S&P Global
Market Intelligence

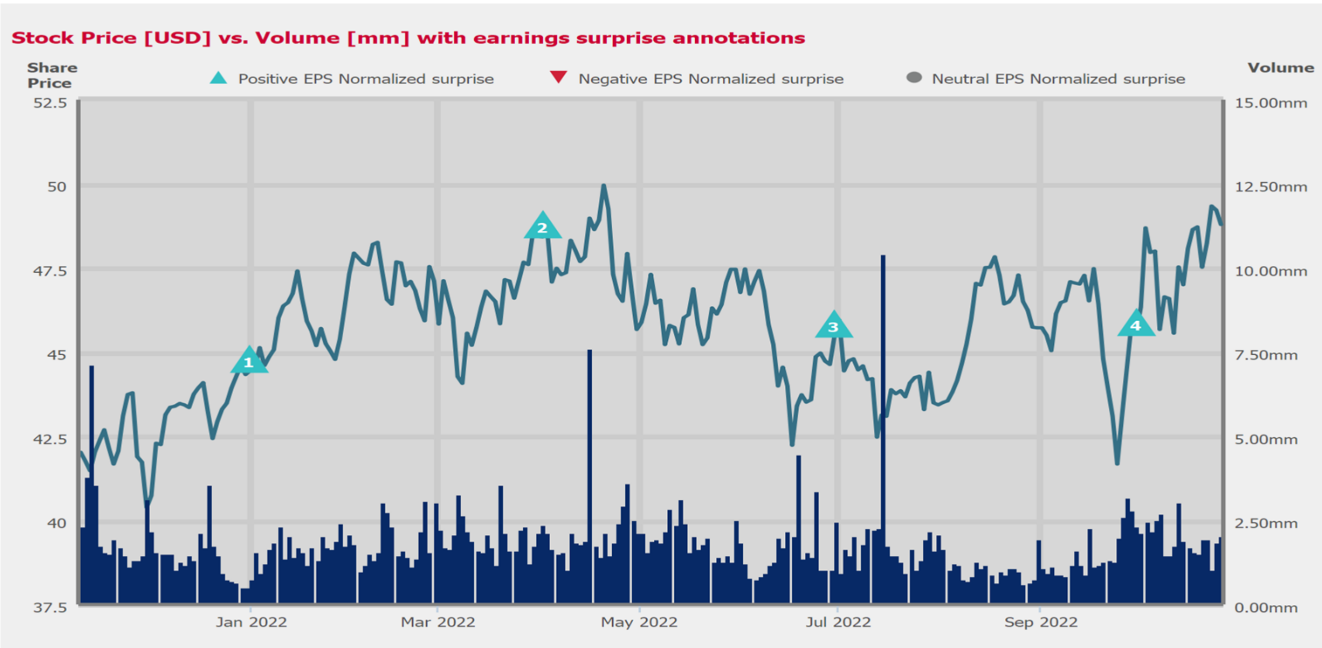
Arch Capital Group Ltd. NasdaqGS:ACGL
FQ3 2022 Earnings Call Transcripts

Thursday, October 27, 2022 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2022-			-FQ4 2022-	-FY 2022-	-FY 2023-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.18	0.28	▲55.56	1.26	3.97	NA
Revenue (mm)	2450.84	2723.77	▲11.14	2477.20	9884.28	NA

Currency: USD
Consensus as of Oct-27-2022 10:35 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2021	1.00	1.27	▲1 27.00 %
FQ1 2022	1.07	1.10	▲2 2.80 %
FQ2 2022	1.07	1.34	▲3 25.23 %
FQ3 2022	0.18	0.28	▲4 55.56 %

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Call Participants

EXECUTIVES

Francois Morin
Executive VP, CFO & Treasurer

Marc Grandisson
CEO & Director

ANALYSTS

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

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JPMorgan Chase & Co, Research Division

Joshua David Shanker
BofA Securities, Research Division

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Morgan Stanley, Research Division

Michael Zaremski

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 Third Quarter 2022 Arch [Soft] Capital Group Earnings Conference Call. [Operator Instructions] As a reminder, this call may be recorded.

Before the company gets started with its update, management wants to first remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the federal securities laws. These statements are based upon management's current assessments and assumptions and are subject to a number of risks and uncertainties.

Consequently, actual results may differ materially from those expressed or implied. For more information on the risks and other factors that may affect future performance, investors should review periodic reports that are filed by the company with the SEC from time to time. Additionally, certain statements contained in the call that are not based on historical facts are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

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

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

Marc Grandisson
CEO & Director

Thank you, Michelle. Good morning, and welcome to Arch's third quarter earnings call. Our investors know that with Arch, you're getting a diversified, time-tested active capital allocator that understands that how you navigate cycles is crucial for long-term success. Hurricane Ian gave us a stark reminder of the importance of insurance. And our hearts go first to all those who loss lives or property.

As we turn to 2023, our agility is never more important. As an insurer, we provide protection for our clients during times of uncertainty. The reality for our industry is that big events like Ian almost always result in opportunities for the company that actively manage their capital and have the ability and the decisiveness to act when markets need their capacity. Arch is one of those companies.

The current environment presents Arch with the opportunity to enhance its relationships with clients as they seek out insurance and reinsurance solutions in these uncertain times. The cat activity in the third quarter has significantly increased pressure on property cat markets, which could have ripple effects across all property and casualty lines as we approach the 2023 renewals.

Over the last several years, we've maintained that property cat rates have been inadequate. Now the market recognizes this as well. The events of the past 18 months significant interest rate hikes, repricing of investments, ongoing general inflation concerns and the increasing cost of capital, all point to the need for a higher margin safety in the premium with property being the deposed child.

