S&P Global
Market Intelligence

Arch Capital Group Ltd.

NasdaqGS:ACGL

Earnings Call

Thursday, July 27, 2023 4:00 PM GMT

Call Participants

EXECUTIVES

Francois Morin
Executive VP, CFO & Treasurer

Marc Grandisson
CEO & Director

ANALYSTS

Brian Robert Meredith
UBS Investment Bank, Research Division

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

Jamminder Singh Bhullar
JPMorgan Chase & Co, Research Division

Joshua David Shanker
BofA Securities, Research Division

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

Michael David Zaremski
BMO Capital Markets Equity Research

Ryan James Tunis
Autonomous Research US LP

Tracy Dolin-Benguigui
Barclays Bank PLC, Research Division

Yaron Joseph Kinar
Jefferies LLC, Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Q2 2023 Arch Capital Earnings Conference Call. [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 laws. These statements are based upon management's current assessments and assumptions and are subject to a number of risks and uncertainties. Consequently, actual results may differ materially from those expressed or implied. For more information on the risks and other factors that may affect future performance, investors should review periodic reports that are filed by the company with the SEC from time to time.

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

Management also will make reference to certain non-GAAP measures of financial performance. The reconciliations to GAAP for each non-GAAP financial measure 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 and on the SEC'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
CEO & Director

Thank you, Josh. Good morning, and welcome to our second quarter earnings call. We're more than halfway through 2023, and through our commitment to underwriting acumen, prudent reserving and cycle-focused capital allocation, we were able to deliver another quarter of profitable growth.

In the second quarter, our results were primarily driven by our willingness and ability to deploy capital into lines with superior risk-adjusted returns. Our operating results in the quarter were stellar with an annualized operating return on average common equity of 21.5% that drove a 4.8% increase in Arch's book value per common share for the quarter. As you know, book value per share growth is our primary focus on our road to creating long-term value for our shareholders. Each segment generated over $100 million of underwriting income in the quarter. These outstanding returns reflect our ability to effectively execute in each segment. We're really operating in our sweet spot.

I also want to commend our employees for the continued exceptional growth they've delivered in the quarter, most notably a 32% increase in property and casualty net premium written compared to the same quarter a year ago. This hard P&C market is proving to be one of the longest we've experienced, and we are in an enviable position as we look to 2024 and beyond.

We often refer to the insurance clock developed by Paul Ingrey to help illustrate the insurance cycle. You can find the clock on the download tab for this webcast or on our corporate website. If you can't do the clock right now, just picture a traditional clock dial. For some time, we've been hovering at 11:00, which is one we expect most companies in the market to show good results as rate adequacy improves and loss trends stabilize.

Last year, a popular topic on earnings calls was whether rate increases were slowing or whether rates were even decreasing. These are classic signs of the clock hitting 12 when returns are still very good, but conditions begin to soften. Yet here we are in mid-2023, and conditions in most markets remain at 11:00.

We've even checked the batteries in the clock, and they're just fine. The clock isn't broken. It's just that the current environment dictates an extended period of rate hardening.

So what's sustaining this hard market? Well, I believe it's a relatively simple combination. Heightened uncertainty is driving an imbalance of supply and demand for insurance coverage. Since this hard market inception in 2019, we've had COVID, the war in Ukraine, increased cat activity and rising inflation, all of which create significant economic uncertainty. Underwriters have had to account for more unknowns.

Beyond those macro factors, industry dynamics also play a role in sustaining the hard market. Generally, inadequate pricing and overly optimistic loss trend assumptions during the soft market years of 2016 through 2019 have led to inadequate returns for the industry. The impact of these factors should cause insurers to raise rate and purchase more reinsurance in a capacity-constrained market with limited new capital formation. Put it all together, and it may be a while before the clock strikes 12, and we begin to move beyond this hard market.

I'll now share a few highlights from our segments. First, P&C. In the second quarter, the reinsurance group was successful again at seizing growth opportunities. In particular, [the media] property and property cat renewals saw a significant improvement in rate adequacy, and our underwriters were ready, willing and able to provide valuable capacity to our clients. Our PML or exposure to a single event in a 1-in-250-year return period went up in the quarter, while our premium income grew substantially.

At July 1, our peak zone exposure rose to 10.5% of tangible equity. Overall exposure to property cat risk remained well within our threshold, and because of our diversified portfolio and broad set of opportunities, we retain the flexibility to pursue the most attractive returns across lines and geographies. Although there are lines where pricing has declined, large public D&O comes to mind. P&C markets continue to see rate changes above loss trends. Even with those few lines with weakening rates, the compounded rate increases over the past several years continue to be earned and are generating attractive returns.

Overall, we like the range of opportunities in front of us, and we continue to lean into the current market.

Next is mortgage, which keeps generating meaningful underwriting income and risk-adjusted returns. Housing and credit conditions remain favorable, although high mortgage interest rates tempered demand for mortgage originations and limit refinancing options. The lack of refinancing has led to a historically high persistency rate of 83%. High persistency stabilizes our insurance in force, which, as many of you know, drives mortgage insurance earnings.

Our disciplined underwriting process and risk-based pricing model have helped us to build a healthy risk-reward profile for the business we write. The composition of the overall book with high FICO scores and low loan-to-value and debt-to-income ratios remains one of the best risk profiles in the industry.

