO 4278955 <GO>}

Okay. Thank you.

A - Francois Morin {BIO 17410715 <GO>}

Sure.

Operator

Our next question comes from Mike Zaremski with Credit Suisse.

Q - Michael Zaremski {BIO 20606248 <GO>}

Hi, thanks. Good afternoon. Focusing on the Reinsurance segment robust growth. Thanks for the commentary, bullish commentary. If we look at the underlying accident the year loss ratio I mean actually expense ratio too, so just a lot of improvement. Anything we should be thinking about? Anything you want to call out? Or is a lot of this just market conditions and operating leverage that you're benefiting from?

A - Marc Grandisson {BIO 4369887 <GO>}

Yes. So the reinsurance group has grown tremendously. So the expense ratio going down or what it did certainly is explained by that in large part. I think in terms of the loss ratio what I would like and we said it on prior calls as well is we tend to look at reinsurance performance on a 12- to 18-month basis. There's a lot more volatility in that segment, that sector. There's also a lot of shift in the mix over time.

Our reinsurance folks do not tend to have a -- they have stable relationships obviously but there is a lot of things moving on in terms of taking, seizing the opportunities in the marketplace. So what I would look at the loss ratio is more like this is -- some quarters is much better than others. And it's really due to the volatility in the reinsurance results. I would say.

Q - Michael Zaremski {BIO 20606248 <GO>}

Okay. Got it. So the expense ratio, some of that's going to...

A - Marc Grandisson {BIO 4369887 <GO>}

Grow.

Q - Michael Zaremski {BIO 20606248 <GO>}

Okay. A follow up on the mortgage side. I think I heard you say earlier that ILN pricing kind of had improved a lot. I guess I'm looking at -- we're trying to -- we've been trying to track overall ILN pricing. And maybe you kind of you still see this double what it was pre-pandemic, but maybe I'm just looking. Maybe Arch's pricing is better, or maybe I'm just incorrect.

A - Francois Morin {BIO 17410715 <GO>}

Yes. I mean, there's two parts there, right, is the structure, meaning in particular attachment points and then the pricing. So right, so this is our third one, our first one of the year,. Really we were the first ones out of the gate after the pandemic. The reality at that point is appetite from the investors was not as good as it was in the past when our attachment point was much higher. Second one attachment point came down with slightly better pricing. And with this new latest one, we're effectively back to the same -- the 2.5% attachment point that we had seen pre-COVID. So that's certainly a very good sign.

Pricing, if you risk adjust for everything, it's still up, no question. It's not at the same level that it was pre-COVID, but it's not double for sure. So it's much better than that much lower than that. And quality of the book is better so how does that get factored in? And so there's a couple of other things that it's hard to make it perfectly apples-to-apples. But directionally and on an absolute basis as well, we're very happy with where things are going.

Q - Michael Zaremski {BIO 20606248 <GO>}

Okay. Got it. That's helpful because I think that you're describing it to me better than what we've thought. Okay. And lastly, sticking on mortgage, hopefully -- you said you -- the delinquency rate doesn't tick up as much as you thought. But are you -- it's almost November now, are you -- have you seen over the last few weeks, the delinquency rate tick up?

A - Francois Morin {BIO 17410715 <GO>}

So last few weeks, it's been actually keeping in the same general direction that we saw in the third quarter. So it hasn't picked up. Flattish, I'd call it and we got a couple of months to go. We'll see how things play out, but that's kind of what we're seeing.

Q - Michael Zaremski {BIO 20606248 <GO>}

Uunderstood. Thanks for the color.

A - Francois Morin {BIO 17410715 <GO>}

Yes. Sure. Thank you.

Operator

Our next question comes from Josh Shanker with Bank of America.