We're pleased that the underwriting discipline of our insurance and reinsurance segments limited Ian's impact to a quarterly earnings event. As we have said before, our proactive approach to cycle management enables us to protect our capital over the long term.

From Arch standpoint, as other insurers are reducing their overall participation, we have an opportunity to showcase our outstanding team, strong balance sheet, underwriting acumen and creative things. Our positioning should reward our shareholders with superior risk adjusted return in the near term. I want to take a few minutes to call your attention to areas in each operating segment where we continue to make positive strides.

In the third quarter, our insurance and reinsurance segments continued to grow premium and delivered solid current accident year x cat combined ratios, 89.5% for insurance and 85.5% for reinsurance. In our insurance operations, we continue to see strong net premium written growth in the third quarter, up approximately 19% in the same period in 2021.

Some of the most significant growth came from professional liability, including cyber as well as a strong increase in travel lines. Our excess and surplus lines business, both property and casualty, also continued to achieve rate increases of up trend, and we are optimistic about the opportunity for further growth in 2023.

Competition in P&C is robust, but rational, and the markets are taking a more technical approach to pricing and a project suits Arch's underwriting philosophy. Cyber insurance has become increasingly important to our insurers globally, and we have substantially increased our support because quite simply, we believe that today's cyber market has changed for the better.

The most important development over the past several quarters is that the alignment between clients and insurance companies have significantly improved as insurers have become more vigilant in their efforts to mitigate cyber risks.

Additionally, insurance terms and conditions have sufficiently tightened, retentions have increased and rates have reached a level where we believe we have an opportunity to earn an appropriate return for the assumption of risk. .

Next, our reinsurance segment once again delivered excellent top line growth across an array of the of the specialty businesses, including property, property cat and other specialty lines. Since inception, a hallmark of our reinsurance group has been its ability to quickly adapt to changing market and reallocate capital to earn better risk-adjusted returns. Excellent market conditions and the likelihood of capacity constraints were to likely create an eventful January 1 renewal period, and our teams are actively planning to meet the demands of our clients.

Now to the mortgage group or, as I call it, our beautiful business. They once again provided proof of their sustainable earnings model by delivering $299 million of underwriting income that is essentially uncorrelated with our P&C operations. Although higher interest rates affected new origination volume, they also improve the persistency of our portfolio, which rose 4% in the quarter to 75.4% and allowed us to grow our U.S. primary mortgage insurance imports to nearly $295 million.

Our embedded book is in great shape. Credit quality remains excellent. Unemployment is still at the historical low and the average borrower had a superior FICO score of 748. Homeowners' equity, a key factor in protecting against claims is very high with 90% of policies having at least 15% equity in the home.

In addition, the MI market is being proactive, increasing rates to adjust to the evolving environment. We continue to be thoughtful in how we manage our mortgage portfolio and because of our diversified model, we have the ability to take a measured view of the business as just one component of our diversified enterprise. In the near term, better returns will most likely come from our property and casualty segment and we would expect that our capital allocation will bear this out.

Although investment returns were challenged again in the third quarter, it's important to note that rising investment yields even after adjusting for claims inflation should help boost our return on equity. Obviously, with the Fed attempting to paying inflation, when we continue to see negative investment markdowns, a significant amount of which we would expect to recover as our fixed income securities mature over the next several years. Ultimately, the relatively high quality and short duration of our portfolio, combined with strong cash flows provide an opportunity for us to reinvest in new money yields that are substantially higher than our current book yields.

In conclusion, outperforming in the P&C insurance market is always a challenge and the most recent paradigm where the property cat market was supported by cheaper alternative capital had increased the level of difficulty.

However, many of the investors in ILS funds have recently seen their returns underperformed and are beginning to leave the market. Without an obvious source of cheaper capital, our industry is nearing an inflection point. There appears to be a shortage of players with the capacity and willingness to participate, creating possible supply shortfall.

Fortunately, for our shareholders, we have both the capacity and the willingness to deploy more capital in that space for as long as the reward justifies the risk. We're optimistic with regards to the opportunities ahead of us in the fourth quarter and into 2023. We talk about our principles of set cycle management and capital allocation at almost every opportunity because they're truly part of our DNA.

We have remained disciplined over time and kept our focus on fundamentals when it came to underwriting. The market needs companies like us to rise to meet their needs. And as I like to say to our team, Arch is open for business. .

With that said, I'll turn it over to Francois to go through some of our financial details before returning to answer your questions. Francois?

Francois Morin
Executive VP, CFO & Treasurer

Thank you, Marc, and good morning to all. Thanks for joining us today. As we communicated in our release earlier last week, our third quarter results were adversely impacted by the effects of Hurricane Ian and other global catastrophe events. Inspite of the severe nature of Ian, which we believe will end up being the largest single loss in our history, we reported after-tax operating income of $0.28 per share resulting in an annualized operating return on average common equity of 3.8%.

Year-to-date, our annualized operating ROE is 11.6%. This result demonstrates once again the value and the resilience of our diversified platform. Now on to catastrophe and losses, where we wanted to provide a bit more color on our assessment of Hurricane Ian. We all know it's still very early in the claim adjusting process, and the final determination of our ultimate loss exposure will likely not be known for quite some time.

Our initial estimate of the ultimate losses is based on an industry loss of $50 billion to $60 billion. We believe this range is appropriate at this time given the unknown impacts of inflationary trends, potential supply and demand imbalances and labor and material costs. The newly introduced Florida Property Insurance Reforms and the extent to which storm search claims may end up being covered by insurers, among others.

