Barclays Global Financial Services Conference

Company Participants

- Francois Morin, EVP, CFO & Treasurer
- Marc Grandisson, CEO & Director
- Tracy Dolin-Benguigui, Analyst

Presentation

Tracy Dolin-Benguigui

Good morning. I'm Tracy Benguigui, Insurance analyst at Barclays. And I'm pleased to host this fireside session with Arch. Speaker is Marc Grandisson, CEO; Francois Morin, CFO.

We have a lot to cover. I would just remind folks some housekeeping items. We do have a portal where you could submit questions. We're also doing some polling questions, so that will be the survey button, and we can review those responses later in the session.

With that, I think I will quickly turn over to Marc if he has some opening remarks.

Marc Grandisson {BIO 4369887 <GO>}

Well, just nice to see you. I was hoping that by this time, the pandemic unfolding that we'll be able to be face to face. But hopefully, that's still happening in not too distant future.

Now it's great to be here. We are very happy to share our thoughts about the market. I'm not sure that we'll, like I told you before, that we'll add much more to what you've heard already, but you'll probably have the little arch play over to things and certainly see our own perspective.

I think we have a couple of things that, for us, are a bit different than others. Like our MI business, for instance, is very different than most other companies. We're very pleased with it and very happy.

And it's a good story, right? It's a good time to be talking to you folks. It's a good market. Good opportunities ahead. So we're pretty excited.

Even though we had a couple of storms that brewed in the Atlantic or the Gulf recently, I think, overall, the industry and certainly Arch is in a really good shape, and we're really leaning into this market very nicely.

So very pleased to be here.

Questions And Answers

A - Tracy Dolin-Benguigui

Excellent. So the first audience response question that I have is we would all agree that the need for rate is not capital replenishment, which of the factors below is the largest driving force behind rate hardening? There's just a huge narrative out there. So if it's something that I'm trying to wrap my head around. Would it be years of underpricing, complacency higher catastrophe frequency events like climate change, social inflation, general inflation, lower investment yields or heightened risk aversion?

As we're waiting for those responses to pop up if I just had to ping like one answer, Marc, what do you think is the largest driving force in your communication with brokers and clients to sustain pricing action?

A - Marc Grandisson {BIO 4369887 <GO>}

Yes. I think that it's a combination of all those, but it's really the last one that you mentioned, which is a heightened risk perception is really what drives pricing momentum. I think that there's fatigue overall in the industry in terms of results, not living up or panning out to where they would need to be. The property cat is certainly an example. So I think overall, it's a combination of all these things.

And by virtue of climate change, uncertainties, social inflation uncertainties, having really a couple of four, five years of underperforming in terms of underwriting-wise and having, frankly, higher capital requirements, right, overall in the industry. I think it just creates a bit more -- not aversion, but a little bit more sensitivity to the risk in our head and the need to get more rate to make sure that we're -- we have enough margin safety as an industry to trade forward. So a bit of everything.

A - Tracy Dolin-Benguigui

Well, I guess the bare case I hear on hard pricing is that absent a traditional catalyst like a capital event, the real catalyst behind hard pricing is buffering reserves for multiple years of pricing complacency. What is your take on that?

A - Marc Grandisson {BIO 4369887 <GO>}

Well, I think that -- the other thing -- it's hard for me to know what other people have -- facing with. But from our perspective, very much like the '98 to 2000 years, '97 to 2000 years, you have -- when you have four or five years of slightly less than adequate pricing, even sometimes more than inadequate pricing for sustainable time that you see losses happen and you sort of don't know how it can develop. So it sort of makes you, as a manager of insurance risk, a bit more careful about this. So I think it's certainly there.

I don't think we've seen a strong evidence through the reporting numbers as an industry, but I do believe that there might be some pressure being built up. And I think that Covid-19 and what happened and in terms of slowing the economy probably delayed that perhaps that recognition or the speed at which is coming through in the industry.

But certainly, it's something that, at the very least, uncertainties around it, like as I mentioned just before, it's clearly something that is near and dear to everybody's -- all the CEOs' minds in the industry.