Q - Josh Shanker {BIO 21718992 <GO>}

Yes, thank you. Two questions, one just to understand accounting, and the other one is about Watford. On the accounting you had a decline in delinquencies due to cures of 6,000 approximately but you took up reserves, I know you can't really reserve for loss that hasn't happened yet, but it looks like you're reserving for these new claims at about $12,000, $13,000 per claim compared to a historical average of $4,000 to $5,000 per claim. Am I doing the math correctly? And can you explain sort of how you think about that in the books? I think in the first quarter you also took up reserves more than typical because you can only take them up when you have claims. But can you walk through that a little bit?

A - Francois Morin {BIO 17410715 <GO>}

Yes. No question that we bumped up reserves this quarter on effectively the delinquencies that we saw in the second quarter. So your math is correct. I mean that's -- I mean the reserves per delinquency, you did the math right. But what you need to adjust for I would say is call it a reserve strengthening exercise that we went through just to reassess where we were, took a hard -- every quarter, we take a hard look. And our view is that might as well not -- be cautious knowing what we know and knowing what we don't know.

So think of about a $45 million adjustment on reserves in the third quarter for effectively Q2 delinquencies. So once you adjust for that, I think you get back to claim levels or severities that you would be -- would be more in line with what maybe you would have expected.

Q - Josh Shanker {BIO 21718992 <GO>}

So along those lines is there a reason to believe that the severity of the losses are going to be different than historical severities? I can understand because there's (a lot of) frequencies and you can't really take frequencies until you get a claim. But is there a reason to be more cautious surrounding severity in this pandemic?

A - Francois Morin {BIO 17410715 <GO>}

We don't see it. With the -- the only adjustment obviously that what we're reporting in our supplement in terms of paid severities is lower than what we're seeing from the new delinquencies, right? New delinquencies, we mentioned it last quarter at about a $65,000 or so per NOD. This quarter it's right around $60,000. So I mean it's certainly higher because it's more recent loans that were -- that are going delinquent versus what the loans we paid on in the quarter.

So that's the only adjustment. But in terms of percentage of the insured value or the insurance in force, or the risk in force we don't, at this point don't have a reason to think that it's going to be materially different than what it's been in the past.

Q - Josh Shanker {BIO 21718992 <GO>}

Okay. And then on Watford, we don't know how it's going to turn out. But your own stock trades around book value. The offers for Watford around 0.8x book. I'm not sure and maybe you've done some thoughts on whether Watford a better investment at 0.8x book than Arch's that 1x book. But if you don't buy in Watford, it would suggest that you have a chunk of excess capital that you were already allocating towards financial uses. Can we expect that your interest in buying business you already know is attractive even given the market opportunities here?

A - Marc Grandisson {BIO 4369887 <GO>}

I think, we made the point clear by putting our offer up there and that's pretty much what we will leave it as, Josh, I think we are -- we think still -- we still think that Watford is a good platform, valuable platform. And we'll see how things shake out.

Q - Josh Shanker {BIO 21718992 <GO>}

But clearly Arch is a more valuable platform than Watford. If you're willing to buy in Watford stock, shouldn't you be willing to buy in Arch stock as well?

A - Marc Grandisson {BIO 4369887 <GO>}

I think the answer is always yes. We're always looking at the possibility of buying our stock. And certainly like I said before, five players on the court I think that the share repurchase is really -- is attractive, as you would expect me to say as the CEO of the company.

Q - Josh Shanker {BIO 21718992 <GO>}

All right. We'll keep watching. Thank you.

A - Marc Grandisson {BIO 4369887 <GO>}

Thank you.

Operator

Our next question comes from Yaron Kinar with Goldman Sachs.

Q - Yaron Kinar {BIO 17146197 <GO>}

Hi, good morning. Thanks for taking my questions. I do want to start by thanking you for giving a basketball analogy, so I can actually understand what's going on. I was worried you'd give a hockey analogy. My first question goes to the slight increase in COVID losses in the quarter. Can you maybe talk about what drove that, specifically? I guess specifically, what I want to get at is does it have anything to do with the FCA court case over in the UK? And how you're thinking about your overseas business interruption exposures?