International growth, along with our GSE credit risk transfer business, enabled us to profitably manage risk better than monoline U.S.-only companies, a key differentiator of our MI global platform. Mortgage insurance plays a valuable role in our diversified business model and continues to generate capital that is and can be deployed into the most attractive opportunities across the enterprise.

Moving on to investments now. Since our second quarter call last year, the Federal Reserve has increased, as we all know, the rates 8x for a total of 375 basis points. Given our short duration portfolio, these hikes have positively affected our net investment income, which is up approximately 22% over the first quarter of '23. New money rates exceed our book yield, which, along with our strong cash flow, sets the stage for further growth and book value creation.

[I have] tennis on the brain after watching the incredible Wimbledon final a couple of weeks ago. It was an epic match-up, 20-year-old sensation Carlos Alcaraz taking on all-time great Novak Djokovic. It was a back-and-forth match that lasted nearly 5 hours before Alcaraz emerged victorious. There was one pivotal moment that will be remembered for years. In the third set, a single game, something that usually takes about 3 to 5 minutes, instead lasted 26 minutes. The game included 13 deuces and 7 break points. It was an incredible display of tenacity and athleticism. Not to mention the mental strength required to remain focused. It was insane.

But what really struck with me was that kind of like this hard market, the game simply refused to end. There were many times where a single winning shot would have ended the game, but it just kept going. About 15 minutes in, it became clear that we just needed to enjoy what we were watching and not focus on the end point. So that's what we're doing with this hard market, returning what the market serves us with gusto.

As always, our goal remains to generate strong risk-adjusted returns in order to create long-term value for our shareholders at lower volatility. The exceptional profitable growth over the last several years has fortified our market presence and helped us achieve one of the most profitable quarters in our company's history. This is a type of well-rounded quarter we've always envisioned, the sweet spot, if you will, and we look forward to building on this momentum in upcoming quarters.

I'll cede the court now to Francois, and then we'll return to answer your questions.

Francois Morin
Executive VP, CFO & Treasurer

Thank you, Marc, and good morning to all. Thanks for joining us today on this gorgeous day in Bermuda. As Marc highlighted, our underwriting and investment teams delivered excellent results across their respective areas in the second quarter, which resulted in a performance that exceeded that from our very strong first quarter.

For the quarter, we reported after-tax operating income of $1.92 per share for an annualized operating return on average common equity of 21.5%. Book value per share was $37.04 as of June 30, up 4.8% in the quarter and 13.5% on a year-to-date basis.

Turning to the operating segments. Net premium written by our reinsurance segment grew by 47% over the same quarter last year, and this growth was observed in most lines of business. Growth was particularly strong in the property catastrophe and property other than catastrophe lines with net written premium being 205% and 53% higher, respectively, than the same quarter 1 year ago, a reflection of the fact that market conditions in these lines remain very attractive. As a result, the quarterly bottom line for the segment was excellent, with a combined ratio of 81.9%, producing an underwriting profit of $245 million. The accident year ex cat combined ratio was 77.4%.

The insurance segment also performed well, with second quarter net premium written growth of 18% over the same quarter 1 year ago and an accident quarter combined ratio excluding cat of 89.8%. Except for professional lines, which saw a slight decrease in net written premium in our public directors and officers business due to a more competitive market, all our underwriting units in insurance, both in the U.S. and internationally, saw good growth in the quarter as market conditions remain excellent.

Our mortgage segment had another excellent quarter with strong performance across all units, leading to a combined ratio of 15%. Net premiums earned were in line with the past few quarters, reflecting a high level of persistency in our insurance in force during the quarter at U.S. MI, partially offset by lower levels of terminations in Australia and higher levels of ceded premium. Benefitting our results was approximately $84 million in favorable prior year reserve development in the quarter, net of acquisition expenses, with over 75% of that amount coming from U.S. MI and the rest spread across our other underwriting units.

[Current year] activity at U.S. MI was again very strong this quarter, and our delinquency rate stood at 1.61%, its lowest level since the onset of the COVID pandemic. At the end of the quarter, over 80% of our net reserves at U.S. MI are from post-COVID accident periods. Overall, our underwriting income reflected $116 million of favorable prior year development on a pretax basis or 3.9 points on the combined ratio and was observed across all 3 segments, mainly in short-tail lines.

Current accident year catastrophe losses across the group were $119 million, over half of which are related to U.S. severe convective storms that have occurred so far this year. Pretax net investment income was $0.64 per share, up 21% from the first quarter of 2023 as our pretax investment income yield was almost up 50 basis points since last quarter. Total return for our investment portfolio was 0.56% on a U.S. dollar basis for the quarter with most of our strategies delivering positive returns. Our interest rate positioning with a slightly shorter duration helped minimize the impact of the increase in interest rates during the quarter.

We remain comfortable with our commercial real estate and bank exposure, which is of high quality and short duration. Net cash flow from operating activities was strong, in excess of $1.1 billion this quarter and continues to provide our investment team with additional resources to deploy into the higher interest rate environment. With new money rates in our fixed income portfolio still in the 4.5% to 5% range, we should see further improvement in our net investment income in the coming quarters, arising primarily from positive cash flows and the rollover of maturing lower-yielding assets.