A - Tracy Dolin-Benguigui

After six consecutive quarters of rate increases above 10%, and as you characterize comfortably ahead of loss trend, what is your crystal ball for the length and the size of that rate momentum to continue?

A - Marc Grandisson {BIO 4369887 <GO>}

Yes. If I knew this, I would be in your position or I'd be investing in the space. I wouldn't be running them.

I think all kidding aside, I think that a hard market, typically a hardening market lasts much more than six quarters, right? If I look back in history, if history can be sort of a teacher to us, I mean, you look at the 2000 to 2003, the market rate increases were there for three to four -- three years, really. I mean the issue is it's not the same clip, no increase. It does tend to increase a lot quicker, a lot faster earlier because you need that correction to take hold.

But then the next -- the last year or the last several quarters, it's a bit less. So I would say right now, we're probably middle of the way into pricing improving. I think it's kind of hard for us to see a turn right away.

Market do not turn flip up and down that quickly. They tend to flip up a lot quicker than they flip down. So it tends to be a ramp up very rapidly, which we've seen over the last six to eight quarters. And we'll probably see a gradual -- after that point, a gradual release because we also have to make sure that we're comfortable with the results as they develop. And it takes a while. In the liability business, Tracy, as you know, sometimes it takes two to three years to realize it as we saw in '04, '05, '06 period from the casualty line.

So we have this -- this has momentum. It's a human system. And clearly, people are collectively thinking about needing for more rate. I mean you hear it everywhere. When everybody is agreeing and understanding it, it tends to -- it's like a big boat. It takes a long time to shift away from its course.

A - Tracy Dolin-Benguigui

Okay. Great. And you said there is a need for more rate. So how would you characterize your loss trend as it is not static? Like what it is now and how much higher connect climb?

A - Marc Grandisson {BIO 4369887 <GO>}

Francois, do you want to chime this one?

FINAL

Bloomberg Transcript

A - Francois Morin {BIO 17410715 <GO>}

Well, we -- I mean, we've always taken a long-term view on trend. We don't want to get caught in a corner where we just focus on what's transpired the last year or two or three years, and that can -- I think that can be dangerous. And so from our point of view, we've taken a long-term view of trend, right?

That's been and Marc has said -- we said many times, like roughly 200 to 250 bps above the CPI is kind of what we see long-term inflation being for the types of lines of business we're in. Certainly, for excess layers, it's more in the double digits, right, 8% to 12%. So it varies. So it's hard to make a blanket statement what trend it's at because, as you know, it varies by line of business and whether your primary or excess.

In terms of social inflation, though, I think people -- there's a bit of -- there's noise around it. I think at this point, while we do see it in some areas, I wouldn't say it's uniform across the whole book. I think some of it is a bit more -- it's less precise. It hasn't really shown up in the data yet. And you hear about a case here, a case there, it makes sense. You read about it in the news, but whether it applies to the whole book is something that we look at. But at this point, it really hasn't transpired. And I can't say it's really been there across the whole book.

So that's how we think about it. We're still kind of in the 3% to 5% kind of trend expectations for most of our lines of business, and then we make adjustments on specific cases.

A - Tracy Dolin-Benguigui

You mentioned CPI. So on inflation, do you think investor concerns are overblown because we just haven't really been in a real inflationary environment. How much insurance risk is really tied to CPI type of inflation? And I'm just also wondering if you could touch upon some countervailing factors like higher insurable exposures or higher asset appreciation.

A - Francois Morin {BIO 17410715 <GO>}

Well, yes, that's where we got -- we have to be careful. No question that what you see on the news, whether it's on property, right, the cost of lumber has made the headlines for the last six months or so. And people, I think, rightly assume that if there's a shortage of labor, a shortage of manpower and materials are more expensive, it's going to materialize in higher loss costs, certainly on first-party property type losses.

Whether that's sustainable, whether that reverts back to more of a long-term kind of view or expectations on losses, we think it will. But you're right. That means a lot of the lines of business on the liability side are a function of the level of activity in the economy. And what we saw last year in 2020 with people being pretty much -- a lot of people being shut down, less cars on the road, less traffic in stores.