A - Francois Morin {BIO 17410715 <GO>}

Yes. I mean it's really in two parts I think in the -- on the insurance side it's very much it's all basically related to our travel book in the U.S. So no connection to the FCA ruling. And the little bit we added in the reinsurance side is around property exposures, mostly out of Europe. So it's a little bit of a BI angle to it, but that's pretty much it.

So I mean it's -- I mean I call it a bit of, just new information coming in, nothing -- no, nothing kind of no material new information that came through that would have caused us to revisit our picks. And the FCA, as we said we didn't change it. And the ruling where it stands it's we're still very much -- we had fully reserved for it. And there's -- again, the ruling doesn't change our position on that.

A - Marc Grandisson {BIO 4369887 <GO>}

The rest of the portfolio, Yaron, for what it's worth and we mentioned that on prior calls is that we have the vast majority, almost the totality of our parties have the exclusions that would protect us somewhat from a deviation. So this is nothing in there to really think about.

Q - Yaron Kinar {BIO 17146197 <GO>}

Okay. That's very helpful. And then my second question, when you talked about the improvement in the accident loss ratio for insurance, you didn't talk about favorable frequency. So is it because you didn't see that? Or is it because you didn't book that?

A - Marc Grandisson {BIO 4369887 <GO>}

It's a little bit of both actually. We saw some of it -- some improvement on the frequency of claims possibly in the second quarter. That was definitely a difference. But if you neutralize for the obvious lines of business where claims would actually naturally go down such as travel for instance where there was a lot less exposure or go up. Then if you neutralize all of this, we didn't see a discernible change through the nine months of this year. It's hard to see what the natural rate would be, but we don't see a discernible change in the frequency to speak of. And really, we put our reserve pick and our loss pick based on long-term trend -- long-term averages.

We're not looking at specifically one quarter at a time and one even accident year at a time. We do get in the mix of multiple years and project out, much more on a longer term expected. So it will take a little while before we would recognize any significant improvement in frequency of claims, if at all.

Q - Yaron Kinar {BIO 17146197 <GO>}

Got it. And then maybe one final very quick one on Watford. If the deal does go through. I just want to confirm that the company wouldn't lose the fee income if Watford is consolidated, right?

A - Francois Morin {BIO 17410715 <GO>}

Correct.

Q - Yaron Kinar {BIO 17146197 <GO>}

Okay. Thank you.

A - Francois Morin {BIO 17410715 <GO>}

Yes.

A - Marc Grandisson {BIO 4369887 <GO>}

Sure.

Operator

Our next question comes from Ryan Tunis with Autonomous Research.

Q - Ryan Tunis {BIO 16502263 <GO>}

Hey, thanks. Good morning.

A - Marc Grandisson {BIO 4369887 <GO>}

Good morning.

Q - Ryan Tunis {BIO 16502263 <GO>}

Hey, thanks. Good morning. The one question I had was just on NII and thinking about low rate headwinds. If -- let's say you guys have almost 30% of your assets and essentially government bonds. Looks like your portfolio yield is sub two. We just heard another Bermuda competitor today say that their new money yield is 2%. It would seem to me given how you're allocated and given your current portfolio yield that there actually wouldn't be that much incremental yield headwind moving forward actually. Arguably if you're going to move out some of the govies and take some credit risk will actually seem that maybe you could expand your portfolio yield? It doesn't sound like that's right, given your commentary. But I'm just kind of trying to understand like why does Arch continue to be incrementally exposed to this low rate environment given the fact that you guys have already really take it on the trend in terms of where your, yields at now.

A - Francois Morin {BIO 17410715 <GO>}

Yes. I mean we've -- no question we've been defensive on credit. So yes, we have a bit more on the treasury side that you are right I mean unless rates keep going down but they seem to have stabilized I guess for the time being. Our play in the last few quarters has been trying to as many others I am sure have done the same is try to find other opportunities that are more in the alternative space that provide us still some level of investment income without taking on too much risk.