Overall, we believe our estimated market share of the event will be comparable to prior or large events of a similar nature. In the insurance segment, net written premium grew 18.6% over the same quarter 1 year ago as our underwriting teams continue to find new business that meets our return expectations. Overall, underwriting performance was excellent with an excellent year combined ratio excluding cat of 89.5%, a 100-basis point improvement over the third quarter of 2021.

In line with the last few quarters commentary, an ongoing shift in our business mix and structure of our reinsurance programs resulted in a slightly different split between the loss and expense ratios compared to the same quarter 1 year ago. In the reinsurance segment, net written premium grew by 73.6% over the same quarter last year. It's worth pointing out that in the third quarter of 2021, we had a catch up in seeded premium the Somers Re, significantly reducing our net written premium. Absent this impact, the year-over-year increase in net written premium would have been 37.9% and much like the insurance group reflects an environment where we are better able to write business that meets our return thresholds.

The segment produced a next cat accident year combined ratio of 85.5%, 230 basis points higher than the same quarter 1 year ago as a result of an elevated number of large attritional claims in our property other than property catastrophe book and also an increase in our expense ratio due to an ongoing shift from excess allowance to more proportional business.

We believe this movement in the loss ratio is well within our expectations of the inherent variability of the underlying claims activity in our book of business. Our mortgage segment had another excellent quarter with a combined ratio excluding prior year development of 39.9%. Net premiums earned decreased on a sequential basis as we continue to see the effects of higher recessions on our U.S. MI book and lower levels of single premium policy terminations.

Persistency of our in-force insurance now stands at 75.4% at the end of the quarter. It has continued to increase due to the rising mortgage rates, which considerably reduces the attractiveness of mortgage refinancing for most borrowers. We recognized $126 million of favorable prior year development across the mortgage segment this quarter as delinquencies continue to cure at a higher rate than expected.

Over 80% of the favorable claim development came from our first lien insured portfolio at U.S. MI mostly related to the 2020 and 2021 accident years. The remainder of the favorable development came from recoveries on second lien loans and better-than-expected claim development in our Australian operations and our CRT portfolio.

Income from operating affiliates stood at $8.5 million and was generated from consistent results of profiles offset in part by underwriting losses at Somers Re due in part to Hurricane Ian. Net investment income was $0.34 per share, up 21% from the second quarter of 2022 and 55% from the third quarter of 2021 on a per share basis. The strong positive cash flow from operations over $2.8 billion year-to-date, combined with the proceeds from maturities and sales of securities, deployed in a rapidly rising yield environment underpinned this improving results.

Going forward, with new money rates above 5% and a growing base of invested assets, we should have a good opportunity to further enhance our operating income through solid investment income results. Total investment return for the investment portfolio was negative 3.01% on a U.S. dollar basis for the quarter in a challenging environment of rising interest rates and weak equity markets.

We remain cautious relative to our duration, credit and equity risk with our investment portfolio, and this defensive strategy helped minimize the mark-to-market hit to book value. Our investment duration remains relatively unchanged compared to 1 year ago and is slightly underway relative to our liability duration.

Turning to risk management. Our natural cat PML on a net basis stood at $851 million as of October 1 or 7.7% of tangible shareholders' equity, again, well below our internal limits at the single event 1-in-250-year return level. Our peak zone PML is currently the Florida Tri-County region.

On the capital front, we repurchased a minimal amount of share this quarter, approximately 236,000 common shares at an aggregate cost of $10.1 million. As our prospects of seeing meaningful opportunities in the business remain very good for the remainder of the year and into 2023. With these introductory comments, we are now prepared to take your questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Jamminder Bhullar with JPMorgan.

Jamminder Singh Bhullar
JPMorgan Chase & Co, Research Division

So first, I just had a question on -- obviously, on pricing in the reinsurance market. Obviously, cat pricing hardening a lot with -- after Ian, how do you think it will affect pricing in non-cat lines? And where do you see the best opportunities for growth for Arch?

Marc Grandisson
CEO & Director

So thanks for the question. I think it's still early. I think the Ian is one part of the equation. This is what I think we should probably see an impact on other lines of business because aside from Ian, we also have the markdowns and inflation concerns and whatever else is out there.

So it would be reasonable to expect dripping effect through the other lines of business. I also want to remind everyone that the market has gone through a hardening outside of cat for the last 3 to 4 years. So I'm not sure we would see a similar or furthering or hardening the same level that we saw. But we're at a really, really good level right now. So anything that is incremental above that is hugely accretive to us on an industry certainly in Arch.

Jamminder Singh Bhullar
JPMorgan Chase & Co, Research Division

And then how do you think about capital? Because a lot of companies, total equity has come down a lot because it marks on AOCI. And I noticed you bought back very little stock this quarter. Not sure if that has anything to do with capital or just preserving capital ahead of cat season. But how do you think about capital overall for the industry as well as for you guys and specifically, how that's affected by declining total book values?

Marc Grandisson
CEO & Director

Yes, I'll start with the overall industry, and I'll turn to Francois for specifics for Arch. I think that the capital going out in the industry is a big deal. We are an industry that rights against the surplus. And unlike 2008, when the markdown has recovered pretty quickly. We don't seem to be right now at this point in time, at least in a position where it will recover soon.

So there's going to be pressure on the capital in terms of how you write the business and how much you're allowed to write or the rating agencies or the regulatory agencies. So I think it will create pressure that pressure is not going to be short term. We think it's going to last for a while.

