# Q1 2021 Earnings Call

## Company Participants

- Francois Morin, Chief Financial Officer and Treasurer
- Marc Grandisson, Chief Executive Officer

## Other Participants

- Brian Meredith, Analyst
- Derek Han, Analyst
- Elyse Greenspan, Analyst
- Geoff Dunn, Analyst
- Jimmy Bhullar, Analyst
- Joshua Shanker, Analyst
- Philip Stefano, Analyst

## Presentation

### Operator

Good day, ladies and gentlemen, and welcome to the First Quarter 2021 Arch Capital Group Earnings Conference 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. Before the Company gets started with its update, management wants to first remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the Federal Securities law. These statements are based upon management's current assessment 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 host for today's conference, Mr. Marc Grandisson and Mr. Francois Morin. Sirs, you may begin.

## Marc Grandisson {BIO 4369887 <GO>}

Thanks, Liz. Good morning and thank you for joining our earnings call for the first quarter of 2021. The power of Arch's diversified strategy is evident again this quarter as we have strong underlying earnings across our three operating divisions in a 7.8% operating ROE despite the cat events. Pricing is attractive in almost all of our insurance markets and more than meets our cost of capital thresholds. As a result, we expect the next several quarters to continue to show improved underwriting margins, partially due to the compounding of rate on rate increases and the rebalancing of our mix. Importantly, the market is showing discipline in maintaining its momentum and the recent cat losses are likely to keep upward pressure on rates.

Our three primary areas of focus for 2021 are one, continuing our growth in the sectors where rates allow for returns that are substantially more than our cost of capital. Two, optimizing our MI mortgage insurance book, as it transitions from forbearance to recovery on its way back to normalcy in the next few quarters, our notices of default are leveling and the quality of recent production is excellent. Three, actively managing our investments and capital to enhance our returns over the longer run. The past quarter P&C premium renewal rates increased across a broader spectrum of lines, including several that did not show movement as recently as the third quarter of 2020.

We also expect to see exposure growth as the economy recovers more fully, which in turn should further spur increased revenues and profit. On the MI front, housing as emerge as one of the stronger economic sectors due to a combination of positive house price appreciation with good affordability for homeowners. All the mortgage interest rates have increased modestly. They remain low compared to historic levels and continue to fuel strong demand for the purchase market. Finally, it's worth noting and Francois will covered it in more detail that there is also some good news on the investment side as yields have increased slightly in 2021.

For Arch, every 25 basis points increase in the yield should result in about a 50 basis point increase in our return on equity. Now let's dive into the businesses a bit more. Turning first to P&C insurance, we are very optimistic about the prospects across our Specialty Insurance Group for 2021. This past quarter, the higher level of premium earned from the post 2019 written period is one of the main reasons why our underlying combined ratio continued to improve. About 2/3 of the improvement was due to lower loss ratios as a result of the impact of rate increases as well as to underwriting actions we have taken over the past several years, the other third of the improvement was driven by a lower expense ratio.

In Q1, we observed a plus 11% rate increase on a global basis, solidifying the momentum for improving margins in P&C. We are now in a fifth consecutive quarter of rate increase in excess of loss costs, as evidenced by our current underlying combined ratio of 93.3% versus 97.1% in the same quarter last year. Adding to the rate improvement already mentioned, we see lower claims activity over the last four quarters. Nevertheless, we continue to be prudent by maintaining what we believe to be an appropriate safety margin in our reserving approach. One of our key principles is that we are cautious when recognizing favorable news, but we are quickly to adverse signs in the data.

Next onto our reinsurance segment. We had another quarter of improving profitability fundamentals. Our trailing 12 month accident year combined ratio ex-cat has improved significantly from a year ago. We again had a meaningful increase in net premium written of 25%. In the first quarter, we estimate that our effective rate change or rate over trend was roughly plus 8%. As with insurance, we expect these rate improvements to continue to be reflected in our underwriting results for the next several quarters. As you can see from our total premium growth in property over the last year, we continue to believe that risk-adjusted returns are more favorable in a non-cat XL property arena.

Our reinsurance group incurred $146 million of cat losses in the quarter, which was within our expectations given the type of event and where we have historically positioned our property cat exposures. Let me explain a bit more. Strategically, we allocate more catastrophe capital towards homeowners and smaller commercial portfolios because we believe, one, they have homogeneous risk characteristics, two, the data used to model their exposure is of better quality and three, policy language tends to have less variability than with larger commercial exposures. We believe that there is less uncertainty in the expected cat load of homeowners and smaller commercial portfolios. As a consequence of this portfolio construction bias when a medium-sized storm such as Uri has between $14 billion and $16 billion in losses that affects personal lines more markedly, we would expect our market share to be around 1%.

