S&P Global
Market Intelligence

Arch Capital Group Ltd. NasdaqGS:ACGL

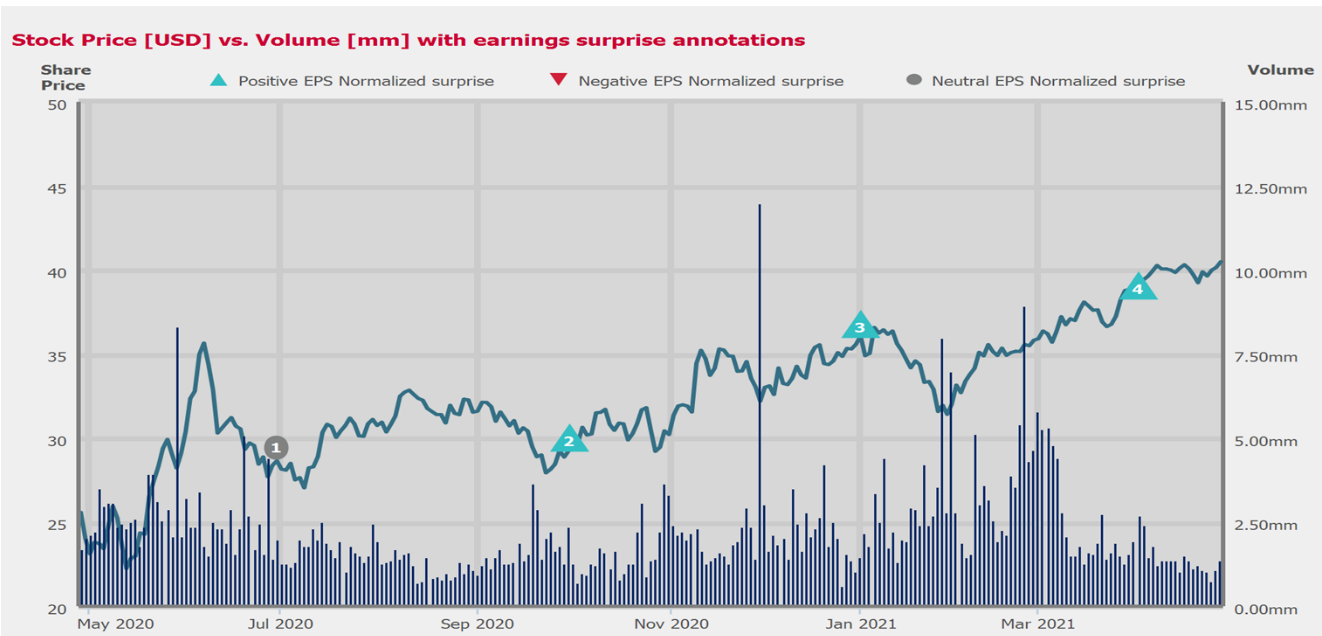
FQ1 2021 Earnings Call Transcripts

Wednesday, April 28, 2021 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ1 2021-			-FQ2 2021-	-FY 2021-	-FY 2022-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.45	0.59	▲31.11	0.64	2.65	NA
Revenue (mm)	2271.04	2508.46	▲10.45	1912.54	8207.58	NA

Currency: USD
Consensus as of Apr-28-2021 10:38 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2020	(0.17)	0.04	NM
FQ3 2020	0.17	0.29	▲1 70.59 %
FQ4 2020	0.38	0.56	▲2 47.37 %
FQ1 2021	0.45	0.59	▲3 31.11 %

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Call Participants

EXECUTIVES

Francois Morin
Executive VP, CFO & Treasurer

Marc Grandisson
CEO & Director

ANALYSTS

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Philip Michael Stefano
Deutsche Bank AG, Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the First Quarter 2021 Arch Capital Group 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 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

Thanks, Liz. Good morning, and thank you for joining our earnings call for the first quarter of 2021. The power of Arch's diversified strategy is evident again this quarter as we have strong underlying earnings across our 3 operating divisions and a 7.8% operating ROE despite the cat events.