Turning to risk management. Our natural cat PML on a net basis of the single event 1-in-250-year return level stood at $1.46 billion as of July 1 or 10.5% of tangible shareholders' equity, again, well below our internal limits.

In light of the improved market conditions in the property market, we were able to deploy more capacity, which resulted in a significant premium growth for property lines in both our insurance and reinsurance segments. This growth was well diversified across multiple zones. Our view is that the current in-force portfolio with a broader spread of risk across many zones is well positioned to deliver attractive returns.

Our capital base remains very strong with $17.4 billion in capital and a debt plus preferred to capital ratio of 20.5%. Even though the results of the past quarter set the high-water mark for us on many fronts, we believe the continued hard work and dedication from our teams, serving the needs of our clients every single day, along with our steadfast commitment as disciplined and dynamic capital allocators, sets us up very well for future success.
With these introductory comments, we are now prepared to take your questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Elyse Greenspan with Wells Fargo.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

My first question, Marc, can you quantify the supply-demand imbalance that you're seeing within the reinsurance market? And how much of that do you think could transpire from an additional -- a pickup in demand potentially at 1/1/2024?

Marc Grandisson
CEO & Director

Good questions. Elyse, I think the numbers we've seen for around $50 billion to $70 billion is not a crazy number. So I think that where we still have this imbalance occurring, I think that market has found a way to do the reinsurance transaction and buy coverage. But indeed, there was also a -- there could have been more to be had from a reinsurance perspective. But we believe and you heard on the call that insurance companies also had to -- [indiscernible] had to evaluate what they can buy and how much they could afford based on what the pricing level was.

So I think there's just imbalance right there on the reinsurance. There's also, I believe -- we also believe there's imbalance in the terms and conditions in the overall broad industry that needs to a bit more of a function -- on one hand, you could create capacity for cat exposure through third-party capital or reinsurance protection. But at the same time, you could also do it through improving terms and condition on the insurance level. And I think that's also something that will help bridge the gap. And we believe that's going to be one of the key elements as well for the next 18 to 24 months.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

And then the 77.4%, Francois, the accident year underlying combined ratio within reinsurance, is that a good run rate level? Or maybe you could get better as we think about some rate earning into the capital? Is there anything one-off in that number in the quarter?

Francois Morin
Executive VP, CFO & Treasurer

Well, I wouldn't say there's anything one-off. It is certainly a very good quarter. I think our view -- as we said in the past, when we had some quarters where there's a little bit more activity, we think it's better to look at it on a 12-month kind of forward-looking view. So is this quarter going to repeat in the future? Maybe. We just don't know. But I'll say it's certainly good. There's room for further improvement. But again, recognizing that there's going to be volatility in the reinsurance segment from quarter-to-quarter, I'd say it's -- I'll let you make your pick from there.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

And then, Marc, one more for you. I mean your stock has done really well. So you have a good problem that any CEO would want in that you have an extremely valuable currency. We sit here with a hard market. You guys obviously have a lot of organic growth opportunities. What would you need to see from an M&A perspective to consider using your stock as currency to enter into any type of transaction?

Marc Grandisson
CEO & Director

Well, many things are needed. Obviously, you need [indiscernible] is going to appreciate in this world. But I think at a high level at least, we're not focused on M&A at this point in time. We're really focusing on growing the book organically. We're also maintaining pretty well EMI as well as other nonproperty exposure. So we do -- we are seeing a lot of opportunities broadly. And this is where -- what our shareholders are paying us to do, and this is what we're doing.

And this is -- this represents really a once in a little while opportunity to really deploy and really get access to the market in a bigger way and provide more capacity to our clients. And we don't want to miss that. I mean an M&A would have to strategically fit for us beyond the money. I think right now, our efforts and time is better focused on organic growth at this point in time. And this is where -- I think we have plenty of opportunities on our own.

Operator

Our next question comes from Tracy Benguigui with Barclays.

Tracy Dolin-Benguigui
Barclays Bank PLC, Research Division

You mentioned that your 1-in-250 PML intangible equity was 10.5% at 7/1, which was up from 8.1% at 4/1. And I recognize your upper tolerance is 25%. It almost feels to me like you have a supplement below the 25%. Is it fair to assume that getting closer to 25% requires an even higher ROE hurdle rate or pricing? Like could we just be theoretical? What would you need to see in order to get more comfortable taking on more volatility in your book where you can get closer over time to that 25%?

Marc Grandisson
CEO & Director

Well, I think the -- we're -- first, the one thing about the PML, which is so interesting to us, is that we're in the early innings of where it's going to go. So we have to be careful that when we talk about this even internally ourselves, these are the early innings of a market getting much better. And as I mentioned, terms and conditions, we believe, also improving and really helping to manage cat and the cat-related risk better as an industry. So we'll see how that develops over time, Tracy.

I think that we're also a different animal than we were way back when. We have -- we've grown up our capital faster than the growth in exposure and needed. So the 25% before is probably a lesser number. I think you're quite right. And we also have to balance the overall portfolio risk profile. But having said all this, there's plenty of room to go from 10.5% to wherever we're going to end up. We don't know where that's going to be. Assuming conditions say as they are or even improve further, it certainly will mean more PML growth.