And last but certainly not least, mortgage. Overall our mortgage group is very well positioned to produce good earnings as a reinvigorated US housing market is promising in 2021 and beyond. In the first quarter, Arch MI US new insurance written was $27 billion, around 60% above the same period last year and new loan originations are tracking towards another very strong year. As you know last year saw a refinancing boom, which meant significant turnover in our insurance in force. Our first quarter annualized persistency was up from the 54% we experienced over the last 12 month as interest rates rose earlier this year. If mortgage rates continue to rise, we would expect persistency to gradually return to the longer-term range of 75%, which would be a net positive as we would hold more of the recent higher credit quality, higher risk adjusted return portfolio on our books for longer.

Looking next at our delinquency inventory. We still expect a large portion to cure based on many factors including the strong equity position of our current DQ inventory; 94% of delinquent policies have over 20% of equity. We also had good news in March as a run rate for new notices of default was nearly back to 2019 levels at about 10,000 new annuities per quarter. Outside of the US, we increased our writings in Australia as the housing market remains strong there. We like the long-term opportunity in Australia as demonstrated by our announcement to acquire Westpac's LMI business in March. The agreement allows us to free up capital, even as we build our Australian presence and diversify our earning streams at attractive risk-adjusted returns.

To borrow a sports analogy for this quarter, with a nod to our friends at Coface, this market feels a little like the last legs of the Tour de France. We just went through the mountainous section came out among the leaders and a lot of riders struggled to keep pace. Now as we roll towards Paris, we can continue to build on our lead while remaining mindful of protecting our position and energy. We can go all out and be reckless at several stages as several stages of the race remain. However our team is in great shape, we have many great riders working together to ensure we're ultimately smiling in that beautiful yellow jersey on the Champs Elysees. As usual, our focus is on finishing the race with grace and winning for our sponsors, our shareholders. Now, I'll turn it over to Francois.

## **Francois Morin** {BIO 17410715 <GO>}

Thank you, Marc, and good morning to all. Thanks for joining us today on to the first 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. On the transaction we announced late last year to acquire Watford in partnership with Warburg Pincus and Kelso to use Marc's cycling analogy, our team has been pedaling hard in anticipation of the closing and we are down to the last few kilometers before we reach our final destination. I will provide a bit more color on its status in a few minutes.

As you will have seen by now, we had a very solid quarter despite the severe winter storms with after-tax operating income for the quarter of $239.8 million or $0.59 per share and an annualized 7.8% operating return on average common equity. Book value per share increased at $30.54 at March 31st, up 0.8% from last quarter. In the insurance segment, net written premium grew 20% over the same quarter one year ago, 28.4% if we exclude the impact of the pandemic on our travel, accident and health units. The insurance segment's accident quarter combined ratio excluding cats was 93.3%, lower by 380 basis points from the same period one year ago.

The improvement in the ex-cat accident quarter loss ratio reflects the benefits of rate increases achieved over the last 12 months and changes in our mix of business. In addition, the expense ratio was lower by approximately 80 basis points since the same quarter one year ago, primarily due to the growth in the premium base. As for our reinsurance operations, we also had strong growth of 25.3% in net written premium over on a year-over-year basis, 40.8% if we adjust for an $88 million loss portfolio transfer that was recorded in the first quarter of 2020.

The growth was observed across most of our lines but especially in our property, other than property catastrophe line or a strong rate increases and a few new accounts help increase the topline by 84.3%. The segment's accident quarter combined ratio excluding cats stood at 84% compared to 91.3% on the same basis one year ago. Once we normalize for the one-time impact of the loss portfolio transfer, the improvement in the ex-cat accident year combined ratio was 590 basis points, which is almost entirely attributable to a corresponding improvement in the loss ratio.

The overall expense ratio remained relatively unchanged again, after adjusting for the LPT. Losses from 2021 catastrophic events in the quarter, net of reinsurance recoverables and reinstatement premiums stood at $188.3 million or 10.5 combined ratio points compared to 7.4 combined ratio points in the first quarter of 2020. These were primarily as a result of the North American winter storms Uri and Viola in February and consistent with our earnings pre-announcement two weeks ago, close to 80% of the losses came from our reinsurance segment with the rest attributable to the insurance segment.

We remain comfortable with our level of loss reserves for COVID-19 claims, which remain essentially unchanged from prior estimates, approximately 65% of the inception to-date incurred loss amount sits within our incurred, but not reported IBNR reserves or as additional case reserves within our insurance and reinsurance segments. The key performance indicators we track to help us assess the ultimate impact of COVID-19 on our mortgage segment keep trending in the favorable direction. Chief of course being the delinquency rate, which came in at 3.86% at the end of the quarter. Arch MI had another excellent quarter in terms of production and with refinance activity leveling off from prior peaks, we saw our insurance and form remain relatively stable with an increase from our international book, offset by a small decrease in our US MI book.