Pricing is attractive in almost all of our insurance markets and more than meets our cost of capital thresholds. As a result, we expect the next several quarters to continue to show improved underwriting margins, partially due to the compounding of rate-on-rate increases and the rebalancing of our mix. Importantly, the market is showing discipline in maintaining its momentum and the recent cat losses are likely to keep upward pressure on rates.

Our 3 primary areas of focus for 2021 are: one, continuing our growth in the sectors where rates allow for returns that are substantially more than our cost of capital; two, optimize our MI mortgage insurance book as it transitions from forbearance to recovery on its way back to normalcy in the next few quarters, our notices of default are leveling and the quality of recent production is excellent; three, actively managing our investments and capital to enhance our returns over the longer run.

The past quarter, P&C premium renewal rates increased across a broader spectrum of lines, including several that did not show movement as recently as the third quarter of 2020. We also expect to see exposure growth as the economy recovers more fully, which, in turn, should further spur increased revenues and profit.

On the MI front, housing has emerged as one of the stronger economic sectors due to a combination of positive house price appreciation with good affordability for homeowners. Although mortgage interest rates have increased modestly, they remain low compared to historic levels and continue to fuel strong demand for the purchase market.

Finally, it's worth noting, and Francois will cover in more detail, that there's also some good news on the investment side as yields have increased slightly in 2021. For Arch, every 25 basis points increase in yield should've result in about a 50 basis point increase in our return on equity.

Now let's dive into the businesses a bit more. Turning first to P&C insurance. We are very optimistic about the prospects across our specialty insurance group for 2021. This past quarter, the higher level of premium earned from the post-2019 written period is one of the main reasons why our underlying combined ratio continued to improve. About 2/3 of the improvement was due to lower loss ratios as a result of the impact of rate increases as well as to underwriting actions we have taken over the past several years. The other 1/3 of the improvement was driven by a lower expense ratio.

In Q1, we observed a plus 11% rate increase on a global basis, solidifying the momentum for improving margins in P&C. We are now in the fifth consecutive quarter of rate increase in excess of loss cost as evidenced by our current underlying combined ratio of 93.3% versus 97.1% in the same quarter last year. Adding to the rate improvement already mentioned, we've seen lower claims activity over the last 4 quarters. Nevertheless, we continue to be prudent by maintaining what we believe to be an appropriate safety margin in our reserving approach. One of our key principles is that we are cautious when recognizing favorable news but react quickly to adverse signs in the data.

Next, on to our reinsurance segment. We had another quarter of improving profitability fundamentals. Our trailing 12-month accident year combined ratio ex cat has improved significantly from a year ago. We again had a meaningful increase in net premium written of 25%. In the first quarter, we estimate that our effective rate change or rate over trend was roughly plus 8%. As with insurance, we expect these rate improvements to continue to be reflected in our underwriting results for the next several quarters.

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

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

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

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

Now I'll turn it over to Francois.

Francois Morin
Executive VP, CFO & Treasurer

Thank you, Marc, and good morning to all. Thanks for joining us today. On to the first quarter results. As a reminder, and consistent with prior practice, the following comments are on a core basis, which corresponds to Arch's financial results, excluding the other segment, i.e., the operations of Watford Holdings Limited. In our filings, the term consolidated includes Watford.

On the transaction, we announced late last year to acquire Watford in partnership with Warburg Pincus and Kelso. To use Marc's cycling analogy, our team has been peddling hard in anticipation of the closing, and we are down to the last few kilometers before we reach our final destination. I will provide a bit more color on its status in a few minutes.

As you will have seen by now, we had a very solid quarter despite the severe winter storms with after-tax operating income for the quarter of $239.8 million, or $0.59 per share, and an annualized 7.8% operating return on average common equity. Book value per share increased to $30.54 at March 31, up 0.8% from last quarter.

In the insurance segment, net written premium grew 20% over the same quarter 1 year ago, 28.4% if we exclude the impact of the pandemic on our travel, accident and health units. The insurance segment's accident quarter combined ratio, excluding cats, was 93.3%, lower by 380 basis points from the same period 1 year ago. The improvement in the ex cat accident quarter loss ratio reflects the benefits of rate increases achieved over the last 12 months and changes in our mix of business.