So that just reduces and that's more, I'd say, a frequency thing than a severity thing. I think the severity trends have been there, I think, have been pretty consistent. There's always a debate over whether courts being closed, whether that delayed some jury settlements or awards, et cetera. So that's all part of the equation that we have to think about.

But -- no question that a lot of lines of business are directly linked to the level of economic activity. And if you -- if GDP is the metric that we use for that, yes, we should -- as GDP picks back up, after the dip we saw last year, I think we should be seeing some levels of maybe slightly higher inflation for the next few quarters, at least.

A - Marc Grandisson {BIO 4369887 <GO>}

Yes. Tracy, for what it's worth, most of the lines of business have an exposure base that you price off of that actually has some inflation sensitivity to it. So you do tend to reflect that. The only thing is you may have a little bit above that looking back. But I think if you appropriately -- like we just talked about, if you use the CPI as the inflation rate, it's 1.7%, right, roughly, right, 1.8%, for last four years. We would argue that you're lagging a little bit there.

So I think it depends with the investors what the investors are assuming in terms of inflation rate. And as you heard Francois mentioned, we tend to be a bit more realistic and know that the CPI -- because insurance tends to make up for a lot of issues, indemnity, there's a lot of people who want to get a piece of the action. So it does tend to create more inflation.

And as long as you stay sane on the long term, like Francois just mentioned, I think you avoid the huge mistake that are structurally on your book for many years. So I guess it depends on what your clients or the stocks you're looking at, what they've assumed in terms of inflation.

A - Tracy Dolin-Benguigui

Yes. I guess, as I mentioned, we haven't really been in this inflationary environment. So everyone's trying to wrap their head around that.

Maybe just turning quickly to catastrophes. I mean it's been a really active quarter and it hasn't even closed yet. I mean, PCS basically doesn't need more than 20 events. So we have Ida out there, but also European flood, you have California wildfires. So I'm just wondering what your early take is on third quarter activity, maybe Ida, in particular? And my follow-up would be, do all these events sustain pricing?

A - Marc Grandisson {BIO 4369887 <GO>}

I'll start a little bit and Francois can talk about the return. I mean, at a high level, our returns are -- again, that we talked about in the cat, the returns should be higher. And I think Ida and the wildfire and the storm burn in Europe.

So a reminder that we need to get better pricing. But that's not new, Tracy. While we've been saying about pricing on a cat being a little bit lower than we would expect it to be on a risk-adjusted basis for two, three years now. And you see our rates -- writings on property cat have not grown a whole out on a net basis for a little while.

And I think it's due to the fact that we have some capital providers who have lower expected returns. And I think it does dampen what we would otherwise see as a -- perhaps a higher -- higher demand for pricing from the traditional reinsurance marketplace. So this is definitely a phenomenon that we've seen, Tracy, right, for five or six years. It's not new. And I think it's just another reminder of that.

Now my argument is always that, listen, we still have to do what's right for our shareholders and make sure that our net return and our return that we provide for our shareholders is -- does clear that risk adjusted. I think we would ask for a higher than the traditional 15% return, frankly, on a property cat because of all the uncertainties that it comes with it.

But again, but if you're competing with someone who is okay with a much less in this, it's really hard to compete and to make a difference. So we're still hopeful, though, I think that Ida and burn are great reminders or sad reminders that the world is risky, and we do need to get a higher return over the long haul.

And I think if you look at the last four years, not only this quarter, Tracy, the last four years have been an underperforming area in the property cat space, in general, not necessarily just for the cat XL but in the property cat exposure. If you roll property cat, it hasn't been a huge winner over the last four years. And I think that hopefully, the alternative provider of capital will sort of come to the table and appreciate that maybe some more -- there's more need for returns in that space.

So I think the short -- that was a long answer. I think the short answer I would tell you is if we see the rates going up to the level that we like and we want -- that we are appreciating and comfortable with the returns, you'll see a property cat writing increase, and it hasn't happened over the last couple of years. So I think when you see us increase cat writings is when you can see yourself, okay, now pricing is getting above a risk-adjusted written that's acceptable for Arch.

A - Tracy Dolin-Benguigui

Okay. So maybe outside your risk appetite, how do you think these losses are going to be shaping up for the industry?