The combined ratio for this segment was 42.4% reflecting the lower level of new delinquencies reported during the quarter, both the loss and expense ratios were slightly lower than the pre-pandemic levels experienced in the same quarter one year ago. As a reminder, I wanted to remind everyone of the seasonality that exists in the reporting of operating expenses across our underwriting segments, investment expenses and at the corporate level. Given all incentive compensation decisions including share based awards get approved by our Board of Directors in the February of each year, the first quarter has generally been the quarter with the highest level of operating expenses and we do expect the current year to follow this pattern.

Overall, with the underlying improvements in both of our P&C segments and mortgage segment fundamentals returning to pre-pandemic levels, we are excited by the prospects for each of the three legs of our stool. Our objective to deliver a well-balanced return to our shareholders with meaningful contributions from each of our underwriting segments should become more and more apparent as we move forward. I've kept my segment level comments a bit shorter than usual in order to give a bit more color on the performance of our investment portfolio this quarter. And on the new line in our income statement titled income loss from operating affiliates.

As regards to the investment portfolio, total investment return for the quarter was a negative 18 basis points on a US dollar basis. Our defensive positioning with a short duration and limited credit exposure relative to our benchmark helped us withstand headwinds we experienced on the heels of an 80 basis point increase in the 10 year treasury rate during the quarter, which was a main factor in the negative 56 basis point price return on our portfolio during the quarter. Net investment income was $78.7 million during the quarter down 9.3% on a sequential basis. This decrease was certainly affected by lower available interest rates and higher investment expenses due to incentive compensation payments and investment management fees is also very much the result of deliberate portfolio actions taken over the last few quarters. Specifically, we continue to maintain a short duration on our portfolio 2.71 years at the end of the quarter based on our internal view of the risk and return tradeoffs in the fixed income markets. We also continue to deploy additional capital to an alternative investments. The returns from which are generally not reflected in investment income. Finally, we also transform some short-term investments this quarter into our 29.5 equity ownership in Coface as well as an investment in corporate-owned life insurance policies. Again both items with returns are included in operating income, but are not reflected in net investment income. Equity in net income of investment funds accounted for using the equity method and realized gains from non-fixed income investments returned approximately $154 million during the quarter and were key contributors to the growth in our book value.

Now onto income from operating affiliates, which we are including in our definition of operating income. This quarter in addition to our share of the quarterly results of investments we have made on operating affiliates being primarily those from Premia Holdings at this time. We also benefited from an initial nonrecurring gain we made at closing of our acquisition of a 29.5% ownership stake in Coface for approximately $74.5 million. Consistent with our accounting policy under equity method accounting, we will report our investment in Coface on a quarter lag. As regards to Watford transaction, shareholder approval was obtained in late March and we are awaiting a few final regulatory approvals before we can close the transaction, hopefully over the next few weeks.

As we disclosed earlier, we expect our ownership of Warford to increase to 40% at closing. The effective tax rate on pre-tax operating income was 10.6% in the quarter reflecting changes in the full year estimated tax rate, the geographic mix of our pre-tax income and the benefit from discrete tax items in the quarter. We currently estimate the full year tax rate to be in the 10% to 12% range for 2021.

Turning briefly to risk management, our natural cat PML on a net basis decreased to $778 million as of April 1, which at approximately 6.7% of tangible common equity remains well below our internal limits at the single event 1 in 250-year return level.

Our peak zone across the group change from the Florida Tri-County area to the northeast reflecting our view of better opportunities given the current rate environment. Our balance sheet remains strong and our debt plus preferred leverage stood at 22.1% at quarter end, well within the reasonable range. On the capital front, we repurchased approximately 5.3 million shares at an aggregate cost of $179.3 million in the first quarter. Our remaining share repurchase authorization currently stands at $737.3 million. With these introductory comments, we are now prepared to take your questions.

# Questions And Answers

## Operator

Thank you. (Operator Instructions) Our first question comes from Phil Stefano with Deutsche Bank.

## Q - Philip Stefano {BIO 20346322 <GO>}

Yeah, thanks. And good morning. So the idea of rate adequacy is something that has gotten a lot of airtime with people focusing on the second derivative of the pricing move. I was hoping you could just talk about how you see rate adequacy from your perspective, primarily as an insurance question but reinsurance, would it be appreciated as well. In my mind, it feels like the messaging is that exposure growth will help to carry the baton, I don't know how to put that into a biking analogy, but and move to the front from the tailwinds of pricing that we've seen and push forward to the next leg?

## A - Marc Grandisson {BIO 4369887 <GO>}

Yeah, it's a good question. I'll try to not to stay away from the cycling analogy myself. I think at a very high level, the rates keep on being really healthy, 11% is above the loss cost trend as we mentioned earlier, we started seeing this last year in the first quarter. So we are in a second round, if you will of round of rate increases where we had some rate increases last year in those policies that are currently being renewed or were renewed in the first quarter had another set of rate increases. So I think where we are right now, the market is really psychologically, the market is in rate increases minded and being very careful in the way to deploy capital. And I think if you look back at where we came out in 18, 19 years where our combined ratio was in the way it has been developing and trending for last six quarters, I think the story tells itself, the fact that we are indeed getting rate above loss cost trend and that also finds its way into our account of combined ratio on a quarterly basis.