And as an underwriter, capital is one of the main ingredients you have to create underwriting decisions and provide service to your clients. So it's a big deal. And we're talking some companies using 20% to 30%, 35% except these are big changes. And I would add, as you know, Jimmy, that in initiatives, we have an environment where there are a lot of uncertainties, inflation, recession and whatever else is out there. So -- and I think we're all collectively bracing for interesting several quarters ahead of us. Francois Morin?

Francois Morin
Executive VP, CFO & Treasurer

Yes. The 1 thing, Jimmy, I'll add to specific to our Arch, right, and that's really part of our history. We've always operated with the principle that we wanted to have a strong and conservative balance sheet, right? And why have we done that? Why are we thinking that route? It was always with a mindset that we wanted to have optionality. We wanted to be able to take advantage of improving market conditions when and if they come around, right?

And what I mean consistent and strong and conservative balance sheet, it's, a, the investment portfolio, you saw that in our markdowns, we got some like everybody else, but I think we're probably more on the low side. And also in terms of leverage, we don't have a very levered balance sheet. Even today at 9/30, we're below 25% or right at 25% on a just-to-capital basis.

So those are the reasons why we feel like that's -- again, that's been our strategy. And this may be a moment in our history that tells us that and we'll be able to enjoy the benefits or reap the rewards of maintaining such a strategy.

So I think we're in a really, really good position. We're positive. We're optimistic about the market going forward. We're still not there yet, and we'll see what happens at 1/1, but at least from the balance sheet point of view, we're in a really good position.

Jamminder Singh Bhullar
JPMorgan Chase & Co, Research Division

And any color on the sort of minimal buybacks this quarter?

Francois Morin
Executive VP, CFO & Treasurer

Well, again, it's twofold. I'd say, a, we typically don't do a whole lot in the third quarter ahead of the hurricane season. So that's very consistent with our history. There's always -- the stock price matters, always, as you know, in the short and stock buybacks.

So going into the quarter, we just wanted to see how things played out. And also with the expectation that we would -- the hard market, even before Ian, we still thought that the hard market would be -- go well into 2023. And that was one of the reasons why we felt maintaining the capital base that give us the ability to write on that business in '23 was critical to us.

Operator

Our next question comes from Elyse Greenspan with Wells Fargo.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

Given your expectations for pretty strong price increases at January 1. Obviously, we have some time right until Florida and other business renews later next year. But where would you think -- based on the growth you think you could see in reinsurance? What do you think your PML will shake out next year?

Marc Grandisson
CEO & Director

What -- a really good question, Elyse. And I think it's obviously dependent on the risk-adjusted return that we would see in there. Like I just want to remind everyone that we're underweight at 7.7%. So we have room to grow if we see the opportunity. We did grow a little bit in 2022, seeing opportunities.

We would do the same thing if we were to be presented with the same situation. I think we have the capital, the appetite and the expertise to really participate in the upcoming market hardening. I think at least the -- if it continues to shape up the way it's designing itself, we're going to be part of a solution. We're going to be part of creating new solutions and providing meaningful capacity to our clients.

What I like about what we are is we have a diversified platform. As you know, it is a lot of flexibility and as Francois mentioned, we're in a very good position. What I could say is, if you tell me what the returns were, I would tell you how much we would be willing to take. But you would expect to hear from Arch that the way we think about building up the risk in the tower is incrementally as we would go up on the PML, we would the expected return to increasingly improve over that period.

So it will be really, really highly depend on how much the rates go. And [indiscernible] I think it's too early to tell. What it's going to be, right now, what we think it could change, but it should be significant.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

So based on what you think could transpire and you think about putting your capital to use next year, insurance, reinsurance, mortgage, I mean it sounds like more will be on the P&C side. And then do you see more going to reinsurance versus insurance, because it sounds like you guys are still seeing some good opportunities on the insurance side as well.

Marc Grandisson
CEO & Director

Yes. Well, I'll tell you, Elyse, if you look at -- this is the beauty of our platform, right? When you had a reinsurance company and an insurance company, was to participate in the upswing of the market that is reinsurance is a really, really quick and proactive way to do.

So we think in the early stages of this hard market gets there, that we would be deploying more capital more quickly into our reinsurance unit because it's also what I think most of the need is going to do, right, on the insurance portfolio, at least as you know, fiscal year to turn over our portfolio, whereas a reinsurance portfolio could be done much quicker.

So I think it's going to be in steps like it always has been. It's the same in 2002 when we were formed. We were really, really reactive and very quick to market on the reinsurance side as we saw our insurance business building up and getting traction and take advantage of hard market.

So I think over time, we then where does it land in 2024 and beyond if we have this opportunity, again, as I mentioned, then it will be relative returns. It will depend who gets a better risk-adjusted return. They will have to go in front of Francois and I and argue their case. These are our prospective units. And this is what we're going to go through. We go through this on a quarterly basis to make sure we're keeping all the returns in the same -- the most optimal as possible.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

And then one number is one. Francois, you pointed 230 basis points in the reinsurance segment, I think from elevated property claims. So if we're thinking about that kind of the run rate, I'm assuming we should x out that $230 million and then assume as the business shifts more towards property and property cat that there would be underlying loss ratio improvement driven off of mix and rate in that business?

Francois Morin
Executive VP, CFO & Treasurer

Yes. I think that's the fair way to think about it. I mean, we've said before, I think looking at loss ratios on a quarterly basis is not something. It's not how we think about it. We like to take more rolling 12 months or even maybe longer periods to have a view of the long-term performance of the book.