I think that it would have to be substantially better. We actually have a very, very solid construct within our overall capital allocation that will dictate what kind of market share we would have of the market. And all I would say is there's always a place to go to the numbers you talk about, but we'll see if we get there. And I will also remind everyone that it's not a bad place to start. The rate-on-line index of one of the major brokers, as you all know, it shows us that the pricing for the cat is the highest it's ever been since 1990, even before Andrew. There's a lot of room, and we're excited to see where that takes us.

And one final thing I will say, Tracy, if you look back at the '05, '06, '07, '08, if you go back on this, if you have enough of a memory or a good document on retention policy or a bad one in your company, you'll see that our PML grew in '06, '07, '08, '09. So we kept on accumulating and growing the PML. So it's just a start.

Francois Morin
Executive VP, CFO & Treasurer

I'll add on that. Just going back to Marc's earlier point about supply and demand imbalance. Florida is obviously a big market. It was a big renewal in 6/1. And the reality is even if we wanted to deploy more capital, I think, or more capacity, I mean, the buyers or the [seating] companies just don't have the resources or the money to buy the coverage that we think they should be buying.

So there's a little bit of wait and see whether it will take -- it will be a full year before they reprice their product. And then it gives them more money potentially to spend on resource protection, which we -- again, assuming the pricing stays at the current levels, we would deploy more capital. But certainly, the demand is a big factor in our ability to grow PML.

Tracy Dolin-Benguigui
Barclays Bank PLC, Research Division

Got it. I would say that if you do change your threshold, and I get it's very fluid and the demand equation is also different, that you would provide an update to the market on that. Real quick, do you have a house view on how this year's hurricane season will shape up? There was talk about average hurricane season, and now people are talking about above average. How do you see that playing out this year?

Marc Grandisson
CEO & Director

Well, we don't have a view on that view. What we have a view with since we have a mineralogist who evaluates the sea surface temperature, I'm sure everybody see those numbers, we expect average to maybe slightly above average the last time you gave us a presentation. But as you know, Tracy, it moves week to weeks, and we'll see when we get there. We're a little bit almost starting this season, so we'll see how that develops.

But we tend to take a longer-term view, Tracy, of the frequency and the severity of the hurricane season. So we believe that the pricing as it is right now accounts for a lot of deviation from the long-term expected that even if you had a little bit above average, I think that the market will be in a really, really good place. Not only us. I think the market is -- on the reinsurance side has priced the business with that long-term expected, which has, as we all know, a little bit of that increased frequency and severity of late. So that is reflected in the modeling that all companies are using.

Operator

Our next question comes from Jimmy Bhullar with JPMorgan.

Jamminder Singh Bhullar
JPMorgan Chase & Co, Research Division

First, just a question on your comments on supply/demand. And besides the absolute price, obviously, terms and conditions have improved as well. And where we can see the data, it seems like most of the primary insurers are absorbing more of the first dollar loss. But obviously, we don't see the data from all of them. But how broad-based is this? And do you think there's sort of been a little bit of a transfer of risk, cat risk from the reinsurers to the primary companies given changes in terms and conditions?

Marc Grandisson
CEO & Director

I think the last part is a true statement. I think the Q2 numbers you saw for some of the other -- some of our clients actually and competitors demonstrate that that's a little bit more retained. And these are the kind of question -- I mean if you get quite a coverage, you have to retain it yourself.

The terms and conditions change. This is [what's fascinating] for this market. It is -- not only the property cat terms and condition change. It is very broad-based property terms and conditions and price improvement that is sought by a lot of companies. I think the market globally has the [indiscernible] squarely. Like I said, last quarter [indiscernible] having to mend and optimize and reshape and re-underwrite the portfolio.

And one of the key things that we see that evidence of that is that a facultative team in our E&S property have an increased amount of submission this first half of the year. And what's interesting, the E&S property on the insurance obviously has some kind of exposure, a fair amount of it, but it's not only that. Our facultative book of business is not necessarily -- it's actually not a cat-heavy portfolio, which is an indication that facultative typically in any market is a good indication for where the market psychology is.

So beyond the cat when they provide fire protection, the pricing and the conditions are improving there as well. It's in very much a broad base and in the early stages. And I will say and remind everyone, and we have to remind ourselves of this, that this is a second or third year that property rates in terms and conditions have improved. So it's not the first shot at it. It's an ongoing process. And I think that it just got -- we [indiscernible] top of mind [indiscernible] and certainly in the second quarter. This year we believe will help maintain a bit of that going forward.

Jamminder Singh Bhullar
JPMorgan Chase & Co, Research Division

And then on the MI business, you've had obviously very sizable reserve releases over the past couple of years. How much of the forbearance-related reserves that you put up -- are those mostly released? Or is there more room to go there?

Francois Morin
Executive VP, CFO & Treasurer

I mean they're mostly gone. I think we've released a fair amount of the reserves that we put up in the early -- in 2020 effectively, during the early days of the pandemic. As I mentioned, like a lot of the cures that we're seeing now are from '21 and '22. So that's good news. And as you know, the reserve base has shrunk quite substantially from the peak of 2020 or late 2020.