In Addition, the expense ratio was lower by approximately 80 basis points since the same quarter 1 year ago, primarily due to the growth in the premium base. As for our reinsurance operations, we also had strong growth of 25.3% in net written premium over -- on a year-over-year basis, 40.8% if we adjust for an $88 million loss portfolio transfer that was recorded in the first quarter of 2020. The growth was observed across most of our lines, but especially in our property, other than property catastrophe line, where strong rate increases and a few new accounts helped increase the top line by 84.3%.

The segment's accident quarter combined ratio, excluding cats, stood at 84% compared to 91.3% on the same basis 1 year ago. Once we normalize for the onetime impact of the loss portfolio transfer, the improvement in the ex cat accident year combined ratio was 590 basis points, which is almost entirely attributable to a corresponding improvement in the loss ratio. The overall expense ratio remained relatively unchanged, again after adjusting for the LPT.

Losses from 2021 catastrophic events in the quarter, net of reinsurance recoverables and reinstatement premiums stood at $188.3 million, or 10.5 combined ratio points, compared to 7.4 combined ratio points in the first quarter of 2020. These were primarily as a result of the North American winter storms Uri and Viola in February and consistent with our earnings pre-announcement 2 weeks ago, close to 80% of the losses came from our reinsurance segment with the rest attributable to the insurance segment.

We remain comfortable with our level of loss reserves for COVID-19 claims, which remained essentially unchanged from prior estimates. Approximately 65% of the inception-to-date incurring loss amount sits within our incurred but not reported IBNR reserves or as additional case reserves within our insurance and reinsurance segments.

The key performance indicators we track to help us assess the ultimate impact of COVID-19 on our mortgage segment keep trending in a favorable direction. Chief, of course, being the delinquency rate, which came in at 3.86% at the end of the quarter. Arch MI had another excellent quarter in terms of production. And with refinance activity leveling off from prior peaks, we saw our insurance inform remain relatively stable with an increase from our international book, offset by a small decrease in our U.S. MI book. The combined ratio for this segment was 42.4%, reflecting the lower level of new delinquencies reported during the quarter. Both the loss and expense ratio were slightly lower than the pre-pandemic levels experienced in the same quarter 1 year ago.

As a reminder, I wanted to remind everyone of the seasonality that exists in the reporting of operating expenses across our underwriting segments, investment expenses and at the corporate level. Given all incentive compensation decisions, including share-based awards get approved by our Board of Directors in February of each year, the first quarter has generally been the quarter with the highest level of operating expenses, and we do expect the current year to follow this pattern.

Overall, with the underlying improvements in both of our P&C segments, and mortgage segment fundamentals returning to pre-pandemic levels, we are excited by the prospects for each of the 3 legs of our stool. Our objective to deliver a well-balanced return to our shareholders with meaningful contributions from each of our underwriting segments should become more and more apparent as we move forward.

I've kept my segment-level comments a bit shorter than usual in order to give a bit more color on the performance of our investment portfolio this quarter and on the new line in our income statement titled, income loss From operating affiliates. As regards to the investment portfolio, total investment return for the quarter was a negative 18 basis points on a U.S. dollar basis. Our defensive positioning with a short duration and limited credit exposure relative to our benchmark helped us withstand headwinds we experienced on the heels of an 80 basis point increase in the 10-year treasury rate during the quarter, which was a main factor in the negative 56 basis point price return on our portfolio during the quarter.

Net investment income was $78.7 million during the quarter, down 9.3% on a sequential basis. This decrease, while certainly affected by lower available interest rates and higher investment expenses due to incentive compensation payments and investment management fees, is also very much the result of deliberate portfolio actions taken over the last few quarters. Specifically, we continue to maintain a short duration on our portfolio, 2.71 years at the end of the quarter, based on our internal view of the risk and return trade-offs in the fixed income markets. We also continue to deploy additional capital to an alternative investments, the returns from which are generally not reflected in investment income.

Finally, we also transformed some short-term investments this quarter into our 29.5% equity ownership in Coface as well as an investment in corporate-owned life insurance policies. Again, both items whose returns are included in operating income, but are not reflected in net investment income.

Equity and net income of investment funds using the -- accounted for using the equity method, and realized gains from nonfixed income investments returned approximately $154 million during the quarter and were key contributors to the growth in our book value.