So something we keep looking at but it's a bit of a challenge. There's not a ton of opportunities out there. We're not -- we're worried a little bit. We're defensive on credit still and that's something that we look at carefully. We don't want to over-source ourselves there either.

Q - Ryan Tunis {BIO 16502263 <GO>}

Do you guys have a new money investment yield you'd call out handy that you did in the third quarter?

A - Francois Morin {BIO 17410715 <GO>}

Well the last call it in the last month, what we've been -- well, we didn't call it putting our money to work. It's just above 2%. So that's kind of where the latest information that we get -- that we have from our investment guys.

Q - Ryan Tunis {BIO 16502263 <GO>}

Got it. Thanks for the answer.

A - Francois Morin {BIO 17410715 <GO>}

Thank you.

Operator

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

Q - Geoffrey Dunn {BIO 3447798 <GO>}

Thank you. Good morning.

A - Marc Grandisson {BIO 4369887 <GO>}

Good morning.

Q - Geoffrey Dunn {BIO 3447798 <GO>}

First question, and I appreciate the added color around the MI reserving. If we make the adjustment, is the math correct that you changed your incidence assumption up to of about 9%?

A - Francois Morin {BIO 17410715 <GO>}

Close enough. 8% to 9%, yes. Yes. And our view on that is that we feel like that the more recent NODs are may be prone to a bit more stress. So the fact that these people took a bit longer to go into delinquency may tell us that there may be again, subject to more stress, but again time will tell.

Q - Geoffrey Dunn {BIO 3447798 <GO>}

And is that 9%, is that a -- just an overall number? Or is it a blend of just as an example 6% on forbearance and 13% on non-forbearance notices? Do you delineate between the two? Or is it just more of a holistic approach?

A - Francois Morin {BIO 17410715 <GO>}

It's more of an aggregate approach that we take. Yes. We don't separate the two as cleanly as you're suggesting, yes. We do like at all -- listen, Geoff, I want to make...

A - Marc Grandisson {BIO 4369887 <GO>}

I mean for the meanwhile...

A - Francois Morin {BIO 17410715 <GO>}

Geoff, I want to make sure you understand that we also do look at prior events prior CAT events, prior programs of the sort. So -- but it's -- as you could appreciate, Geoff, it's probably more art than science at this point in time.

Q - Geoffrey Dunn {BIO 3447798 <GO>}

Right. With the new ILN, a little confusing in the documentation. It looks like it applies for policies after Jan 19, but it looks primarily more recent loans over the last 3, 4 months. What is it designed to do? Is it really the last quarter or so?

A - Francois Morin {BIO 17410715 <GO>}

Yes.

Q - Geoffrey Dunn {BIO 3447798 <GO>}

Or is it part of the design to come underneath the 20-1?

A - Francois Morin {BIO 17410715 <GO>}

No. It's -- the latest, the 20-3 is very much -- I mean the vast majority is covering June, July and August, so that's three months of production. There is a little bit of kind of spillage of the 20-2 that -- and also some 2019 loans that had kind of been late being processed whatever. It's just -- we did a little bit of a catch up on a few small things, but think of it as really June, July, August production.

Q - Geoffrey Dunn {BIO 3447798 <GO>}

All right. Thank you.

A - Marc Grandisson {BIO 4369887 <GO>}

Yes, sure.

Operator

Our next question comes from Meyer Shields with KBW.

Q - Meyer Shields {BIO 4281064 <GO>}

Thanks. Marc, I'm a little confused by something that you said. You're talking about the five capital deployment opportunities and you cited the investment portfolio. And I guess I would have thought that if you're going to be writing more P&C or mortgage insurance, then the supporting capital will be in the investment portfolio anyway.