So we're still very prudent. We still look at the data every single month as the new delinquencies come in and how quickly we cure and all of that, but we're still very comfortable with our reserve position there.

Jamminder Singh Bhullar
JPMorgan Chase & Co, Research Division

And if I could just ask one more on -- in the past, when the market has been really good, we've seen some companies go out and raise equity, try to take advantage of that. And a couple of your peers have done that as well, obviously, not to a very large extent. But what do you think about your sort of desire to do that if the demand really picks up and your business continues to grow?

Francois Morin
Executive VP, CFO & Treasurer

Well, it will be a function of the market. I mean it's -- we've been able to grow quite substantially in the last few years without raising any additional capital. As I've told many people over the last few months, we have the luxury of having a mortgage unit that provides a source of capital that we have been able to redeploy in the P&C space.

So assuming similar conditions where P&C start stays very hard and mortgage still does very well but isn't growing substantially, we still think there'll be -- we'll be able to generate capital internally. But again, hard to have the crystal ball on what 2024 will look like. So we're -- as I mentioned, we got plenty of capacity. We have low leverage, so that we got a lot of tools in the toolbox, and we'll react to the market as it presents itself.

Operator

Our next question comes from Michael Zaremski with BMO.

Michael David Zaremski
BMO Capital Markets Equity Research

Great. Maybe just wanted to learn more about market conditions in the primary insurance segment. I definitely heard your comments about rate change, loss trend and pieces of where overall we are in the underwriting life cycle clock. But just curious, we're seeing kind of different data points from companies on pricing power levels. Some are showing flattish pricing power. Some are showing deceleration. I know you guys operate in a lot of different pockets. But would you say overall pricing in the primary insurance segment is accelerating? Or maybe it's worth bifurcating between casualty versus property as well?

Marc Grandisson
CEO & Director

Yes, you have to bifurcate the market, to your question. I think the overall statement, I will say is that from our perspective, we look at our portfolio, as you just mentioned, by all the specialty lines. And most of them are still getting rate increases that actually get a bit more pickup in rate increase over the last quarter or 2, which was a good thing to see and the right thing to see, obviously.

But I think the workers' comp is a good example for rates not going up still, and there's a reason for it. It's been historically well performing, performing better than all the initial picks from all the folks out there. So I can see why there is some validity or at least reason behind that.

This is what I would tell you. The word we use for the insurance industry right now in the U.S. specifically is rationality. It's a very rational market. That's a reason for things to happen. The reason, for example, are economically based and not grow the market share or making it flash or marketing driven. Companies are really, really doing the best they can to underwrite the best and being appropriate, right, in getting price increase, a certain degree to lines that needed more than others. I think the market is fairly rationalized as we speak.

Michael David Zaremski
BMO Capital Markets Equity Research

Okay. Switching gears a bit to the reinsurance side of the marketplace. Would you say there's been a lot of terms and conditions changes and just season changes, too, especially in Florida. Would you say that if there is a major event, should we be looking at historical market shares that the reinsurers and Arch have had and then -- for cutting it? Would that be like the right exercise to do given we're kind of in hurricane season?

Marc Grandisson
CEO & Director

I think we've grown our portfolio, right? I mean you can see the exposure growth. I think the proxy for market share is probably better to use, the delta and the PML, even though that's only one zone. But as Francois mentioned in his remarks, we do have -- we have an increased participation in a much more wider set of property cat exposure than we used to have before. But the market share that we said anywhere from -- historically from 0.5 to 0.8 is going up a little bit. And I think I will use the PML as a proxy. That's the best thing to tell you right now. [It's very different] zone.

Operator

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

Joshua David Shanker
BofA Securities, Research Division

I've read the Paul Ingrey reinsurance clock, but it doesn't really relate to something that [Paul] knew about, which I don't, which is how to make money in the late 1970s in the insurance industry. Given where you see loss trends are and given that pricing is going up over an extended period of time, is there an element that we just don't know really what the loss cost trend is and we need an extra padding in there compared with our historical appraisals? And is it possible to put a supplemental ambiguous loss trend on top of what you think the loss trend is currently and still get new business attractively?

Marc Grandisson
CEO & Director

Yes. So a very good question. I think this may break it in parts. I think that, yes, we do. As you know, as a reserving practice, we're very keen on the reserving being prudent. We do reserve to a higher level of trend than is embedded in the pricing or what we even observed in the data to make sure that we're accounting for this.

I think as a result of that uncertainty and the need to get a bit more cushion and the uncertainty that it generates, I mean, you heard us on the other call. I think it does generate that need to get higher price for that reason. But there's a need -- there's a recognition in the industry that we need to be a little bit on this side of the decimal to create some kind of margin of safety. So I do believe that companies are pricing for a higher inflation ratio going forward and also adding a little bit, and that's what helps sustain the hard market as we speak.

Joshua David Shanker
BofA Securities, Research Division

Is Arch padding more now than it has as a company standard practice in the past?

Marc Grandisson
CEO & Director

Not really. I think we've -- like we talked about this, Josh, on calls for the last 2, 3 years. And I think we've been consistent. We -- it is a little bit of art, right? It's not only science. It's not as granular as you might think it is. You do the reserving process. You do the reserving process. And then you look at what your expectations are versus what the actual is emerging, and you adjust your loss ratio.