Again, I was just making a point that just to let everybody know that we're not worried about this little blip in our quarter, very much part of the normal volatility of our business. But going forward, if the market ends up being very constructive, let's say, on the short-term lines. Specifically, yes, the loss ratio presumably could come down a little bit.

Operator

Our next question comes from Michael Zaremski with BMO.

Michael Zaremski

I guess just sticking with capital. Is the -- I know we don't -- I don't want to spend too much time about this S&P Capital model. But I remember checking my notes from the spring when they were all using them as a punching bag or at least I was. And they were supposed to release a new version soon before year end, I thought. And there was always the issue of kind of the Bermuda senior debt, maybe not getting credits. I don't know. Any thoughts? Is that something you guys are thinking about? Or does that issue kind of not a tail risk we should -- or anything we should be thinking about?

Francois Morin
Executive VP, CFO & Treasurer

Yes. I mean I think we -- many of us thought we haven't answered all those questions by now. The model proposals that they perform were substantial and broad. So I think it impacted most -- I mean most types of companies, Europeans, North Americans, like B&T, et cetera. They did get a lot of feedback. So the current thinking and what they just let the world know recently that there -- call it, their second version of their proposal will be out in the first quarter.

So there's a little bit of uncertainty there as to what changes they may make to what they suggested initially. We've had discussions with them. Many others have as well, specifically in this Bermuda debt issue. We'd like to think that's going to get resolved reasonably well. We don't have finality on that. But we're somewhat positive that we'll get a good resolution there. So from that point of view, I'd say our capital base is strong, and we don't see a need to make any changes to it at this point.

Marc Grandisson
CEO & Director

If I may add, Mike, one of our key things on capital and we allocate capital on an economic basis, S&P is definitely an important piece of the puzzle, but it's not the only thing that drives us. So we're carefully paying attention to it. And we'll see what happens.

Michael Zaremski

Okay. Understood. Appreciate it. Maybe switching to your primary insurance operations, which I know are diversified among a number of businesses. But I guess a lot of good commentary in the prepared remarks. Could you give us an update on kind of where pricing has been trending? And maybe just a broad question on the primary insurance marketplace and maybe it's just -- maybe it's tough to put a paint with a broad brush. But if we thought about the angry insurance life cycle clock. Just kind of curious where you -- what time you think it is?

Marc Grandisson
CEO & Director

It's a great question. I look at the clock many times a year and looked at it last week, we're about 12 noon, 11:30, 12 noon on the P&C side, I would say. And probably 08:00-ish on the property cat space. But the clock can be turned back. So I'm not sure that 11:30 is going to stick. So that will be my comment and sort of alludes to the first question -- the first question I answered.

I think that overall, most lines are getting rate over trend. We're still seeing plenty of opportunity. The fact that this is a broad statement, right, you're rightfully point that were specialty product company were many different products and everyone, every one of these products has different characteristics, different exposure base, different attachment points, different geographies.

Broadly speaking, most lines are still getting rid over trying, I think some others have said that in other calls this week. But I think that as an every hard market, this is what we're sort of observing in a few areas. We've -- there's been a lot of -- they have been for the last 3 years, almost over correction in some certain pockets. And I think that appropriately and rationally, people are looking at the history and the experience and they're seeing the experience is much improved. One example is x D&O for instance.

I think it's a line of 2 here and there that have smaller rate increase or smaller rate decreases. The thing is it gets recorded broadly, gets a lot of headlines in the papers, but it's just not really a true reflection of the wider market. I think that by virtue, if you look at the way we operate on the insurance and reinsurance on the P&C and mortgage for that matter, we're really focused on risk-adjusted returns. And if we -- if you see us grow, it's because the risk-adjusted return is and the profit is there. So I think overall, the market is still very, very -- is presenting us with a lot of opportunity, both on insurance, P&C and reinsurance. .

Michael Zaremski

And maybe -- I think you brought up the excess in surplus lines marketplace. Any -- maybe you can remind us how large of a business that is for you all? And is that -- is that -- are the dynamics different in that marketplace versus kind of the picture you painted in terms of the primary insurance marketplace clock?

Marc Grandisson
CEO & Director

No, I think that -- no, actually not. It's actually an area that is still very, very active and very interesting for us. A lot of our growth actually comes from those E&S property and Casualty line of business. But to be selective, not all 1 line and all 1 monolithic subline as you can appreciate. But certainly, we're participating in the ones where we like the risk return. Our E&S premium right now in the U.S. because it's hard to decipher what's in London. But in the U.S., it's about 28% of our premium that we write at E&S is almost double from what it was 3 or 4 years ago.

So we have really leaned heavily into that marketplace and continue to do so. I think that what's happening with Ian and the acute need for capacity, specific kind of property should mean more E&S property opportunity and potentially some E&S Casualty opportunities as well. I want to remind everyone this is a beautiful business to have as a specialty insurance company because you have a little bit more freedom of form, freedom of great and I think this is where really our underwriting acumen and underwriting expertise could showcase itself.

Operator

Our next question comes from Yaron Kinar with Jefferies.

Yaron Joseph Kinar
Jefferies LLC, Research Division

My first question is with regards to the changing reinsurance market. Do you see that leading to changing retention rates in both insurance and reinsurance? And if so, what impact do you see that having not only on the top line but also on potentially lowering the attritional loss ratio and increasing the acquisition costs?

Marc Grandisson
CEO & Director

That's a broad question, Yaron. It's a great question. And I think we're all incurring intently observing. I think -- maybe the best way to -- if I could allow me for 1 second to sort of draw a parallel with Katrina and the way it evolved back in '05. It's not exactly the '05 , but let's go there for 1 second and we'll back and come again turning back the clock, as I just said before, after the '05 turn market, portfolios have to be priced at the insurance level.