A - Marc Grandisson {BIO 4369887 <GO>}

Yes. So you're saying that we should -- just repeat the question, Meyer, please.

Q - Meyer Shields {BIO 4281064 <GO>}

So I'm trying to figure out what -- how capital deployment in the investment portfolio is distinct from capital deployment in either P&C mortgage.

A - Marc Grandisson {BIO 4369887 <GO>}

Okay. Now I see what you mean. So the way we look at the underwriting returns is we attribute to the units the treasury return or the risk free return. And we try and separate church and state, what we call it internally. We actually credit the float on the insurance on the underwriting pieces at the treasury rate level. And then we allocate the capital for the excess over that to the investment portfolio. So this is how we separate the capital usage between those -- between the underwriting unit and the investment unit.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. That makes sense. Got it. I'm trying to get a general sense of how you see either profitability and property catastrophe in retro. Or your view as to whether the vendor catastrophe models are conservative enough based on recent years' CAT activity and the underlying trends.

A - Marc Grandisson {BIO 4369887 <GO>}

Yes, it's a good question, Meyer. I think that our position on this we have weather scientists upstairs and we have a lot of lengthy experience and information to look at. Listen, actually augment and modify the vendor models as we see fit. So the vendor model represents to us a solid starting point. From where we can, there's definitely had a lot of science into this one. So we have been historically using them as a starting point and augmenting it and modifying it with our own view of the world.

But I would caution everyone by saying that yes, we do have a view of various perils and various exposure around the world. And we also try to factor in shorter-term versus longer-term possibly modification of what could happen out there. But it's hard to predict those things. So what we tend to do is to hold ourselves to a higher return for those risks that are inherent in the way we underwrite the business. That also helps explain why where we've taken possibly somewhat of a more conservative approach to property CAT exposure over the last 4, 5 years as you've seen in our numbers.

So I think -- and it's a year-on-year analysis, so we would look at it. And we'll evaluate I think, in some of our discussion we had El Nio, La Nia and all these various discussions happening all the time. And we're not the largest rider of property CAT, but we do have a very the team looking into this. But I think we make it up -- try to make it up with holding ourselves up to a higher level of returns.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. That's very helpful. Thank you so much.

A - Francois Morin {BIO 17410715 <GO>}

Sure.

Operator

Our next question comes from Phil Stefano with Deutsche Bank.

Q - Phil Stefano {BIO 18965951 <GO>}

Yes. Good morning. Just one -- most have been asked and answered. One follow-up on the MI piece and thinking about the increase in the default rate, I guess in my mind there are three mechanisms to get there. It's either new defaults are increasing, cures are slowing down or the denominator policies in force is shrinking. I'm just curious how you're contemplating which of those levers is contributing to the increase in the default rate. I think it helps us think about does this come through as losses or premiums or maybe development if the cures are right.

A - Marc Grandisson {BIO 4369887 <GO>}

Okay. So Phil, let me try and take this. There's as a lot of -- it's a big question, a lot of parts. So first and foremost, the denominator is not changing a whole lot, right? It's about a ($1 billion, $1.250 million) that's what it is in terms of policy. The DQ rate has decreased this quarter right? It went from 5.1% to about 4.7% this quarter. So this is like what's the number of policies at the numerator that are in default and you divide by a similar number. So it did go down.

I think what we're saying in terms of reserving, you reserve for the new notices that you received in the quarter, right? We received 58,000 in the second quarter. We received 20,000 this quarter. And what we're telling you is we take that, the book of these 20,000 new notices. The cures are the cure. They go away from the overall balance if you will that we just mentioned which is the 4.7%. But the new notices we reserve for those in the quarter. So we have to reserve in the quarter on those that were newly notified.

This is what typically you would do on a reserving. What we did in addition to this is we modified our view of what we should have booked for the second quarter for the new notices in that quarter. So I'm not sure -- I'm trying to sort of help give you a picture a whole -- a bigger picture hopefully that helps you understand how we (reserve on al this). Sure.