These 2 things are -- right now, there's a tendency to sort of take a higher loss ratio than otherwise will be indicated because we have to still see through that underwriting year develop, and it's been very consistent. And if you look at our IBNR ratios and that we book the business on our insurance portfolio, it's been consistent for the last 3 years. So we tend to want to make sure that [indiscernible] that allows us to reduce some of that before we do. So we have not changed a whole lot. And it's not -- so it's quite a bit a way above you expected. There will be actual emerge with the losses. But inflation develops in the future. So it's an appropriate thing to do, I think, at the early stages. Francois?

Francois Morin
Executive VP, CFO & Treasurer

Yes. I'd add like COVID certainly through a wrench in the whole process, right? I'd say it's -- the way we think about the business today, the way that the environment is today is different than it was 5 years ago. It was different than it was 10 years ago. So great question, Josh. But it's -- no 2 periods are alike.

And right now, back to Marc's point, I'd say the reaction or how do we think about courts closing and courts reopening and coverages and everything that came with COVID, I think -- I mean we're still kind of working through that. So that's why I think it would suggest that we're -- we like to be prudent and maybe even more so in this environment.

Joshua David Shanker
BofA Securities, Research Division

And then on Tracy's PML question, you kind of ripped, Francois, on this a little bit. But the corporate charter says you're willing to put 25% of the company's equity capital at risk for a 1-in-250-year event. You're nowhere near that, and I don't really expect there's any market where Arch at this point, given how big it is, would really put 25% of its equity capital at risk for a 1-in-250-year event. How -- what's the reasonable feeling on how much cat risk you'd be willing to take in the best cat market ever?

Francois Morin
Executive VP, CFO & Treasurer

I'd say -- I mean, we think we're in a good market. We know we're in a good market, but we don't know what tomorrow holds. So I mean rates could go up again by a factor of -- quite substantially next year. Again, I don't want to speculate, but there could be some markets kind of pulling back. And then I think -- I agree that in what we know today, it's unlikely that we would hit 25%, but we just don't know what the future holds. So I think we're cognizant that there could be better opportunities at some point down the road.

Operator

Our next question comes from Ryan Tunis with Autonomous Research.

Ryan James Tunis
Autonomous Research US LP

I guess my first question is in MI. It's kind of a follow-up on Jimmy's. So on Page 21 of the supplement, it looks like you guys give reserves -- loss reserves like by vintage year. And the dollar amount of reserves in '20, '21, '22 looks pretty similar to what it was at the end of last year. Against that, you continue to release quite a few, over $100 million. So I guess I was just trying to square that a bit. Like where exactly have these releases been coming from?

Francois Morin
Executive VP, CFO & Treasurer

Well, just to clarify, I'd say, Ryan, that the reserves, we don't disclose the reserves by year. We show the risk in force. We give you the total dollar amount of reserves as of -- $403 million at the end of the quarter and the same at the end of the year, but there are some shifts between what was at year-end versus now. I will say that most of the reserves that we've -- the releases in the first 6 months of the year have been coming primarily from the '21 to '22 years, I mean, and a little bit of '20 as well.

Marc Grandisson
CEO & Director

What you're saying is also recognition by the MI group that there were more uncertainties and potential recession figures, a lot of things going on. So the assumptions when you do reserving in the long term at that time, you'll tend to increase because of the increased level of risk. So I think that also could explain why well after 2, 3 quarters, we don't need them well. It's because things are also, as we know, changing for the better as we speak on the MI group. So that could explain a little bit why it's a bit higher this quarter.

Ryan James Tunis
Autonomous Research US LP

Got it. And maybe just some perspective on kind of where the ultimate loss ratios on those years are now trending at?

Francois Morin
Executive VP, CFO & Treasurer

Well, they are -- I mean, they turned out to be really, really good. I mean the reality is with -- even with COVID and kind of what transpired after that and the forbearance, et cetera, I'd say -- again, we've talked historically about, call it, a long-term average loss ratio in the 20% to 25% range. We're certainly going to be below that.

Still a little bit -- we're not there yet, but I mean there still has to be -- we need more clarity on how the remaining delinquencies are going to settle or whether they're going to cure or not. But where we're at today, I'd say we're going to be below the long-term average.

Ryan James Tunis
Autonomous Research US LP

Got it. And then just a follow-up -- go ahead, sorry.

Marc Grandisson
CEO & Director

Just to let you know, in terms of loss emergence in MI, it takes a little while, right? It takes 2 or 3 years for losses to start emerging. So it takes a little while to get -- to know what the ultimate is going to be. So I just want to make sure you know it's not like a one and done. It's -- you generate an underwriting year. It takes 2 or 3 years for losses starting to emerge, right? Situations, [family] situation, economic situation and the borrowers evolve over time. So I just want to make sure you know that it's not -- just because nothing has happened...

Ryan James Tunis
Autonomous Research US LP

Yes. I'm still trying to figure this business out, so appreciate it. A follow-up, I guess, for Marc, just on P&C. I'm not sure there's ever been a cycle where like when rates started to decelerate, they reaccelerated. Why hasn't that happened before in your experience?