The insurance company took a long time, took 1.5 years to really repurpose and re-underwrite and reform, reshape their insurance portfolio to make sure that it was better appropriate and not as risky. So risk -- not risk off but readjusting the risk that insurance companies are taking is something that I believe they will be doing for the next 12 to 18 months. But as I said before, it takes a long time to do so. In the meantime, you still have the exposure. So typically, what happens is the reinsurance companies come in, say, well, we're going to need more returns for the capital or capacity that we're providing to you the portfolio hasn't changed for last 2 months, it's going to take a little while.

We want to see what impact, what you're going to do in the portfolio. That was '05, right? So -- and then what happened as you get into the new year, as a buyer where our interest group is no exception, you still need to buy reinsurance and cat reinsurance. It's still a volatility that it's appropriate and prudent to purchase.

So the purchasing still occurs. There might be some push and pull on the retention. Presumably, your retention would have to go up somewhat, may be constrained -- they were constraint on what limit is available. So I think if you put it all back together, they'll be shifting and changes in the reinsurance side, more likely everyone on, as I mentioned, and as we lead towards floater renewal in midyear.

The insurance portfolio will sort of be reacting to what the reinsurance market is telling them that it's more costly from a cat perspective. It's going to take a long time to develop. I mean it's not like a one renewal and done, like '05.

Yaron Joseph Kinar
Jefferies LLC, Research Division

But do you think -- I guess if we focus on reinsurance segment for a second. So ultimately, I would think with maybe lower or higher retentions, maybe you actually see some improvement in the attritional loss ratio, but at the same time, some head to the acquisition ratio?

Marc Grandisson
CEO & Director

Yes. So you had the question, I apologize. So the answer is [indiscernible] a few point. As you see the reinsurance price gets more expensive, if you change the word perhaps to even buy reinsurance. The insurance team now know that they need to charge more to make up for what they lost or to get the protection because the reinsurance market is also telling them something very, very, very informative as what is the price of cat charge, and you need to charge for cat risk.

So you're right. So overall, we'll have pricing increase on the primary insurance portfolios, which, to your point, where lead to -- should lead to a lower attritional loss ratio because it's the same kind of losses from an attritional perspective with our premium. So yes, that is a fair assessment, fair expectations.

Yaron Joseph Kinar
Jefferies LLC, Research Division

Okay. And then a follow-up to the segment you made earlier on the marks. I had always [Audio Gap]

rating agencies is largely looking through interest rate-related marks maybe with some exception with S&P. And I also thought that stat accounting doesn't really account for interest mark. So why would that lead or become an industry capital issue?

Francois Morin
Executive VP, CFO & Treasurer

Well, I think it's -- there's the official kind of announcement or what the official view of how people look at certain things, but to be honest here. I don't think anybody totally put it to the side and doesn't consider it at all. There's companies that have lost 20-plus percent of their capital base so far this year, rates go up another 100 to 200 basis points over the next 12-plus months.

At some point, there's -- you can't write a diversified book of P&C business at 3 or 4 or 5 to 1. I mean that's just people are going to push back and you got to have a plan to either remediate or have a view on when those markets are going to refer back. So rating agencies are, I think, in that camp. I think they'll give us and others some latitude, but it's not infinite.

It's not like they don't consider it at all. So that's really our point here is that like it or not, some capital has evaporated, not permanently, but for the time being, it's something we need to work through.

Operator

Our next question comes from Tracy Benguigui with Barclays. .

Tracy Dolin-Benguigui
Barclays Bank PLC, Research Division

I have follow-up questions on your ability to grow prop cat risk and capitalization. I feel like your 25% target of 1-in-250 PML tangible equity, it's an easy way to communicate your appetite to the street. But I realize a low consideration is allocating capital on a risk-adjusted basis. So can you remind us -- how do you view diversification credit or covariance between MI and catastrophes? Or said another way, does your risk-adjusted capital consumption from MI restrict your ability to take on prop cat risk even if there is diversification credit?

Marc Grandisson
CEO & Director

I'll start, Tracy, a very good question, but we won't divulge why are -- what economic model is. But if you look at the economic model, there is a large amount of lack of correlation between MI and the P&C doesn't mean that they can't go bad at the same time, but it's some noncorrelation between the 2.

There's also a lot of correlation benefits that we derive from being a multitude [indiscernible] of around the world. So we have a very fairly diversified portfolio. I think the way that we look about this is the way you look at the curve, your economic curve, again, we have to be careful. It's a mathematical exercise. We're not beholden to only mathematics. But if you look at the way you flex the PML, if you put the pressure on an increase of curve and see what could happen in, what is scenarios. And -- but you always have the eye of a maximum downside that you're wanting to take combining both of these or 2 or 3 of these really like 45 curves that we have.

That's -- I'm going to leave it at that for now. I think that this is an exercise that we do all the time. We're going through it right now and it's ever changing because pricing is moving. And it's one thing that is I want to remind everyone is that we don't only look at the loss itself. You have to look at what premium you charge for the risks, that's what really is important. The combined ratio on the profit level is very, very important.

And every time you have a line of business, that provides more profit. When margins improve or increase, it helps the overall balance sheet, the overall portfolio that you have on the insurance risk. Having said all this, we have a proper hard stuff on a downside potential. We don't want to bet as Francois mentioned, the balance sheet because we still want to be able to take advantage of the next market if and when it does present itself.