There is more to go. We've put our first coat of prime last year.There's another -- the first coat of paint this year, will be surprised that we have another coat to paint given over the next several quarters remains to be seen how much, how much more it will be, but certainly anything we have at this point in time is helps improving the margins.

## Q - Philip Stefano {BIO 20346322 <GO>}

Okay. And switching gears a bit to look at mortgage, the incident rate assumptions were high single digits, something like 8%, 9% as we talked through the second half 2020 results. Can you just let us know where about you're looking at booking that now and maybe weave in some additional color commentary around what exactly it means optimizing our MI book as we kind of migrate from the forbearance world to a more traditional operating environment?

## A - Marc Grandisson {BIO 4369887 <GO>}

Absolutely. I think we have a first on the optimizing, we have a very substantial market share in the US and we will very soon have a very decent one in Australia as well. I think it's ready to go towards the area where the better returns are. We are as and we grew a little bit in the last half of 2020, we see the opportunity the market is coming back to some more normalcy. So I think our game plan will be to as we were doing in 2019 as we were heading into (inaudible) rely on our our risk-based pricing to make sure we pick the best area of the marketplace to make sure we are enhancing the returns as we go forward.

In terms of NODs, our roll rate for the new NODs this quarter, if you remember last quarter was 9.4%, this quarter, we booked it for the US MI at 9.1%, so it is slightly better than the last quarter. We did not -- we are sort of the odd of the predicting business of where it's going to end up at the end of the year in terms of the delinquency rate, but you see it is going to 3.86% this quarter, which is way, way, way better than we would have anticipated sitting here a year ago.



## Q - Philip Stefano {BIO 20346322 <GO>}

Okay, hopefully a quick follow-up on the MI, is there any clarity on the GSE limitations on dividends out of the operating entities. Any sense on, when this will be lifted?

## A - Francois Morin {BIO 17410715 <GO>}

Well, great question. Phil there is a moratorium that's in place till the end of June. We are certainly hopeful that the moratorium will expire and not be extended, nothing definitive, there is discussions going on, but the, certainly from our side the hope is that in the second half of the year, we would be able to start dividending some of the capital from our US MI operation.

## Q - Philip Stefano {BIO 20346322 <GO>}

Thanks.

## Operator

Our next question comes from Elyse Greenspan with Wells Fargo.

## Q - Elyse Greenspan {BIO 17263315 <GO>}

Hi, thanks, good morning. My first question on, on last quarter's call, you guys had alluded to I believe your Property, Casualty business is generating returns in the double digits and mortgage kind of getting back to the 15% level, obviously some noise in the quarter with cats and some of the investment items, your investment income items you pointed to, but you guys broadly see your businesses generating returns in the double-digit and mortgage kind of around that 15% level?

## A - Marc Grandisson {BIO 4369887 <GO>}

Yeah, I think, have you, our view has not changed in terms of expectations what we have written from what we said last quarter at least, very much in line.



## Q - Elyse Greenspan {BIO 17263315 <GO>}

Okay, that's helpful. And then on the underlying side in your prepared remarks where you alluded to continuing to debt underlying margin improvement and you guys have done a really good job over the past few years of rejiggering the business mix and we're seeing that come through in both insurance and reinsurance, so was that comment imply that the back three quarters of the year on an underlying basis would be better relative to the Q1, was it a year-over-year comment just directionally how should we think about the margins in insurance and reinsurance?

## A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. It's all relating to the price increase that the market will push through, right, over the next several quarters. But certainly the earnings that we're seeing currently in the first quarter, right, at least some of it was at lower pricing in the last year. I know in the first half of the year and third quarter and that kept on getting better as we went towards the end of 2020 and into 2021. So we should all, everything else being equal, expect an expected the margins to be expanding and if there is more rate increases, then we should hopefully see this, well, nothing will we'll see them in the numbers right away, but certainly the feeling and the momentum is building to get more and more margin improvements. Yeah.

## Q - Elyse Greenspan {BIO 17263315 <GO>}

And then in terms of mortgage right you guys had pointed to kind of getting back to the 35% to 45% combined ratio, 42.4% in the quarter [ph] right so firmly within that range based up of what you know today in the fact that you mentioned right the level of new notices is falling, would you expect that the combined ratio for that business would continue to trend better during the next three quarters relative to what you reported in the Q1?

## A - Francois Morin {BIO 17410715 <GO>}

Well, couple of points on that. I think that just to clarify the comment that I think I made was call it the 35% to 45% range was meant to be more of a call it over the cycle steady state, not in a stress environment reasonable combined ratio, do we feel we're in that environment, yeah, delinquency, yeah, new notices Marc touched on it, they're back to being roughly 10,000 a quarter, so that's a good sign, could the combined ratio in the last three quarters of the year be lower than it was in first quarter, it could we were not, we don't know I think some of it will certainly be a function of reserve releases, if there is any, we just, again that's, we will have more clarity on that once forbearance programs expire or get people come out of that.