Marc Grandisson
CEO & Director

It's happened before. It's happened before. From '99 to 2001, we had -- 2002, '03, '04, actually, we had a hardening market on the liability side in the U.S. We had new lines of business such as terror and aviation going through the ringer. So we have that going. And I remember a period of time when Arch was underweight cat for the first 2, 3 years of its existence, and we were sort of the eye going against the grain. Most people were shying away from casualty and doing more property. And then we ran into a KRW in '05, and then we had a hard market as well in property.

And I think it helped maintain even the business on the liability lines a bit longer. If you look back, the years '06, '07, '08 were still very, very good. And the price decrease were not as probably as high as they could have been otherwise. I think the one factor with these kinds of hardening market in the property side is us competing -- is competition for capital. And I think it also helps buffer or paying down the rate decrease that would otherwise have happened. And that's an important -- or rate stabilizing more than just going down first. So we've had this before. We've had this before.

Ryan James Tunis
Autonomous Research US LP

And then -- so after Katrina, correct me if I'm wrong, there was like 1 year of really good rate. There's quite a bit of supply that came in, and now it's kind of [indiscernible]. I'm just kind of trying to contrast from a reinsurance standpoint how the supply-demand balance looks today sort of a year after Ian and versus how it did a year after Katrina.

Marc Grandisson
CEO & Director

It hasn't changed the hold up. We hear from our third-party capital team and in the market. I mean you hear from other markets. I think that there's a general more leveling off of capacity that's been deployed than we would have expected from the existing incumbent, which helps explain a lot of the price increase that we've seen and our ability to flex in incidents.

We're not seeing or hearing supply increasing for a while. I think that there's still a very much -- the money that was there before that Brazil was requiring lower returns has not returned back to the table. And even if they were to come back to the table, what we hear is their return expectations, like ours, have increased dramatically. So we'll see where that ends up [indiscernible].

Ryan James Tunis
Autonomous Research US LP

What are you paying the most attention to, thinking like looking forward into 1/1, kind of what might drive pricing when you get to the end of the year?

Marc Grandisson
CEO & Director

Well, activity, cat activity, of course, and demand increasing, demand people, like we said before, needing to buy more or having to bite the bullet and do the right thing at the same time as they are improving on insurance portfolio. That's a big tell for us.

Operator

Our next question comes from Brian Meredith with UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

A couple of questions here for you. First, just on your PML, what is your peak zone right now? Is it still Northeast?

Francois Morin
Executive VP, CFO & Treasurer

[indiscernible], Florida.

Brian Robert Meredith
UBS Investment Bank, Research Division

Where is it? Pardon me? Florida?

Francois Morin
Executive VP, CFO & Treasurer

Florida. [indiscernible] Miami-Dade [indiscernible].

Brian Robert Meredith
UBS Investment Bank, Research Division

Okay. And then on the PML question, I'm just curious. You gave us 1-in-250. But how has your kind of 1-in-50 and 1-in-100 kind of increased over -- since, call it, at the beginning of the year? Is it -- they increased more, less, about the same amount? I'm just trying to get a sense of where you're playing in programs.

Marc Grandisson
CEO & Director

Yes. So from a big zone perspective, it's gone up similarly in terms of percentage. It's a very similar increase.

Brian Robert Meredith
UBS Investment Bank, Research Division

Got you. That's helpful. And then, Marc, I'm just curious. I know there was a lot of one-off type transactions, top-up programs that happened in the second quarter. Can you give maybe some perspective on how much of that contributed to your growth here in the second quarter? And how much is kind of continuing here going forward? Just so we can get a sense of how is this growth sustainable here for the remainder of the year, maybe into '24.

Marc Grandisson
CEO & Director

We've had a couple of -- we've had a couple of programs, for instance, in the Asia that we won. And we've had a couple of big -- but I don't think this quarter is necessarily a large transaction quarter Brian, the way you make it sound. I think it was more regular growth. A couple of transactions here and there, but nothing to the extent that when we talk on the call, as Francois mentioned in his remarks, that he has to highlight it specifically before. I don't think there's nothing really to highlight in this quarter, actually.

Brian Robert Meredith
UBS Investment Bank, Research Division

Good. And then I guess last one, just quickly here. One of your competitors talked about reducing market share in the MI business because there's some concerns about [potentially] recession here going forward. Maybe give us your kind of perspective on what you're seeing right now in your MI and kind of outlook and potential for some higher loss ratios there if we do go into recession as we look into '24.

Marc Grandisson
CEO & Director

Yes. I think pricing has improved over the last 2 years, and credit quality stays really, really beautiful. And it's why it's among the best, I think if we go back to 2013, 2012 in terms of quality of origination. So it's -- as you know, credit is not readily available. The availability of credit is still pretty tight out there. So from a credit quality perspective, Brian, it's as good. It's a really, really solid marketplace.

I think the market share question, which we never -- we don't lose sleep over this, as you know, Brian, I think a couple of things in the market share that we're trying to do in terms of shaping the portfolio in the MI is trying to get the higher quality, like I mentioned in my remarks, lower FICO -- higher FICO, lower LTV and also geographically go to the places where there's less perceived inflation or overvaluation.