On the mortgage side, we remind everyone that we buy a fair amount of quota share, so that sort of protects a lot of downside. It's also part of our consideration. We buy quota share; we also buy excess of loss. So we have some protection. That's also a good example of how we manage the risk, even what we like. We still very much like the MI risk, but we feel very prudent in making sure some of the downside is somewhat protecting for the same reasons that Francois mentioned earlier on the call. Francois, do you also want to add?

Tracy Dolin-Benguigui
Barclays Bank PLC, Research Division

Yes. Thank you for reviewing the process. I was just trying to get out, do you think that gives you an advantage to grow and prop cat risk given the diversification credit?

Marc Grandisson
CEO & Director

Absolutely. There's no doubt in my mind. But it's not -- again, it's not the diversification. The diversification we always were conscious, as I mentioned, to make sure the profit is improving. And I guess on the property cat, the one thing that's should be clear. I mean we -- it's riskier. So now the charges that's what we talk about having a higher charge need to take a commensurate or similar rate that we would take let's say, in trade credit points.

We need to be cognizant of those things. I think, yes, it is really a fact that -- in addition, earnings power, to your point, I mean, that's what you're sort of alluding to the fact that we have earnings coming from MI definitely help us as we redeploy capital into the other opportunities that we think we see ahead of this.

Tracy Dolin-Benguigui
Barclays Bank PLC, Research Division

Okay. And I also want to go back to the conversation on negative marks and capital in a way why does it matter? I know S&P would penalize you for that. But don't you have access of up to $1.3 billion line of credit. So you should actually crystallize any unrealized losses by being a for-seller? Is that fair? I'm just wondering if investors should pay more attention to liquidity.

Francois Morin
Executive VP, CFO & Treasurer

Well, I mean, it's a fair point, we -- again, we're not constrained. I think that's the most important thing. Leverage ratio is down, but we also have access to other forms of capital. Our line of credit is 1 that you mentioned. There are others. So if the opportunity is there for additional growth in P&C lines and maybe mortgage whatever, we'll see them as we move forward, I think my view is that it's hard to write on, call it, capital that's just not on the balance sheet, right? So it's got to be in the balance sheet somehow. And our view is, yes, we see recovery in the unwinding of that mark-to-market hit so far. But the capital base has to show that it's real and silent to get credit and right on it.

Marc Grandisson
CEO & Director

And Tracy, the argument that you're pushing us on, I mean, you could take it to the extreme, right? Because what if the capital goes up by 80%, why shouldn't I? What's -- but at some point, it starts to matter. It's not as important, it's 5% or 10%, it's more 30% and becomes progressing more important because in the end, we have to pay our policyholders.

And we have a reserve, we did a cat loss, we need to take care of our cat loss and it does matter in the big world. So I think it's -- I'm not think it should matter 100% now because there's some marks and it's still capital available, but it has to make a difference somehow over time because argument would fall, right? At what point do you think it stacks to matter 50, 60, 80, I think it's matter it's a different degree through the capital stack.

Tracy Dolin-Benguigui
Barclays Bank PLC, Research Division

Okay. Just 1 last one, really quickly. Given the higher reinvestment rates. How long will it take Arch's mark to creep back to book value?

Francois Morin
Executive VP, CFO & Treasurer

Well, I mean, there's -- we've done some rough math. I mean, you can kind of look at it like a portfolio turning over in, call it, 2 years on average. So that's all it 8 [indiscernible] over and you can do kind of rough math by that. But the reality is we're going to also -- I think we're going to -- Yes, we do have plenty of free cash flow coming through and that's going to be reinvested at pretty significant levels. So we think that overall, the book value should start growing pretty quickly beyond just the recovery of the markets.

Operator

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

Joshua David Shanker
BofA Securities, Research Division

I wonder if you can give a little outlook on the mortgage insurance sector. Are we at the bottom of the issuance cycle here for opportunities? Does this last for a little while? Are there even fewer mortgages that are going to be purchasing insurance over the next year? Where do we stand right now?

Francois Morin
Executive VP, CFO & Treasurer

Sorry, Josh. In what sense and on the primary side of MI or ...

Joshua David Shanker
BofA Securities, Research Division

Yes, primary MI, clearly new home sales are down. And so obviously, we're going to expect less flow. Are we -- is it going to continue to decline from here? Or is this kind of what, I guess, a holiday from mortgage issuance looks like for the MI business?

Francois Morin
Executive VP, CFO & Treasurer

Well, we've said it before. I think -- and it still holds. I mean, the in-force book is where we're going to generate most of our underwriting income for the foreseeable future, right? For the next 2 to 3 years, doesn't matter really materially weather production is stable, declining, increases -- increasing, the in-force book is going to drive the underwriting income for the next 3 years or so.

And we are very comfortable with the level and the performance of that book right now because as we know as we said before, home price appreciation is a big part of that. Refinancing, refinance activities coming down. So persistency is up, et cetera. So there's a lot of things pointing us in the direction of saying, yes, that in-force book is doing well, and we'll keep doing well, we think. Over time, no question that if new production keeps declining the levels, very low levels for an extended period, then it maybe starts to showing the numbers, but we don't think that's anytime soon.

Marc Grandisson
CEO & Director

And on the NIW, which Francois mentioned about new production, if you look at the MBA numbers, the purchase market, which is my part and most important one for the MI business is a lot more stable. There's not as much of a decrease. So we're still fairly positive that we're still going to get some nice production from our team over the next several quarters.

And again, I remind everyone that as you know, mortgage is up 7%, but it does make it a bit harder to get into a home. But the fact is there's still pent-up demand for home. So the purchase market should stay pretty active for this next several quarters, which bodes well for NIW just forward-looking.