A - Marc Grandisson {BIO 4369887 <GO>}

Well, I'll just tell you what I heard recently, but I mean you have to be careful, right, because I've called a hard market in cat about four times of the last four times it didn't happen. So I got to be -- I don't have a great track record in predicting it. But logic should dictate and what happens in the marketplace is very different.

So I think right now, there seems to be a -- not a consensus, but the initial discussion from the alternative capital is to say, well, maybe we have a cat fatigue, cat return fatigue.

Trapped capital will probably be another event. We're closer to 1/1. They've been promised price increases every time there's a cat event for a little while. They didn't come through as much as they would have hoped for and had more losses coming through.

So we're hearing that a lot more questioning on a third-party capital, and definitely, a flag to quality. So people are really trying to sell to your hub. Let me take a step back and let me re-underwrite the underwriters that I'm providing -- that I'm giving capital to, to make sure that I'm optimizing my return and that I'm making sure I'm taking the best advantage of the market return.

So we hope that -- we're cautiously optimistic for the 1/1 renewal. I think we do need more rate. We've said it for a while now. Having the storm, the winter storm in Texas earlier in the year, let's not forget that. And having these two events this quarter, I think it just makes the case for -- certainly, our team is expecting to get more pricing for them to play going forward. I don't think we're the only ones out there.

So again, building on the momentum to sustain a bit more property increase, probably cat increase in the 1/1 renewal. That's what we're hoping and thinking is going to shape up right now. But I've been wrong before, we'll see how -- to your point, it's all about supply and demand of capital. So we think that the supply of capital now may be taking a pause and must be bit more bespoke, a bit more thoughtful about the way they're doing it. That's what it seems to be from last week, the narrative.

A - Tracy Dolin-Benguigui

Got it. I mean, Arch is known for cycle management. You did compress growth in 2015 to '18. But you did grow meaningfully in 2019 before the industry had taken real noticeable rate increases. It was just the beginning. So in hindsight, do you feel good about this? Or do you think you've met your risk-adjusted return hurdle?

A - Marc Grandisson {BIO 4369887 <GO>}

Yes. I mean, and the growth we had in '19 was already in some -- I mean, whenever we talk about an overall rate increase in our speeches, it's a blend of all the lines of business. But underneath that, and it's a lot less now, but you have really a wide range of rate increases. So if you look at the increase in 2019, they were in lines of business in areas where there was pressure already building -- built up and pricing was getting us to the higher threshold.

And frankly, one thing that's very important to us is one of our key principles is when a market gets hard, you need to own the renewals. You need to get on it. Because by the time people realize it's good, you won't be able to get on it.

So it really behooves us to maybe, maybe we have been earlier in some lines of business that we, in retrospect, should have been on, but it will -- if we hadn't done this, we wouldn't have had the next three years of our performance that we will get -- be picking up as a result of that. That's a principle I learned back in the '90s from Paul Ingrey. That's something that we're very -- that's very near and dear to our hearts.

So owning the renewal is very important in that space. So that's why you probably saw us tilt and switch there because we want to make sure that we're -- as soon as we could see the market sort of getting there, it took us a while to tell you on The Street, but we were seeing the building momentum of rate increases and momentum of hardening.

As soon as we see it happening, we just lean into it, and we started leaning into it heavily. And we got heavier and heavier, as you know. And I would say we're carrying on this leaning hard into it.

A - Tracy Dolin-Benguigui

Got it. I want to touch upon all these start-ups and scale-ups that are coming into reinsurance and specialty insurance. As I look back at the class of 2001, I remember being that $500 million of capital was like the floor to operate, then it came $1 billion, then it just grew from there, especially for casualty risk. What do you think is the new floor for capital for a start-up to be a formidable player?

A - Marc Grandisson {BIO 4369887 <GO>}

To me, to recreate an Arch or to -- it depends what you want to recreate, right? If you want to -- right, it depends what you want to recreate.

I think that the floor -- it's funny you say that because the floor -- I did some work on the capital requirements from the various rating agencies back in 2001 versus now. And $1 billion 21 years ago is really $2 billion right now. It's about twice as much capital needing -- needed to even play and have a similar rating. So there are more capital requirements than there were 20 years ago.