And also, there's some different programs that have different returns, meaning they are less than we would have hoped for them to be. And they just don't meet our threshold. And especially, Brian, if you overlay the opportunity set that we have on the property side, it just makes for our fellow folks in MI willing to take the earnings that they generate and give it to us on the P&C side to generate even better returns. So really good return business, Brian. It's just also for us a matter of comparative ROEs as well as absolute.

Operator

Our next question comes from Meyer Shields with Keefe, Bruyette, & Woods.

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

A quick question to start. The level of reserve releases in reinsurance was lower than it's been in recent quarters. I was hoping you can give us some color. Is that because you're assuming higher loss trends? Or are there other factors that may have played into the quarter's results?

Francois Morin
Executive VP, CFO & Treasurer

No, I'd say it's -- I mean we will look at the data, right? So I think some quarters, there's evidence that we can release a bit more. This quarter, maybe not as much. It's a process that we go through every quarter. So I think our underwriters and our actuaries kind of sit down and take a look at the respective treaties and come up with a point of view on whether there's enough evidence to release reserves.
So I wouldn't read too much into it right now. I think it's a just another quarter still, we think, healthy reserves, healthy reserve releases, but not as much as you said in prior quarters.

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

Okay. No, that's fair. Second question, and I'm really not sure how to ask this. But there's a lot of chaos right now in U.S. personal lines. And Arch has always been really opportunistic. I was wondering if there's a way that in a line of business that's so dominated by major players, but you do have this level of instability. Is there an opportunity for Arch?

Marc Grandisson
CEO & Director

I think it's a hard one, Meyer. I think that our shareholders -- I mean, we could always see what we could do there. But from our perspective, I think we're more of a B2B and more of a commercial provider of insurance and specialty provider of insurance. Certainly, on the reinsurance side, we're hopeful. Our companies -- a lot of companies are homeowners, writers, and we do provide significant capacity for them, be it on a core share basis or excess of loss and also be on property.

So I think our game plan on homeowners is more to support the clients that we have because I think on a long-term basis, it has a set of characteristics, as we all know, and focus that is not necessarily core to what we do every day, great filing and everything else in between. It's a bit of a different animal for us.

Operator

Our next question comes from Yaron Kinar with Jefferies.

Yaron Joseph Kinar
Jefferies LLC, Research Division

With most of my questions already asked and answered, I figured I'd maybe focus on a couple of more esoteric items. So first, on ad covers, can you maybe talk about how much you're still writing in '23 versus '22?

Marc Grandisson
CEO & Director

We've cut our ad book significantly over the last 12 months. You see even in 2022, we started cut already as we saw this. And again, it's a matter of opportunity, right? I mean we do some, but we've cut the book heavily because of the better -- frankly, better opportunities on the excess of loss occurrence. Much better, yes.

Yaron Joseph Kinar
Jefferies LLC, Research Division

And is the client base there? Has that changed at all? Can you maybe talk about the mix between large globals, smaller regionals?

Marc Grandisson
CEO & Director

Well, we had a -- when we grew [indiscernible] Florida, as you know, is a different kind of animal because of all the [indiscernible] small companies out there. But in general, I would say that our portfolio will opportunistically grow into the larger global companies. We tend to think that they're relatively not as -- this has transparency and visibility into what they write. So our tendency is to be more of a super-regional businesses and more ones that have a lesser footprint in terms of stake. We think we can better allocate capital.

This is sort of a high-level philosophy that we've had for years. That hasn't really changed our own. I think that we prefer to grow with these clients over time. But having all this opportunistically, being on a core share basis of excess of loss if it's a large corporate, we definitely were able to provide more capacity, if they needed. As we speak and then price, we believe we're effective at the higher level of risk that they have. So I think I would say same as before, a little bit opportunistically on larger companies.

Yaron Joseph Kinar
Jefferies LLC, Research Division

Got it. And then if I put this together then and we look at the very large cat activity that has really been incurred much more by the primaries here. With the changes in terms and conditions and maybe tighter or more limited cover per peril, ultimately, how does that impact ad covers later in the year if, let's say, the primaries had a lot of cat losses on secondary perils that are now no longer covered by reinsurers, at least not per event? Ultimately, does that also flow into the ad covers that will not be breached on a reinsurance level because of that?

Marc Grandisson
CEO & Director

Yes. So I think that excess of loss is very similar to the current. If you do change terms and conditions and cut the coverage at the underlying portfolio level, it will have a leverage impact into your aggregate excess or occurrence, meaning it will definitely cut down the loss expectations heavily into these layers.

But what I would tell you, Yaron, is we're not there yet, right? This is the early innings, like I mentioned to you before on the call, is that we're going to have -- the phenomenon we just talked about, we'll have a much better perspective and view on this and the impact it's going to have on the losses next year and through '25. I think right now, we still have a portfolio that hasn't gone through quite 100%, right, of all these [indiscernible] that you and I expect to happen, I think, in the marketplace.

So the aggregate of losses for that reason, probably still a bad bet in 2023, right? So we probably need to see this underlying change in terms and conditions on the insurance portfolio before we can see this being a potential viable product.

Operator

Thank you. And I'm not showing any further questions at this time. I would now like to turn the conference over to Mr. Marc Grandisson for closing remarks.

Marc Grandisson
CEO & Director

So from gorgeous Bermuda, I want to wish everybody a good month of August, and we'll see you in the fall. Thanks for your support.

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