So I think at a high level where we, the range we put out there is, we're still very comfortable with, could we beat that or could we come in a bit lower, I guess, we'll see when the data shows up. But certainly, yeah, it's not inconceivable.

## Q - Elyse Greenspan {BIO 17263315 <GO>}

Okay. And then one last line on the FHFA this morning announced new refi options for low-income families. Could you just help us think about how that could impact the back book within your mortgage insurance portfolio?

## A - Marc Grandisson {BIO 4369887 <GO>}

Yeah, I think the, to me the all the questions about the FHA, the FHFA and all the various government policy that could be put out there. I think we are on the receiving end and react to it than what we have at hard, our risk-based pricing is really making sure that we're allocating capital and supporting the policies that meet our threshold or return thresholds. I think that we still believe that the even though there are some push to become, get more affordable housing available to folks, which we are encouraging. There is still a very healthy level of appreciation for the risk in Washington. So we're not overly concerned with that, and most of the targeted markets that are towards that these policies are geared towards would be the lower FICO and most likely the higher LTVs, which is not typically where we are more most competitive and most focus on at this point in time, so we're not losing sleep over this at least.

## Q - Elyse Greenspan {BIO 17263315 <GO>}

Okay. Thanks, Marc. I appreciate all the colors.

## A - Marc Grandisson {BIO 4369887 <GO>}

Thanks, Elyse.

## Operator

Our next question comes from Jimmy Bhullar with JPMorgan.

## Q - Jimmy Bhullar {BIO 4278955 <GO>}

I had a couple of questions. First is on the MI business, can you talk about delinquencies obviously have improved a little bit, there is still fairly elevated and it seems like a lot of this has to do with this government forbearance programs versus actual hardship on the part of the borrower, but if you could just talk about what your view is and I think that you addressed a little bit of that in your comments about equity in homes and stuff?

And then secondly, on your COVID related reserves. I think last quarter you gave a number that around 70% or so were still in IBNR. And you haven't had much in the way of additional losses recently, so I'm just wondering what the likelihood is that number might be overly conservative now given the economy is opening up and the chances of reserve releases related to those?

## A - Marc Grandisson {BIO 4369887 <GO>}

Yes, on the forbearance, clearly well, I would have a different spin on you than you would have obviously on the delinquency rate at 3.86% I think it's a pretty, pretty good place to be, we're not still out of the COVID, some of the potential issues that could develop. It's just looking very, very good obviously, but we're still not out of it completely. Of the 3.86% by two-thirds of our delinquencies are actually in the forbearance program and of those who are in those forbearance program delinquency 90% -- 94% of them actually have more than 10% of equity. So, yes, there is the delinquency counts staying in the inventory, we still have an extension of the forbearance moratorium until the end of June, but potentially could be extended.

And that's all with the idea that the GSCs and sort of the government agencies want the homeowners to give back on their feet. So it's helping, it's maintaining a little bit higher level of uncertainty, because the forbearance are still there, you still don't know 100% how they're going to turn out, but we still have many cure that's occurred out of the forbearances that were put in there back in April or May of last year right two-thirds of them are fewer now back into current being current. So on one hand yes, it shows as a higher number in terms of delinquency, but when you look at being two thirds forbearance program, which is very helpful for the homeowners on the heels of a high level of equity, this is all things considered, very reasonable place for us to be, and we think it's going to get most likely get better throughout the end of the year and go back to way we saw core delinquency, which is a 1.4% or 1.35%, which is more like what we have historically seen at least as of late as of the end of 2019. I let Francois to answer the COVID question?

## A - Francois Morin {BIO 17410715 <GO>}

Yeah. Jimmy on the COVID yeah I mentioned it quickly. I think we're still at 65% in IBNR and ACRS through the end of the quarter, are we redundant I mean, again, it's early for us to have a view, I mean whether that mean what we accrued on our reserves are is going to hold up. I think we're, again we're very comfortable that we've got a prudent provision for COVID but COVID-related claims, but it's going to take a while for everything to settle out and from that point of view, I would think that a lot of our reserves will probably stay in IBNR for quite some time and we'll see from there.

## Q - Jimmy Bhullar {BIO 4278955 <GO>}

Okay. Thank you.

## A - Marc Grandisson {BIO 4369887 <GO>}

Yup.

## Operator

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

## Q - Joshua Shanker {BIO 5292022 <GO>}

Thank you. A quickie and a longer one. The quickie is, so I understand that the expenses are elevated in the first quarter, but first quarter 2020 didn't have the same elevated expenses, can you talk about what was exceptional in that quarter. And why maybe, going forward we should, how we should think about 1Q expenses?