But I think if you are going to be specialized, if you just -- if you're an insurance player, you probably don't need $2 billion. But if you're going to be like us, a combination of -- a collective of various units to deploy capital, we had $1 billion back into -- I can only speak from experience, right? Because I'm not sure about the other ones. But from my perspective, we had $1 billion when we started 2001, and we were pressing hard on the accelerator. And we had to go and raise the secondary very, very early on because it was so successful.

So I would say that $2 billion to $2.5 billion is -- if you want to recreate an Arch and really take the market, to where it needs to get to, that's probably what you need to -- that you would need to recreate an Arch. But I don't know, right? I mean it depends on your aspirations to what you want to recreate. And I would say that, to be fair, we didn't think we're going to create a company such of our size as we are right now 20 years ago. That's not what we were thinking about.

But I think a couple of billion. I think Convex is about a couple of billion. I think they've been successful in the marketplace. We see them being a decent player and really being able to work their way into placements.

So I mean, clients are also -- not worried but they're concerned and they're rightfully prudent in providing big limits, giving -- taking big limits from smaller players. They want to make sure that the risk management is -- will be proven before they place more risk into this. So I'd say a couple of billion is probably to create a broad-based multiline business. This is my view.

A - Tracy Dolin-Benguigui

Got it.

A - Francois Morin {BIO 17410715 <GO>}

Yes. I'd add to that. I think there is a little bit of the market reception to size, whether you're an approved reinsurer, whether the rating agencies give you the ratings you're looking for. So that's an angle that you have to -- that's certainly part of the discussion.

But I think I just want to throw in here that the costs that we're facing now as an industry in terms of compliance, regulation, you could -- 20 years ago, you could open up a shop and on Front Street in Bermuda with a couple of computers and off you went -- off running you went. And now it's -- it's a much more complicated system you have to navigate through that's expensive, whether it's cyber and all the systems you have to get to be able to operate in this environment.

So it's something that I think there's a minimum scale that is, I think maybe has gone up a little bit from what it was 20 years ago just because just the infrastructure needs that are required to really be successful in this market that are just a bit higher than they were back then.

A - Tracy Dolin-Benguigui

Got it. We've all heard from you that MI and P&C operate a different market cycles and having MI business actually allows Arch to be more agile during changes in market conditions. Why do you think investors are not getting the punch line here? What kind of bias do you want to squash? And you did talk about capital a number of times. How should we be thinking about your capital diversification benefits?

A - Marc Grandisson {BIO 4369887 <GO>}

Yes. I think -- It's kind of hard because we've tried to -- we've played that part, and I read your note last week, which was very appropriate. So it is something that we believe is a competitive advantage to us because we do -- we are able to still provide a reasonable return to our shareholders, at least for the last four or five years. Not as much as we would have wanted, but still reasonable despite having big headwinds up until 2020 and 2019 on the P&C side.

I think that the question -- I think what's not missing -- the backdrop to this phenomenon, Id' say, well, I can recreate MI by buying an MI company, and I can buy a P&C company by buying a P&C company.

But the question and what we like to tell the world, and I think we've proven that over the last 21 years, 20 years is that but you can't buy Arch management in either of those. Arch management is the only place where you can get it is at Arch, buying the MI and the P&C. And I think that we've proven ourselves to be pretty good, pretty adept at being capital managers and really moving things around and playing around.

And I think over time, I think you sort of backing us in terms of being able on a long-term basis. If you're a long-term player, I think Arch is a good place from that perspective. If you're just looking for the next quarter, it might be a totally different story. That's not what we're -- Francois and I manage the business for. We manage it for the long haul. And I think you'll see that over time, our results are going to be higher with a much less risk around the expected margin. And that's because of our ability to move around those things.

In addition to this, I would say that having MI or having P&C, because we might be coming to a place where MI at some point becomes a bit softer, and we can still deploy capital on the P&C side is that it allows us to stay sane and stay economically rational through a market. And that's really, really important from our perspective. And I think that what I would tell the world is you need to think about yourself, is Arch a good steward of capital and can they really manage capital effectively? And I think we've proven this for the last 20 years.