Now on to income from operating affiliates, which we are including in our definition of operating income. This quarter, in addition to our share of the quarterly results of investments we have made in operating affiliates, being primarily those from Premia Holdings at this time, we also benefited from an initial nonrecurring gain we made at closing of our acquisition of a 29.5% ownership stake in Coface for approximately $74.5 million.

Consistent with our accounting policy under equity method accounting, we will report our investment in Coface on a quarter lag. As regards to Watford transaction, shareholder approval was obtained in late March, and we are awaiting a few final regulatory approvals before we can close the transaction, hopefully, over the next few weeks. As we disclosed earlier, we expect our ownership of Watford to increase to 40% at closing.

The effective tax rate on pretax operating income was 10.6% in the quarter, reflecting changes in the full year estimated tax rate, the geographic mix of our pretax income, and a benefit from discrete tax items in the quarter. We currently estimate the full year tax rate to be in the 10% to 12% range for 2021.

Turning briefly to risk management. Our natural cat PML on a net basis decreased to $778 million as of April 1, which had approximately 6.7% of tangible common equity remains well below our internal limits at the single event 1-in-250-year return level. Our peak zone across the group changed from the Florida tri-county area to the northeast, reflecting our view of better opportunities given the current rate environment.

Our balance sheet remains strong. And our debt plus preferred leverage stood at 22.1% at quarter end, well within the reasonable range. On the capital front, we repurchased approximately 5.3 million shares at an aggregate cost of $179.3 million in the first quarter. Our remaining share repurchase authorization currently stands at $737.3 million.
With these introductory comments, we are now prepared to take your questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Phil Stefano, Deutsche Bank.

Philip Michael Stefano
Deutsche Bank AG, Research Division

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

Marc Grandisson
CEO & Director

Yes. It's a good question. I'll try not to steer away from the cycling analogy myself. I think very -- at a very high level, the rates keep on being really, really healthy. 11% is above the loss cost trend, as we mentioned earlier. We started seeing this last year in the first quarter. So we're in the second round, if you will, of round of rate increases. While we had some rate increases last year and those policies that are currently being renewed and [whirring] in the first quarter, had another set of rate increases.

So I think where we are right now, the market is really -- psychologically, the market is in rate increases minded and being careful in the way to deploy capital. And I think if you look back at where we came out 18, 19 years, where combined ratio was in the way it's been developing and trending for the last 6 quarters, I think, the story tells itself. The fact that we are indeed getting rate-above-loss cost trend, and that also finds its way into our combined ratio on a quarterly basis.

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

Philip Michael Stefano
Deutsche Bank AG, Research Division

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

Marc Grandisson
CEO & Director

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

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

Philip Michael Stefano
Deutsche Bank AG, Research Division

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

Francois Morin
Executive VP, CFO & Treasurer

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

Operator

Our next question comes from Elyse Greenspan with Wells Fargo.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

My first question, on last quarter's call, you guys had alluded to, I believe, your property casualty businesses generating returns in the double digits and mortgage kind of getting back to the 15% level. Obviously, some noise in the quarter with cats and some of the investment items -- investment income items you pointed to. But do you guys broadly see your businesses generating returns on -- in the double digits and mortgage kind of around that 15% level?

Marc Grandisson
CEO & Director

Yes. Our view has not changed in terms of expectations of what we've written from what we said last quarter, at least, very much in line.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

Okay. That's helpful. And then on the underlying side, in your prepared remarks, right, you alluded to continuing to get underlying margin improvement. I mean you guys have done a really good job over the past few years of rejiggering the business mix, and we're seeing that come through in both insurance and reinsurance. So would that comment imply that the back 3 quarters of the year from an underlying basis would be better relative to the Q1? Was it a year-over-year comment? Just directionally, how should we think about the margins in insurance and reinsurance?

Marc Grandisson
CEO & Director

Yes. It's all relating to the price increase that the market will push through, right, over the next several quarters. But certainly, the earnings that we are seeing currently in the first quarter, right, Elyse, some of it was at lower pricing last year. I know in the first half of the year and in the third quarter, and that kept on getting better as we went towards the end of 2020 and into 2021.