## A - Francois Morin {BIO 17410715 <GO>}

So two things I'd say. One is I encourage everyone to compare the first quarter 2020 expense ratio on the operating expenses compared to that the last three quarters of 2020 and there is a quite, there is a good differential there, so that I think is, that's what I was trying to refer to and recognize that there is, what we saw in Q1 is, in 2021 we don't expect is going to reoccur or is going to be the going forward rate. This quarter a little bit more I mean I don't want to get too much in the weeds, but there is a couple of things that I think impacted this quarter's results, one is call it short-term bonus related compensation where we have a process where we accrue bonuses throughout the year and what we think is going to happen and when they get finalized in February, the following year then there is a true up and last year based on where we were in the first certainly, the first six to nine months of the year, we slowed down our accruals a little bit because we didn't think that the performance would be there and that turned out to be actually not as bad as we had thought at that time. So there is effectively this quarter there is a bit of a catch up on the call of the bonus accrual that came through. So I call that a bit one-off. And second there is on the equity side, there is performance shares that were introduced three years ago, last year was the first time that or this year, the first time they actually vested and there is a final calculation that came through this quarter and while we accrued for, that's never quite perfect and we do our best, but a bit of a catch-up going on this quarter as well here. So I'd say those are the kind of two things I'd point you to, I think it's OpEx we manage those, we track them very carefully and unfortunately there is a bit of noise from quarter to quarter, but as we look forward for the rest of the year. I think we're, we're very confident that they're going to trend down from the current level.

## Q - Joshua Shanker {BIO 5292022 <GO>}

Okay, great. And that's the second question is now, this is a back of the envelope calculation. Maybe I'm not exactly right, but it looks to me that you're carrying right now about $20,000 worth of reserves per mortgage and defaults and I look back before the pandemic, you were like at a little bit higher, maybe $21,000, but we kind of go back to the same reserve per notice that you were before the pandemic, when I think about the pool of mortgage in default that you have right now my thought to be that a higher probability of those are going to cure then in run rate conditions when people go into default, am I wrong to think that? Do you think that when you think of the pool that the percentage that we're going to cure is normal to history or do you think a higher percentage will cure a higher will go into claim given the amount you're carrying for reserves, I guess there's a lot in there, but may give some thoughts here.

## A - Marc Grandisson {BIO 4369887 <GO>}

Yeah, I think, Josh. I think the probably a shorter answer than you might expect actually the fact is that it's very uncertain and we took, we did take, we believe we've taken a conservative at is prudent, numbers to put the reserve because of due to the tremendous uncertainty surrounding what was going to happen however, loan to forbearance would have would take place would be in place, what would the economy turn around, how long would COVID last and frankly we still again that we said to you Josh, we're still not out of the wood. So we have taken not only us, I think as an industry, people have taken a somewhat prudent approach to reserving. You're right, we should expect everything else being equal and forbearance programs in the past have showed us that when you had an 8% ultimate claims rate on a regular delinquency when you compare to the forbearance through a cat event for instance, that would be sort of a 1% to 2% ultimate claims rate, but we decided to be a bit more careful and prudent in establishing reserve.

And I would say that we haven't really changed our mind quite yet. I think we've also put a moratorium on our revising our prior reserves and we'll see what the data takes us for the next several quarters. And I hope that your assumption on the back of the envelope is right and I hope that we prove to ourselves that it was yes indeed a regular a more of a regular forbearance phenomenon in terms of curing than a more of a regular DQ phenomena.

## Q - Joshua Shanker {BIO 5292022 <GO>}

Is there a timeline for when that moratorium ends or is that a subjective item?

## A - Marc Grandisson {BIO 4369887 <GO>}

On our reserving, we, I think if you look at the CFO I think that's pretty difficult and I think we just have to take several more quarters, I don't think we're quite ready yet for that. I would expect Josh over the next two, three quarters, it's certainly inflecting a lot quicker than we would have anticipated back in third quarter of 2020. So we're like you seeing things well at some point we'll need to be as we are typically when we have solid data to back it will, we'll take action at that point in time. And I'm hoping that it's over the next three to four quarters.

## Q - Joshua Shanker {BIO 5292022 <GO>}

Thank you.

## A - Marc Grandisson {BIO 4369887 <GO>}

You are welcome.

## Operator

Our next question comes from John Collins with Dowling and Partners.

## Q - Geoff Dunn {BIO 3447798 <GO>}

Good morning, it's actually Geoff Dunn. Two questions, one, just back on the provision this quarter from MI, can you share the average severity assumption that went along with the 91 incidents, I think it was about 54K last quarter?

## A - Marc Grandisson {BIO 4369887 <GO>}

4800

## Q - Geoff Dunn {BIO 3447798 <GO>}

What was the total severity factor?

## A - Marc Grandisson {BIO 4369887 <GO>}

9.1% is that the one you're looking at?

## Q - Geoff Dunn {BIO 3447798 <GO>}

I'm sorry, so 4800 was the actual provision

## A - Marc Grandisson {BIO 4369887 <GO>}

Average reserve.