But it's hard for people to appreciate. It's kind of hard from the outside to see the inner workings of Arch. And I think if you see -- if you saw the Board meeting discussion we had last week, the quarterly call we have on our units. I mean, the capital management is a constant, constant discussion in our company. It's not about market share. It's not about whatever, all the top line, it's always about capital management.

And you saw we bought a fair amount of shares this year because we do believe that, yes, you're right, the market is missing some of that aspect of it. And now what we have is the three units, the B and C insurance, reinsurance and MI, really, really at a high level in terms of return expectations. So we're in an unusual place where we've never seen this before, Tracy. It's like it's a beautiful place for Arch to be. The three businesses are hitting on all cylinders. And it's a really nice place. And very nice thing to see.

It's a -- based on our meetings, Francois and I with our team a lot easier, a lot of easier discussions, we have much more fun discussions.

So what I would tell the world -- what I will tell the investors is that you got to first believe in the cycle management. And if you believe in cycle management and believe that Arch is probably the only company that really does it effectively, then you would welcome and be very pleased that they have another place, another way to deploy in and out of markets. That's what I would say. Francois, anything to add or...

A - Francois Morin {BIO 17410715 <GO>}

No.

A - Tracy Dolin-Benguigui

I want to spend a little bit more time on MI. How should we be thinking about the potential of reserve releases, considering you had added $400 million last year, believe since seen higher housing prices, unemployment rates have been trending down, wages are going up, delinquencies are going down. I'm also cognizant that the mortgage forbearance program is ending on October 1 or at least beginning to end.

A - Francois Morin {BIO 17410715 <GO>}

Yes. I think that's a very good question, people. We've gotten that question many times. As you can imagine, people are interested to see how the whole thing plays out. We're still patient. I mean, the one thing that we do think about is, yes, there is a scenario that, as you suggest, that tells us that there may be material reserve releases that would come our way if and when the delinquencies cure, all the borrowers become current again or they come up with some agreement with their lenders. So there's -- that's certainly a scenario.

But again, it's something we've never seen before. So it's a bit -- other forbearance programs that we've seen in the past have been typically around disaster areas, hurricanes and those programs are a lot shorter. They're good for 30 days, 60 days and then the economy -- the local economies pick back up and people get back to work and they get their jobs and then they become current on their mortgages.

So here, while there's a lot of good economic trends that suggest that, yes, this will -- and certainly, the one that we keep telling everybody, and we truly believe in is home price appreciation has been just so much better than anybody could have thought back a year or 18 months ago. That is working in our favor, and that's the highest, the best predictor of performance in mortgages and defaults.

So yes, I mean, no question that if and when the data confirms that the reserves we set up are a bit -- are not necessary, we will release them at the time. Could that start in the fourth quarter? It might, as you said, because the 18-month kind of length of duration of these forbearance -- loans and forbearance will start to roll off, I mean, the vast majority having started last April and May. So in the fourth quarter, this year, we could see some data. But then a bit of a lag. People have to go -- so I mean it could start. And I think maybe the bulk of it might be more in the first half of 2022.

A - Tracy Dolin-Benguigui

Got it. And what is your 12-month outlook for new insurance written, including your view of refinancing activity and portfolio persistency?

A - Francois Morin {BIO 17410715 <GO>}

Well, that's interesting because we went through a very heavy wave of refinancings, as you know, in the last year. So now we're -- we basically, for the -- I mean, pretty much turned the portfolio over almost completely. And what we're thinking and again, depending on how the economy behaves, I think we should see good persistency in our portfolio because we have less incentives to refinance. So that's a positive to us. So the premiums will stay on -- we'll stick to our ribs and we'll have those loans on our -- as part of our portfolio for a longer period.

In terms of NIW, so you would think that refinancings will be down, presumably, if things stay the same. I think the big question mark to us on terms of new home purchases is the inventory. I mean the one thing that we've been lacking and that is lacking in a big way in the economy across the country is really a lack of inventory for starter homes, in particular. So that's where we still see strong growth, strong demand. Does NIW really pick up in a big way I think will depend on how much inventory is available in the market.