So we should all, everything else being equal, expect -- and expect the margins to be expanding. And if there is more rate increases, then we should hopefully see this and -- well, nothing will -- we'll see them in the numbers right away. But certainly, the feeling and the momentum is building to get more margin improvements, yes.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

And then in terms of mortgage, right, you guys had pointed to kind of getting back to the 35% to 45% combined ratio, 42%, [44%] in the quarter, right? So currently, within that range, based off of what you know today and the fact that you mentioned, right, the level of new notices is slowing, would you expect that the combined ratio for that business would continue to trend better during the next 3 quarters relative to what you reported in the Q1?

Francois Morin
Executive VP, CFO & Treasurer

Well, a couple of points on that. I think just to clarify the comment that I think I made was the, call it, the 35% to 45% range was meant to be more of a, call it, over the cycle, kind of a steady state, not in a stress environment kind of reasonable combined ratio. Do we feel we're kind of in that environment? Yes. Delinquencies, new notices, Marc touched on it. They're back to being roughly 10,000 orders. So that's a good sign.

Could the combined ratio in the last 3 quarters of the year be lower than it was in first quarter? It could. We were not -- we don't know. I think some of it would certainly be a function of reserve releases, if there's any. We just -- again, that's -- we'll have more clarity on that once forbearance programs expire or get people come out of that.

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

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

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

Marc Grandisson
CEO & Director

Yes. I think the -- to me, all the questions about the FHA, the FHFA and all the various government policy that could be put out there. I think we're only receiving it and react to it. And what we have at heart is a -- our risk-based pricing is really making sure that we're allocating capital and supporting the policies that meet our threshold, return thresholds. I think that we still believe that the -- even though there are some push to become -- get more affordable housing available to folks, which we're encouraging, there's still a very healthy level of appreciation for the risk in Washington. So we're not overly concerned with that.

And most of the targeted markets that are towards -- that these policies are geared towards would be the lower FICO and most likely the higher LTVs, which is not typically where we are more -- most competitive and most focused on at this point in time. So we're not losing sleep over this, Elyse.

Operator

Our next question comes from Jimmy Bhullar with JPMorgan.

Jamminder Singh Bhullar
JPMorgan Chase & Co, Research Division

I had a couple of questions. First, on the MI business. I think my speaker's on, let me see if I could turn it off. So first on the MI business. Can you talk about -- delinquencies, obviously, have improved a little bit, but they're still fairly elevated. And it seems like a lot of this has to do with this government forbearance programs versus actual hardship on the part of the borrower. But if you could just talk about what your view is, and you addressed a little bit of that in your comments about equity and homes and stuff.

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

Marc Grandisson
CEO & Director

Yes. On the forbearance, clearly, well, I would have a different spin on you than you would have, obviously, on the delinquency rate. At 3.86%, I think, it's a pretty good place to be. We're not still out of the COVID, so the potential issues that could develop. Now it's looking very, very good, obviously, but we're still not out of it completely.

Of the 3.86%, right, 2/3 of our delinquencies are actually in the forbearance program. And of those who are in those forbearance programs delinquency, 90% -- 94% of them actually have more than 10% of equity. So yes, there is -- this counts, the delinquency count staying in the inventory. We still have an extension of the forbearance moratorium until the end of June extended to -- for -- potentially could be extended. And that's all with the idea that the GSEs and sort of the government agencies want the homeowners to get back on their feet. So it's helping.

It's maintaining a little bit higher level of uncertainty because the forbearance is still there. You still don't know 100% how they're going to turn out. But we still have many cures that had -- that occurred out of the forbearances that were put in there back in April or May of last year, right? 2/3 of them or fewer are now back into current being current. So on one hand, yes, it shows as a higher number in terms of delinquency. But when you look at being 2/3 forbearance program, which is very helpful for the homeowners on the heels of a high level of equity, this is, all things considered, a very reasonable place for us to be. And we think it's going to get -- most likely get better throughout the end of the year and go back to way we saw core delinquency, which is at 1.4% or 1.35%, which is more like what we have historically seen, at least, as of late as of the end of 2019.

I'll ask Francois to answer the COVID question.