Joshua David Shanker
BofA Securities, Research Division

And as premium yield declines on insurance in force, I mean, is there a bottom that we should be expecting? Or does it continue to tick down in the coming years?

Marc Grandisson
CEO & Director

Yes. I think I mentioned in my comments, the industry is everyone else here on the call, talking about what's happening around the world, some uncertainties, recessions, whatever else, potential thing that could happen. And the industry is raising rates -- rising premium rate as we speak on the mortgage sector, which is good news, which speaks, I believe, volume for the new environment that we have in MI, an industry that is a lot more disciplined and deliberate in what it's doing. It's something we would've expected, but it's good to see it happen in life in the like case that we're seeing right now.

Joshua David Shanker
BofA Securities, Research Division

Depending what happens at 1/1 is mortgage insurance still the highest RIOC of your opportunities?

Marc Grandisson
CEO & Director

Right now, we have a lot of discussions about this. Right now, we believe that our P&C operations are slightly gaining and getting ahead of it not only the MI group that, but it seems that the P&C units are squarely taking the lead.

Operator

Our next question comes from Michael Phillips with Morgan Stanley.

Michael Wayne Phillips
Morgan Stanley, Research Division

The question is no discounting in the current times we're in with property cat and massive hurricane on the heels of what's going on with interest rate environment and everything else in mark-to-market. But -- and we into a lot of events around property cat pricing, obviously. But to what is it you think we're in a period that's very early innings of more respectful property cap that this will continue actually over the long term, which clearly has not happened in a very long time.

Marc Grandisson
CEO & Director

Well, the answer is we don't know, right? I mean this is protecting the future. I mean there's a lot of modeling out there that is trying to address it, and we certainly are on the cutting edge ourselves with mineralogists and everyone else, we have to make sure we're on top of it.

But again, it's like everything else, it's a prediction, and we try to put as much cushion or a little bit of extra level of conservativeness to make sure that you're on the right side of the equation. And if things keep on going and you're getting worse and even better, then you adjust and you're fracking the last data point into your next year's expectations.

I think that if you take a step back, I talked about it on my comments, what's also going on is that we sort of disregarded the true expected cat losses if you were to just allocate without putting a lot of weight or a lot of the increase into some of the factors that parameters that go to cat pricing, we, as an industry, should have priced more to which we're charging more for the cat risk and we didn't.

And I'm always reminded of a lot of large numbers, which says, over the long run, you get what you deserve in the results. So it's not far from my mind to think that perhaps just perhaps it's not necessarily any change in climate change that could be the case, but it could also be just that by virtue of not charging enough over time that you sort of get -- [indiscernible] reward at mispricing.

Operator

Our next question comes from Yaron Kinar with Jefferies.

Yaron Joseph Kinar
Jefferies LLC, Research Division

Yes, I'd take this opportunity to follow up on, so you mentioned the script cyber. So maybe 2 questions there. First, on the attritional side, my understanding is that it's really about active management, so not just the annual questionnaire at the time of renewal, but really identifying and managing real-time vulnerabilities. So as a traditional insurer, what capabilities do you have on, on that front come from a tech angle? Or are you partnering with third-party vendors to achieve this?

Marc Grandisson
CEO & Director

Yes. So the answer is -- a great question, Yaron. I think number 1 is we are partnering up with guys who are cutting at really on top of data technology and forensic work for our clients, and that's a really good place to be. We also have a team of funding our -- a lot of our teams who are on the tech side because cyber risk are not part of the underwriting team. So we get a lot of people within the underwriting units were actually IT people and cyber specialists and they themselves also contract with other third-party vendors as well to make sure that we're on top of it. In addition to all the third-party better that we have ourselves within the company. So we also want to look out and understand it more and more. And it's a big investment that we can mentioned.

Yaron Joseph Kinar
Jefferies LLC, Research Division

Got it. And then the other question I had on cyber. Actually, one of your competitors was talking about this today as well. Kind of the need to get more comfortable with the tail before really pursuing more significant growth in this line. So how are you thinking about the tail? And how are you -- are there actions you're taking in order to manage it and allow yourself to get the comfort to grow?

Marc Grandisson
CEO & Director

That's very good question. This is harder to manage a technical level, as you can appreciate, right, because it's from the cloud and other outside systems. I think that what we do right now is instead of -- in lieu of adding this technical structure, infrastructure, which we think at some point, it should come or will come is let's be shortfall and realistic about what our worst case downside hurricane be. And we have various scenarios that we've done every quarter to make sure that we're on top of it.

and again, there's the downside to everything we do in life. But again, we are weighing it with the returns that we're seeing, and we think the risk which reward is fairly in our favor. We like the odds of that business.

Francois Morin
Executive VP, CFO & Treasurer

And 1 thing I'll add to that, Yaron, is to us, we think of it as an earnings event, not a capital event. So we -- some of these kind of, we think, pretty severe widespread events would not hurt our capital base.

Yaron Joseph Kinar
Jefferies LLC, Research Division

But that's probably also because the book is still relatively small in the overall portfolio, if it does grow, that could become a capital event unless you have proper exclusions or risk protection and so on.

Marc Grandisson
CEO & Director

Yes. We also have reinsurance that we buy and other things that we can do there as well. So yes, we're on.

Operator

I'm not showing any further questions. I'd like to turn the call back over to Marc Grandisson for closing remarks.

Marc Grandisson
CEO & Director

Thank you for your listening to our call. Looking forward to talk to you again in New Year, but perhaps no more exciting news. We'll see what the market gives us. Thank you very much.

Operator
This concludes today's conference. This concludes the program. You may now all disconnect. Everyone, have a great day.