And at this point, there's progress being made, but we think there's still a lot to be done specifically for millennials that are looking to maybe make their first home purchase, et cetera. That is something we're watching. But at this point, we think it's going to take a bit of time for the whole -- that whole issue to work itself out.

A - Marc Grandisson {BIO 4369887 <GO>}

Tracy, quickly, a couple of things I will add to this is the NIW is also increasing because the house prices are also increasing. So we, too, are getting inflated -- increasing amount of insurance, which is good news for us.

I think that the -- to go back to what Francois just said, I mean, the refinance was 35%, 40%, as high as that last year when other interest rates were going down. But the purchase is about 90% now, which is -- for the purchase market. But the purchase market expectation from the MBA for the next two, three years is still increasing. And our penetration and the purchase market is clearly what MI is number for. This is what -- we have a much higher market share.

So what we hear our guys on the MI tell us is we had a record last year. We're looking at carrying a really good year this year, but we're not seeing a significant -- that much of a drop next year because of the factors we're mentioning, the pent-up demand for housing. And the key thing is our insurance in force, which really is a driver for future earnings and premium is healthy, stabilized to increasing, and by virtue of the persistency across going back to 75%, 80% that we would expect in a normal case, should bode well for sustainability of earnings and premium in the foreseeable future. So NIW will help us build a bit more than IIF, and that's a good place to be.

A - Tracy Dolin-Benguigui

Got it. Just going to remind everyone that we do have some audience response polling questions. If you could go to the survey button.

The second one I have is Arch had annualized operating ROE of 10.3% for the first half of 2021. My ROE expectation for Arch in 2022 is 8% to 10%, 10% to 12% or above 12%, and we will revisit that. And just on the topic of ROEs, just going back to my old role, I heard reinsurers, insurers talking about achieving 15% ROEs through the cycle. And I guess after the financial crisis, that really became 900 or 1,000 basis points ahead of the risk-free rate, which would really imply that during the hard part of this cycle, returns will have to be so extraordinary that will make up for that high single-digit returns during the soft market. Do you think reinsurers or insurers have unrealistically set this blended ROE target through the cycle?

A - Francois Morin {BIO 17410715 <GO>}

Well, I think the 15%, I would say, we were certainly in that camp. That was one of our guiding principles from day one. I think if we step back, those were set when risk re-interest rates were much higher than they are today by at least 300 basis points. So it was a big difference.

And if you just run the simple math and if -- and I think most insurers have taken the approach in the last couple of years, at least, to maybe take on a bit more aggressive, slightly more aggressive views on investment strategies and moving away from core fixed income to some alternative like funds and maybe some equity strategies as a way to make up for that loss of investment income.

But fundamentally, when we look at it, I think that's been one of our challenges is for us to achieve a 15% return when you're basically earning nothing on risk-free interest rates, which is how we compensate our underwriters, is almost an impossible task. I mean it's not impossible, but the way to get there is you have to really take on a lot more risk on the underwriting side and then that introduces a volatility that is not necessarily something we're looking for.

So having the balance and saying, yes, okay, we're willing to take a bit of risk, some risk on the underwriting side, measured risk and risk we can understand and quantify, that's something we need to do. But what's a realistic return on that book of business, we think, again, given the level of interest rates, 15% is a bit ambitious, if not impossible, over the cycle.

Now if we go back in that -- if 10 years from now, if interest rates go back up to something back to what they were back 20 years ago, then -- or 10 years ago, then we'd say, okay, now let it keep floating at -- for us, it's 9.50 [ph] above the risk free and then you will get back to a 15% ROE, let's say.

A - Tracy Dolin-Benguigui

I have a follow-up there since you mentioned about the interest rate dynamic. Do you think 90% is the new 94%, maybe if we look back at a prior point?

A - Francois Morin {BIO 17410715 <GO>}

Yes.

A - Tracy Dolin-Benguigui

Yes?

A - Francois Morin {BIO 17410715 <GO>}

Absolutely. You can't make a decent return unless you have like a 20-year tail on the business, with these levels of interest rates. So absolutely. What we -- even us, we were saying like two years ago, we were saying, hey, 95% should be kind of -- would be a good starting point for us to make a decent return, and that is no longer the case. We have to be -- if not 90%, very low 91%, 92%, whatever, depending on line of business, but you're absolutely correct.