Francois Morin
Executive VP, CFO & Treasurer

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

Operator

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

Joshua David Shanker
BofA Securities, Research Division

A quickie and a longer one. The quickie is, so I understand that the expenses are elevated in the first quarter. But first quarter '20 didn't have the same elevated expenses. Can you talk about what was exceptional in that quarter? And why maybe, I'm thinking going forward, we should -- how we should think about 1Q expenses?

Francois Morin
Executive VP, CFO & Treasurer

Well, two things I'd say. One is, I encourage everyone to compare the first quarter 2020 expense ratio and operating expenses compared to the last 3 quarters of 2020. And there's a quite -- there's a good differential there. So that, I think, is -- that's what I was trying to refer to and recognize that there's -- what we saw in Q1 is -- '21, we don't expect is going to reoccur or is going to be the going forward rate.

This quarter, a little bit more -- I mean, I don't want to get too much in the weeds, but there's a couple of things that, I think, impacted this quarter's results. One is, call it, short-term bonus-related compensation where we have a process where we accrue bonuses throughout the year and what we think is going to happen and when they get finalized in February, the following year, then there's a true up. And last year, based on where we were in the first -- certainly the first 6 to 9 months of the year, we slowed down our accruals a little bit because we didn't think that the performance would be there, and it turned out to be actually not as bad as we had thought at the time.

So there's -- effectively, this quarter, there's a bit of a catch-up on the, call it, the bonus accrual that came through. So I call that a bit -- a one-off. And second, there's -- on the equity side, there's -- and performance shares that were introduced 3 years ago. Last year was the first time that -- or this year their first time they actually vested. And there's a final calculation that came through this quarter. And while we accrued for it, it's never quite perfect and we do our best. But it's a bit of a catch-up going on this quarter as well here.

So I'd say those are the kind of two things I'd point you to. I think it's OpEx, we manage those. We track them very carefully. And unfortunately, there's a bit of noise from quarter-to-quarter. But as we look forward for the rest of the year, I think, we're very confident that they're going to trend down from the current level.

Joshua David Shanker
BofA Securities, Research Division

Okay. Great. And that's -- the second question is -- this is the back of the envelope calculation. Maybe I'm not exactly right. But it looks to me that you're carrying right now about $20,000 worth of reserves per mortgage default -- mortgage and default. And if I look back before the pandemic, you were like a little bit higher, maybe '21, but kind of your back to the same reserve per notice that you were before the pandemic. When I think about the pool of mortgage and default that you have right now, my thoughts would be that a higher probability of those are going to cure than in run rate conditions when people go into default.

Am I wrong to think that? Do you think that when you think of the pool that the percentage that are going to cure is normal to history? Or do you think a higher percent will cure or higher will go into claim given the amount you're carrying for reserves? I guess there's a lot in there, but maybe give us some thoughts.

Marc Grandisson
CEO & Director

Yes. I think, Josh, I think, to that probably a shorter answer than you might expect, actually. The fact is that it's very uncertain, and we took -- we did take -- we believe we've taken conservative, at least prudent numbers to put the reserve because of -- due to the tremendous uncertainty surrounding what was going to happen, however long the forbearance would take place, what would be in place, what would the economy turn around? How long would COVID last? And frankly, we're still -- again, like we said to you, Josh, we're still not out of the wood.

So we have taken -- not only us, I think, as an industry, people have taken a somewhat prudent approach to reserving. You're right. We should expect, everything else being equal, and forbearance programs in the past have showed us that when you had an 8% ultimate claims rate on a regular delinquency. When you compare to the forbearance through a cat event, for instance, that is -- that would be sort of a 1% to 2% ultimate claims rate, but we decided to be a bit more careful and prudent in establishing reserve. And I would say that we haven't really changed our mind quite yet.

I think we've also put a moratorium on our revising our prior reserves, and we'll see where the data takes us for the next several quarters. And I hope that your assumption on the back of the envelope is right. And I hope that we prove to ourselves that it was, yes, indeed, a regular -- a more of a regular forbearance phenomenon in terms of curing than more of a regular DQ phenomenon.

Joshua David Shanker
BofA Securities, Research Division

Is there a time line for when that moratorium ends? Or is that a subjective item?