Q - Phil Stefano {BIO 18965951 <GO>}

No, I -- that makes sense from the reserving side. But the default rate is loans in default that population over policies in force.

A - Marc Grandisson {BIO 4369887 <GO>}

Right.

Q - Phil Stefano {BIO 18965951 <GO>}

And if the policies in force isn't changing and the default rate is going up, then presumably there's an expectation that new default is going to increase this quarter. And I guess I just wanted to make sure that I was thinking about it correctly, because I -- to get to 4.7% to 5% 5.5%, there must be an acceleration in new default or cures is slowing down. I don't know. That's kind of the question.

A - Francois Morin {BIO 17410715 <GO>}

I mean that's -- listen, it's a big -- I mean kind of top down view. It's hard to know. We don't have -- we can't predict. We don't have the crystal ball on whether cures are going to accelerate or not or slowdown and same thing with new notices. Again, we're trying to I think just provide a bit of color that we think the -- obviously or knock on wood we're not going to be at 8% delinquency rate by the end of the year. We're certainly well below 5%. Does it go back to above 5% by the end of the year? That what we think could happen but again we don't know. So I think if everything stays the same, the odds are probably that it won't be at 5%. But we -- that's...

A - Marc Grandisson {BIO 4369887 <GO>}

But Phil, you're right. You're right on your assessment that if we go from 4.7%, and we tell you it's going to be 5.5% at the end that we will have to have an increase in NODs or lesser cure. I'm not sure, we have made enough assessment as to which is which. I would argue that we have tended to -- since May, we have tended to -- at least the last two quarters, we have overstated the amount, the number of new NODs that we received. And that probably is what would drive the potential. We just still don't know Francois has said that we haven't been as good as we would have liked to be predicting. So I think the new NODs would be more the place to look at.

Having said this, Phil, you also know that we had two things going on, less new NODs and higher cure rate. So they both actually helped to manage the amount. And they helped accelerate and actually go -- no help explain why we had a projection of about over 10% earlier in the year to much less right now. They're two moving parts.

Q - Phil Stefano {BIO 18965951 <GO>}

Yes. No understood. I guess in my mind, this default rate might continue to come down. But as you said...

A - Marc Grandisson {BIO 4369887 <GO>}

Yes, it very well could be.

Q - Phil Stefano {BIO 18965951 <GO>}

It's -- the crystal ball is very cloudy at this point, thank you, guys.

A - Francois Morin {BIO 17410715 <GO>}

Thank you.

Operator

Our next question comes from Brian Meredith with UBS.

Q - Brian Meredith {BIO 3108204 <GO>}

Thank you. I have a couple of them for you just quickly. Francois, just curious given that you're getting 2% new money yields and your book yield is below that, should we just expect that your book yield on your investment portfolio fixed income to kind of be stable here going forward?

A - Francois Morin {BIO 17410715 <GO>}

I think in the short-term I think it's reasonable, yes.

Q - Brian Meredith {BIO 3108204 <GO>}

Okay. Good. That's helpful. Second, question on the reinsurance business, I'm just curious. Your property mix is definitely increasing as a percentage of your overall book. How much of the underlying combined ratio improvement that you're seeing there is actually driven by that mix shift versus just better loss picks?

A - Marc Grandisson {BIO 4369887 <GO>}

Well, then -- boy, I don't think we parse out this way. It's still early in the game to see what it's going to look like. I would say that it's probably more mixed at this point in time because our growth is largely in property other than CAT, CAT XL. So we have a lot of play in that sector right now. It's more and more mix. I would say, Brian.

Q - Brian Meredith {BIO 3108204 <GO>}

Yes. So it's not so much the rate activity that we're seeing, it's the mix shift that's driving it?