## Q - Geoff Dunn {BIO 3447798 <GO>}

Okay, perfect. And then secondly, Francois. You mentioned looking for dividends in the back half of the year from MI, how do you think about the capacity there given that the surplus levels of both the primaries are down to about $200 million at year-end?

## A - Francois Morin {BIO 17410715 <GO>}

Well, we got room and that's for sure. Yeah, the one thing that is a factor for us, and I'm sure many of the peers as contingency reserves. So there is a right so it's not purely I'd say PMIs driven, there is NAIC constraints around the amount of dividends we can declare based on contingency reserves and the tenure time of that. So while on the face of it, you might say, all 190% PMI ratio there is tons of capacity, we have some and we're happy with it. But no question that we will have to go through a bit more modeling and figure out how much we could move out and then there is other sources for those funds but ballpark a couple of hundred million I think is easily assuming we get the approval from both the FHFA and GSCs and the state regulators, and then if we can get more, we will certainly trying to do so.

## Q - Geoff Dunn {BIO 3447798 <GO>}

So would you say $200 million, is that assume that you can commence the regualtors to let you release contingencies earlier or do you think you can bleed surplus down below $100 million to each of the operating companies?

## A - Marc Grandisson {BIO 4369887 <GO>}

Well, no, we think we, it's, we would be within, we wouldn't do anything, any special dividends from the regulators, it'd be very much within what's allowed from the regulatory point of view.

## Q - Geoff Dunn {BIO 3447798 <GO>}

Okay, all right, thanks.

## A - Marc Grandisson {BIO 4369887 <GO>}

Yup.

## Operator

Our next question comes from Brian Meredith with UBS.

## Q - Brian Meredith {BIO 3108204 <GO>}

Hi, a couple of questions here for you, first, Marc I'm just curious. Now that Watford is going to be, I guess 40% of it, if you look at kind of the model there, it's a little different in the model, you typically deploy in your traditional business, combined ratio is well above 100, is there any thoughts to maybe changing the strategy there a little bit or are you going to keep the same one, and then as you book those numbers you are going to assume those realized gains are kind of going through your operating results?

## A - Marc Grandisson {BIO 4369887 <GO>}

Yeah, I'll let the second question to Francois. The first part Brian is, I think that, first, we have 40%, so we're not majority so there is a Board of Director but I do believe that at heart, this is a harder market, this is a good market on the underwriting side, and I think that collectively, we believe that there is an opportunity to maybe focus more to risk or the effort of the capital towards the underwriting as opposed to the investment side of things, but this will have to take place over time, right, we will have to also talk to our the partners that are currently in Watford and see what expectations they have in return. So this is an ongoing discussion, but at a high level right I think that we should expect Watford to become a little bit more strategic from an opportunistic positioning right now at this point in the cycle based on the opportunities that we have right now. I think that the reliance on investment income was probably more in favor back in 2014 and 2015.

## Q - Brian Meredith {BIO 3108204 <GO>}

Makes sense.

## A - Francois Morin {BIO 17410715 <GO>}

Yeah, and quickly and by part 2 of your question, Brian the listen, with the acquisition it opens up I call it a little window for us to take a harder look at accounting policies and what you mentioned around realized gains is something that we'll look at as well in the at closing I mean what we're already looking at it, I mean just a matter of, we got a few documents and agreement that need to get finalized, but we'll be, we'll make sure we communicate to you exactly how if things are going to change, how they're going to impact our financials.

## Q - Brian Meredith {BIO 3108204 <GO>}

Great. And then Marc my second question is, some of the, I guess calls we've heard so far from the insurance brokers this quarter have highlighted the fact that new business has gotten competitive, renewals, companies still try to raise prices, but new business is getting much more competitive. I'm just curious, are you seeing that and what does that potentially mean for if you're kind of lengthen duration of the cycle, are we getting towards the end, when that happens?

## A - Marc Grandisson {BIO 4369887 <GO>}

No, I don't think so, I think that the, some comments were made as well Brian about the E&S markets to be very vibrant, which is a good sign of not dislocation, but really a renewed or a new underwriting appetite by the main, the main street writers, that's not going away. In new business it's normal to be expected, right, I think we went through the first year from underwriting, shuffling and re-adjusting to the new underwriting policy to now and then well, let's say, what do we have and what do we want to focus on in terms of new business and maybe seek and grow that and frankly all of us here, Brian talk about how the good, the market is, so I think it probably makes them a little bit more willing to take on those policies, but, I think hardening market and I will add that new business could be more competitive but the rates are not going down.

I mean it's not like somebody is coming to undercut which is really the important factor here, I do believe that the new business typically and we were once, way back when a new player in the marketplace and I do believe that we have pretty lofty expectation in terms of pricing, we would need to get on that piece of business and I'm expecting and we just what we're seeing, we're not seeing the softening from that positioning from the external world. And frankly, Brian, I mean the existing players are not growing so significantly that is creating a lot of competition necessary, the new business is probably needs to find a new home with new players.