Marc Grandisson
CEO & Director

On our reserving, we -- I think -- I actually looked at the CFO, I think, they're pretty difficult. And I think we just have to take several more quarters. I don't think we're quite ready yet for that. I would expect, Josh, over the next 2, 3 quarters, it's certainly inflecting a lot quicker than we would have anticipated back in third quarter of 2020. So we're like you seeing things well, at some point, we'll need to be as we are, typically, well, when we have solid data to back it, we'll take action at that point in time. And I'm hoping that it's over the next 3 to 4 quarters.

Operator

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

Geoffrey Murray Dunn
Dowling & Partners Securities, LLC

It's actually Geoff Dunn. Two questions. One, just back on the provision this quarter from MI. Can you share the average severity assumption that went along with the 9/1 incidents? I think it was about $54,000 last quarter.

Marc Grandisson
CEO & Director

$4,800.

Geoffrey Murray Dunn

Dowling & Partners Securities, LLC

What was the total severity factor?

Marc Grandisson
CEO & Director

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

Geoffrey Murray Dunn
Dowling & Partners Securities, LLC

I'm sorry. So $4,800 was the actual vision and then [indiscernible]

Marc Grandisson
CEO & Director

Have a reserve for annually. Yes. Yes.

Geoffrey Murray Dunn
Dowling & Partners Securities, LLC

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

Francois Morin
Executive VP, CFO & Treasurer

Well, we've got room. That's for sure. The one thing that is a factor for us, and I'm sure many of the peers is contingency reserves. So there is a -- right? So it's not purely, I'd say, PMIs driven. There is an EIC constraints around the amount of dividends that we can declare based on contingency reserves and the 10-year time of that.

So while -- on the face of it, you might say, "Oh, 190% PMI ratio, there's tons of capacity." We have some, and we're happy with it. But no question that we'll have to go through a bit more modeling and figure out how much we could move out. And then there's other sources for the -- for those funds. But ballpark, a couple of hundred million, I think, is easily -- assuming we get the approval from both the FHFA, the GSEs and the right -- the state regulators. And then if we can get more, we'll certainly try and do so.

Geoffrey Murray Dunn
Dowling & Partners Securities, LLC

So when you say a couple of hundred million, does that assume that you can convince the regulators to let you release contingencies earlier? Or do you think you can bleed surplus down below $100 million at each of the operating companies?

Francois Morin
Executive VP, CFO & Treasurer

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

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, Marc, I'm just curious, now that Watford is going to be -- I guess, you own 40% of it. If you look at kind of the model there, it's a little different in the model you typically deploy in your traditional business. Combined ratio is well above 100%. Is there any thoughts to maybe changing the strategy there a little bit? Or are you going to keep the same one? And then as you book those numbers, are you going to assume those realized gains are kind of going through your operating results?

Marc Grandisson
CEO & Director

Yes. I'll let the second question to Francois. But the first part, Brian, is, I think, that, first, we have 40%, so we're not majority, so there's a Board of Directors. But I do believe that at heart, this is a harder market. This is a good market on the underwriting side. And I think that collectively, we believe that there is an opportunity to maybe focus more the risk or the effort of the capital towards the underwriting as opposed to the investment side of things, but this will have to take place over time, right? We'll have to also talk to our -- to the partners that are currently in Watford and see what expectations they have in the return. So this is an ongoing discussion.

But at a high level, right, I think, that we should expect Watford to become a little bit more strategic from an opportunistic positioning right now at this point in the cycle based on the opportunities that we have right now. I think that the reliance on investment income was probably more in favor back in 2014, 2015.

Francois Morin
Executive VP, CFO & Treasurer

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

Brian Robert Meredith
UBS Investment Bank, Research Division

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

Marc Grandisson
CEO & Director

No, I don't think so. I think that the -- some comments were made as well, Brian, about the E&S market, so they've been vibrant, which is a good sign of not dislocation, but really a renewed or a new underwriting appetite by the Main Street writers. That's not going away.