A - Marc Grandisson {BIO 4369887 <GO>}

Well the way we are, you know us, Brian for all these years is we'll tend to go where the rates are the better and we have a better increase in margin. So that sort of goes hand-in-hand. So...

Q - Brian Meredith {BIO 3108204 <GO>}

Got you. That makes sense. Another one, just quickly on Watford I'm just curious. Is it your guys' intentions to significantly increase your ownership in that ultimately? Or you going to buy the whole thing in just because the volatility of the investment portfolio is kind of just a different strategy?

A - Francois Morin {BIO 17410715 <GO>}

Well, what we said publicly is that, we are certainly talking to other parties to bring into the fold to support us in this vehicle if it moves forward if we close on the acquisition. So the answer is, yes, we would most likely increase our participation but not to 100% and be much less than that.

So increase little bit but recognize that we -- it's a different model that we -- others would want to participate on with us as well.

Q - Brian Meredith {BIO 3108204 <GO>}

Got you. So the net capital outlay for this transaction wouldn't be this big as it could? OKay. That makes sense.

A - Francois Morin {BIO 17410715 <GO>}

Correct.

Q - Brian Meredith {BIO 3108204 <GO>}

Got you. And then last question, I'm just curious. Any updates with respect to the Coface investment, where that stands? Are regulators going to ultimately make a decision on this?

A - Marc Grandisson {BIO 4369887 <GO>}

Yes. I think we're in -- it's in process. We're going through the regular process. It's in -- it's on track. We're hopeful that we could get something done potentially in the first quarter, second quarter of next year. It takes a while, as you know, in this COVID environment. Government and regulators take a little while longer than otherwise. But yes, it's on track. And they produced, as you know, their results I believe earlier this week or early or late last week. So it's also looking much better for them, which is good for us.

Q - Brian Meredith {BIO 3108204 <GO>}

Yes. Great. Thank you.

A - Marc Grandisson {BIO 4369887 <GO>}

Thanks Brain.

A - Francois Morin {BIO 17410715 <GO>}

Thank you.

Operator

Our next question comes from Jimmy Bhullar with JPMorgan.

Q - Jimmy Bhullar {BIO 4278955 <GO>}

I just wanted to clarify your comment on not losing the fee income on Watford. Is that just because of the five years remaining on the contract, and so there's sort of a finite life to it? Or was there something else that was behind that comment?

A - Francois Morin {BIO 17410715 <GO>}

Well, I mean a question was asked if we buy the vehicle do we still retain the fees? The answer is yes. I mean I...

Q - Jimmy Bhullar {BIO 4278955 <GO>}

Yes, that it's an internal allocation then. But in case it goes to somebody else then that fee arrangement stays intack through the lens of the existing contract.

A - Francois Morin {BIO 17410715 <GO>}

Yes, correct.

Q - Jimmy Bhullar {BIO 4278955 <GO>}

So it's five years. Okay. And then does your approach to underwriting overall and how much sort of capacity you have and take on in a given change if you own more of Watford versus maybe if it does end up being bought by a third-party at a higher offer?

A - Marc Grandisson {BIO 4369887 <GO>}

I think in a third-party environment Jim I think it's pretty clear that we need to take care of our of our brethren as well as we could take of ourselves. So our view is always to do the similar underwriting. Watford had a different investment profile which allowed us to do slightly different things. But at a high level the underwriting is very, very similar. And I would remind everyone that whatever we do on Watford we take 15% of it on a quota share basis in the back. We also are participating on the capital. We had like we're up about 13%, I believe, in our shareholding. So we collectively own something like 20% of the underwriting. So we do eat our own cooking there as well, and it's really important to us.

Q - Jimmy Bhullar {BIO 4278955 <GO>}

Okay.

Operator

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

A - Marc Grandisson {BIO 4369887 <GO>}

Thank you, everyone. Looking forward to the last remaining couple of months in the year, and I hope you have a good one.

Operator

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