So that's not that surprising. So I wouldn't lose, I'm not losing sleep over this, hard market is not last forever. As you can appreciate, but we're really in the second round of this, I would not be surprised we have another round to go. And even after that Brian, it takes a bit longer for things to get softer yet again to the point of not getting the returns. So we have win our sales for a little while here.

## Q - Brian Meredith {BIO 3108204 <GO>}

Great. And then one just last quick one here, I noticed your construction and national accounts business finally started to grow again in the first quarter, is there anything unusual there or is that something that we should see picking up growth as the economy improves?

## A - Marc Grandisson {BIO 4369887 <GO>}

I think a couple of things I think seeking quality accounts, are still some shuffling of accounts around, some people are debating what to do, stay where clients, were able to we have a very good product offering both on these instances, and this is, these are two areas actually where I referred to in my comments where that didn't seem to be moving a whole lot. And then we're seeing finally for the first time rates moving in the right directions as you could appreciate, a lot of it is workers comp driven, but it's still we can still see clients working with us as we evidence the lack of interest in investment income, some COVID exposures. I think we're seeing some good traction there and still offering good product, but we have to be careful obviously, we are here for the long haul, this is a franchise positioning for us, so little bit of everything. It's a really good story for us and I'm glad you picked that up right.

## Q - Brian Meredith {BIO 3108204 <GO>}

Great, thank you.

## A - Marc Grandisson {BIO 4369887 <GO>}

Thank you.

## Operator

Our next question comes from Derek Han with KBW.

## Q - Derek Han {BIO 20338442 <GO>}

Good morning, thanks for taking my question. My first question is, you talked about strong pricing, a new accounts, driving growth in the property business line within reinsurance and how are you thinking about the loss trends in that line of business both in reinsurance and insurance?

## A - Marc Grandisson {BIO 4369887 <GO>}

Yeah. So very much with the same way we would the other lines of business Derek, where we would look at the history of the loss costs and modeling out in terms of, in speaking specifically talk about cat loss specifically just looking at the cat history of these accounts that are similar if it's a reinsurance portfolio then is the experience on the portfolio and build in some modeling magic I would call it based on our own expectations of demand surge or maybe some unmodeled perspective and we just price it this way to make sure we have a healthy level of margin and it's pretty nothing new from what we've had historically, I think on the property, the one, beautiful thing about property is the, the feedback loop is a lot quicker, as opposed to a GL portfolio where it may take you four, five, six, 10 years sometimes, to really figure out whether you did the right thing and you price your goods at the right level, property allows us to do a lot of repricing.

And right now our ability to grow in that lines of business is it could also be willing and able to go anywhere on the reinsurance side, for that matter, in terms of core share or risk excess where some of the other players out there could be a little bit more reluctant to go and the one thing you have to keep in mind when you price for business and property, you can just take the last data point and saying this is going to be a recurring one you have to take a small and a longer-term period with the proper caveat on the margin for safety to price. So I'm trying to give you a 25-year knowledge base in 5 minutes, I'm not sure I'll be doing that great. But I think, hopefully, that gives you a good flavor for it.

## A - Francois Morin {BIO 17410715 <GO>}

Yeah. And, but the one thing I'll add to that. I think there has certainly been a lot of press in the last few weeks and months around building materials, costs going through the roof in some areas. So, that's certainly something that our underwriters are fully aware of and fully engaged in adjusting their view of price as they trend and so that's part of the underwriting decision when you're in some parts of the country where cost of materials whether through shortage or just a lot of significant demand. I think that is impacting the trends or that the pricing that we're trying to get from on the product. So I'd say that's maybe a bit more on the insurance side more direct but I think it's a bit of a something that is more and more top of mind that currently.

## Q - Derek Han {BIO 20338442 <GO>}

That's really helpful. And then I have a quick second question, there was a sequential increase in the MI G&A ratio, was that all incentive comp?

## A - Francois Morin {BIO 17410715 <GO>}

Well, there's a couple of things, I mean sequential there is always Q1 is yes there is comp, but there is also and it gets very granular around payroll taxes and there is other things that we're just we picked up more of those expenses in the first quarter and they do decrease over time throughout the year or so, I'd say, yes, for the most part is incentive comp is yeah, a big part of it, but there is also a few other things that just enhanced staff or make it stand a bit more but again, not from our point of view, your point of view, you should fully expect a return back to a lower level and starting in the second quarter.

## Q - Derek Han {BIO 20338442 <GO>}

Okay, thank you for all the answers.

## A - Marc Grandisson {BIO 4369887 <GO>}

Yup.

## Operator

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

## A - Marc Grandisson {BIO 4369887 <GO>}

Thank you for joining us this morning. And we're looking forward for better news hopefully in the second quarter.

## Operator

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