A - Marc Grandisson {BIO 4369887 <GO>}

Yes. Yes.

A - Tracy Dolin-Benguigui

I can't help but notice that your cost to equity is pretty high, it's 11.5%, which would imply that buying back stock is very compelling. Help us understand your capability or wherewithal to buy back shares. I understand that you did tap into the debt markets, you raised $1 billion last year. But I guess the way I understand that, that in order to get Tier 3 capital credit from the BMA, it really was pushed down to the operating companies. So how do you kind of think about, I guess, the capital needed to support growth and capital for repurchasing?

A - Francois Morin {BIO 17410715 <GO>}

Yes. Well, we can debate the cost of equity. I think our view would be that at it's -- the cost of capital is a bit less than that for us. But no question that when we raised $1 billion last June, part of our view at that time was we were still in the early days of Covid was as much a defensive measure, make sure we had sufficient capital, specifically on the uncertainty around the mortgage segment. But also, we saw the opportunities coming our way for growth, and we wanted to be -- have the ability to deploy capital in their businesses where the returns were going to be we were going to see good returns.

So you were right, that money was -- had to be pushed down. But since then, at some point, once it's pushed down and then you write the business on capital, it becomes somewhat fungible, right? So our view is when we think about share buybacks, it's another way for us to deploy capital.

I mean, our preferred way to deploy capital, as you know, is to put it to work in the businesses. But when the businesses are doing very well and they're producing healthy returns, I mean, you do generate a fair amount of excess capital along the way. And not only in the last year but also as we look forward and look ahead, we do think that our return should be should be good. So that gives us more comfort that we are in a strong capital position.

We're growing very -- at a good clip, and that's not changing. But as we think about how much more capital can we deploy and we're going to be disciplined about the whole process, we do think that buying back shares and returning the capital to our shareholders is a good mechanism, is a good practice. And at the current level, the current pricing, stock price, I think we're comfortable buying back the shares. And as long as we can -- we remain comfortable that we're in an excess capital position, we can certainly do that at this price.

A - Tracy Dolin-Benguigui

We were just reminiscing about being part of the class of 2001 and you've grown tremendously. You're in a much more mature state right now. So I'm just curious how you're thinking about the possibility of introducing dividends or that disrupt your ability to be agile? I guess on an investor perspective, dividends will convey confidence in the consistency of your earnings.

A - Francois Morin {BIO 17410715 <GO>}

Yes. We talked about it last week at our Board meeting had a very long discussion on that. That is certainly a valid way to look at it. But going back to Marc's comments, I think our reputation, which we think has been built over the last 20 years, is we're good stewards of capital. And our shareholders expect us to deploy the capital when we see fit, when we see the good opportunities, absolutely.

Could we introduce a small dividend that would be a regular dividend that wouldn't really make a big -- be a big issue for us to manage? Yes, we could. But for the time being, we're still very comfortable buying back shares. That's been our preferred way of returning capital to shareholders.

And again, the -- I think what we've done over the last 20 years suggests that when we don't see the opportunities, we shrink, we give it back, and we wait for the next big moment for us to grow and deploy that capital aggressively.

A - Marc Grandisson {BIO 4369887 <GO>}

And Tracy, for what it's worth, most of our investors are saying they don't want a dividend, by and large. We trust you that -- and somebody wants to get capital away from you and buy back their shares, that's on them. They will make the decision from a tax perspective and capital deployment on their own perspective. But there's a high level of trust that we'll be able to deploy it in the right places. So -- but we're talking about it all the time. Always.

A - Tracy Dolin-Benguigui

Very insightful. Sad to say that time is up. Thank you so much for today's discussion. But that will conclude it.

A - Marc Grandisson {BIO 4369887 <GO>}

Thanks for having us, Tracy.

A - Francois Morin {BIO 17410715 <GO>}

Yes. Thank you, everyone.

FINAL

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A - Marc Grandisson {BIO 4369887 <GO>}

Nice seeing you.