In new business, it's normal to be expected, right? I think we went through the first year from underwriting, shuffling and readjusting to the new underwriting policy to now, well, let's say, what do we have and what do we want to focus on in terms of new business and maybe seek and grow that. And frankly, all of us here, right, Brian, talk about how the good the market is. So I think it probably makes them a little bit more willing to take on those policies.

But I think it's a hardening market. I will add that new business could be more competitive, but the rates are not going down. I mean it's not like somebody is coming to undercut, which is really the important factor here. I do believe that the new business, typically -- we were once, way, way, way back when a new player in the marketplace. And I do believe that we had pretty lofty expectation in terms of pricing, we would need to get on that piece of business. And I'm expecting -- and that's what we're saying. We're not seeing a softening from that positioning from the external world.

And frankly, Brian, I mean, the existing players are not growing so significantly that it's creating a lot of competition necessary, right? The new business is probably -- probably needs to find a new home with new players. So that's not that surprising. So I wouldn't lose -- I'm not losing sleep over this. Hard market does not last forever as you can appreciate. But we're already in the second round of this. I wouldn't be surprised we have another round to go. And even after that, Brian, it takes a bit longer for things to get softer yet again to the point of not getting the returns. So we have win our sales for a little while here.

Brian Robert Meredith

UBS Investment Bank, Research Division

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

Marc Grandisson
CEO & Director

I think a couple of things. I think seeking quality accounts. There's still some shuffling of accounts around. Some people are debating what to do, stay with clients. We're able -- we have a very good product offering both on these instances. And this is -- these are 2 areas actually where -- I referred to in my comments where that didn't seem to be moving a whole lot. And then we're seeing, finally, for the first time and on rates moving in the right direction.

As you can appreciate, right, a lot of it is work is comp-driven, but it's still -- we can still see clients working with us as we evidence the lack of interest in investment income, some COVID exposure. So I think we're seeing some good traction there and still offering good product. But we have to be careful obviously. We're here of the long haul. This is a franchise positioning for us. It's a little bit of everything. It's a really good story for us, and I'm glad you picked that up, Brian.

Operator

Our next question comes from Derek Han with KBW.

Derek Han

So my first question is, you talked about strong pricing and new accounts driving growth in the property business line within reinsurance. How are you thinking about the loss trends in that line of business, both in reinsurance and insurance?

Marc Grandisson
CEO & Director

Yes. So very much with the same way we would the other lines of business, Derek, where we would look at the history of the loss cost and modeling out in terms of specifically talking about cat loss specifically. Just looking at the cat history of these accounts that are similar. If it's a reinsurance portfolio then it's the experience on the portfolio. And build in some modeling magic, I would call it, based on our own expectations of demand surge or maybe some on-model perspective. And we just price it this way to make sure we have a healthy level of margin.

And it's really nothing new from what we've had historically. I think on property, the one beautiful thing about property is the feedback loop is a lot quicker as opposed to a GL portfolio where it may take you 4, 5, 6, 10 years sometimes to really figure out whether you did the right thing and you price your goods at the right level, property allows us to do a lot of repricing. And right now, our ability to grow in that lines of business is because we're also willing and able to go anywhere on the reinsurance side for that matter in terms of core share or risk access where some of the other players out there could be a little bit more reluctant to go.

And just one thing you have to keep in mind when you price for business and property, you can't just take the last data point and say, this is going to be the recurring one. You have to take a small -- a longer-term period with the proper caveat on the margin for safety to price. So I'm trying to give you a 25-year knowledge base in 5 minutes, I'm not sure I'll be doing that great. But I think, hopefully, it gives you a good flavor for it.

Francois Morin
Executive VP, CFO & Treasurer

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

Derek Han

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

Francois Morin
Executive VP, CFO & Treasurer

Well, there's a couple of things. I mean, sequential, there's always -- Q1 is, yes, there's current, but there's also -- and it gets very granular around payroll taxes. And there's other things that we're just -- we pick up more of those expenses in the first quarter, and they do decrease over time throughout the year. So I'd say, yes, for the most part, is -- incentive comp is a big part of it, but there's also a few other things that just enhance that or make it stand out a bit more. But again, from our point of view or your point of view, you should fully expect a return back to a lower level and starting in the second quarter.

Operator

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

Marc Grandisson
CEO & Director

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

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