Q2 2018 Earnings Call

Company Participants

- Albert A. Benchimol, Director, President & Chief Executive Officer
- Matt Rohrmann, Head-Investor Relations
- Peter J. Vogt, Chief Financial Officer

Other Participants

- Brian Meredith, Analyst
- Elyse B. Greenspan, Analyst
- Ian J. Gutterman, Analyst
- Josh D. Shanker, Analyst
- Kai Pan, Analyst
- Meyer Shields, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, and welcome to the AXIS Capital Second Quarter 2018 Earnings Conference Call. All participants will be in a listen-only mode. After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

I would now like to turn the conference over to Mr. Matt Rohrmann, Head of Investor Relations. Please go ahead.

Matt Rohrmann {BIO 15132648 <GO>}

Thank you, operator. Good morning, ladies and gentlemen. I'm happy to welcome you to our conference call to discuss the financial results for AXIS Capital for the second quarter period ended at June 30, 2018. Our earnings press release and financial supplement were issued yesterday evening after the market closed. If you would like copies, please visit the Investor Information section of our website at axiscapital.com.

We set aside an hour for today's call, which is also available as an audio webcast through the Investor Information section of our website. A replay of the teleconference will be available by dialing 877-344-7529 in the United States, and international number, 412-317-0088. The conference code for both replay dial-in numbers is 10121836. With me on today's call are Albert Benchimol, our President and CEO; and Pete Vogt, our CFO.

Before I turn the call over to Albert, I will remind everyone that the statements made during this call including the question-and-answer session, which are not historical facts, may be forward-looking statements. Forward-looking statements involve risks, uncertainties and assumptions. Actual events or results may differ materially from those projected in the forward-looking statements due to a variety of factors including the risk factors set forth in AXIS' most recent report on Form 10-K as well as the additional risks identified in a cautionary note regarding forward-looking statements in our earnings press release issued yesterday evening.

We undertake no obligation to update or revise publicly any forward-looking statements. In addition, this presentation may contain non-GAAP financial measures. Reconciliations are included in our earnings press release and financial supplement, which can be found on the Investor Information section of our website, which is located at www.axiscapital.com.

With that, I'd like to turn the call over to Albert.

Albert A. Benchimol {BIO 2023727 <GO>}

Thank you, Matt. Good morning, everyone, and thank you for joining us to review our second quarter results. For AXIS, the story of the second quarter is that we continue to see very encouraging performance and further evidence that our transformation efforts and focus on market leadership are generating real traction. This was the second consecutive quarter in which we delivered double digit ex-PGAAP operating ROE. The integration of Novae into our business is progressing as planned and Novae's business is delivering an underwriting profit.

We're also seeing progress with our transformation program to become more effective, efficient and agile to position access for enhanced profitability under a wide range of market conditions. While Pete will provide more detail on the numbers, I'd like to put our results within the context of our transformation and provide you a sense of the sustainability of our progress.

Through the hard work of our talented team, AXIS has evolved from an intelligent and opportunistic provider of large capacity for volatile lines in what was once a hard market to now becoming a profitable and leading player in attractive specialty lines markets. To achieve this repositioning, we've concentrated our resources in both our insurance and reinsurance operations on lines where we have the opportunity to be profitable market leaders on the basis of our expertise, agility, service and strong mutually beneficial relationships with key business partners.

Concurrently, we exited a number of lines where we did not see a path to leadership or profitable growth. We've also invested in areas where we see exciting potential for profitable growth including renewable energy, cyber, agriculture reinsurance and mortgage reinsurance. We grew our geographical footprint and made targeted acquisitions including Novae and Aviabel. We've empowered our underwriters with stronger tools and made our business more customer-centric, committing to greater engagement with our clients and partners in distribution.

By the end of last year, these actions positioned AXIS as a relevant top 10 player in substantially all of its chosen markets including U.S. E&S wholesale, North American Professional Lines, and the London market for international specialty risks.

While much work remains, our efforts are building momentum. This quarter's results provide some insights into the earnings potential of our progress to date. We reported operating income of $106 million or $1.27 per share and operating ROE of 9.5% in the quarter. But we believe this understates the true run rate profitability of our business due to PGAAP adjustments. Pete will speak to how the net drag from PGAAP will substantially runoff by midnight 2019. However, for now, adjusting for PGAAP, our second quarter results would have been earnings per share of $1.43 with an ex-PGAAP operating ROE of 10.7%.

Similarly, the six month results represent an ex-PGAAP operating ROE of 11.1%. As I also emphasized during our last earnings call, this performance still does not reflect the full benefit of the recent and ongoing underwriting actions on both the legacy AXIS and Novae portfolios, nor the synergies we expect to achieve from the integration.

You'll recall we announced revised integration synergy projections of $50 million (00:05:58) by year-end 2020. This quarter reflects $10 million of achieved synergies or $40 million on an annualized basis. In addition, we've made good progress with regards to the redesign of our operating model while reinvesting savings into our business to provide better tools to our teams, enhance our ability to leverage data and analytics and position the company to take advantage of change in the marketplace.

From an organizational design standpoint, we completed the realignment of our A&H operations into the insurance and reinsurance segments, restructured our finance and IT functions around an integrated organizational structure and are continuing to build out our new global underwriting and analytics office.

Separately, our new Reinsurance CEO, Steve Arora has worked with the reinsurance leadership team to establish a new structure for our reinsurance operations that will result in greater engagement with our clients, a differentiated service offering that will deliver innovative solutions and help us gain market leadership. These actions put access on a strong path forward while improving our efficiency and profitability.

We continue to expect that our ongoing transformation will deliver net additional expense reductions of $40 million by year-end 2020 even as we invest in our people and in our business. Coupled with the $60 million in synergies from the integration of Novae, we continue to project total expected cost savings of $100 million by year-end 2020.

As we close the first half of 2018, we're encouraged by the continued improvements in our results as well as the progress we're making against our strategy. We see a clear runway to enhance profitability and remain committed to a journey that we believe will provide substantial rewards to all our key stakeholders.

And with that, I'll turn the call over to Pete who will go through the figures in more detail. Pete?

Peter J. Vogt {BIO 17059745 <GO>}

Thank you, Albert. Good morning, everyone. As Albert noted, the story of our second quarter is that AXIS is continuing to see very encouraging results and further evidence that our strategy is working. During the quarter, we generated net income of $93 million. Our operating income for the quarter was strong at $106 million, generating an annualized operating ROE of 9.5%.

On an ex-PGAAP basis, our operating income was $120 million, generating an ex-PGAAP annualized operating ROE of 10.7%. The quarter benefited from good underlying – underwriting results, a low level of catastrophe of weather-related losses, continued favorable prior-year reserve development and strong investment income. These positive factors were partially offset by modest non-cat weather (00:08:52) property losses, net unrealized and realized investment losses and amortization of value of business acquired (VOBA) and intangible assets.

Before I get into specifics of the income statement, I'd like to provide an update on several items. With regard to the acquisition of Novae, in the quarter we recognized amortization of intangibles of $57 million including amortization of VOBA of $53 million. This expense affected the company's consolidated operating income but was not included in the segment results.

As previously disclosed, VOBA is expected to be immaterial beyond mid-2019. At June 30, $160 million or 62% of the pre-tax VOBA has been amortized. Underwriting income in the quarter continued to include the earn-out of Novae's unearned premium as of the closing date without the recognition of the associated acquisition costs since the DAC asset was written off at closing.

We estimate that the consolidated acquisition costs on an as-if basis would have been approximately $40 million higher, resulting in an acquisition cost ratio of 22.9% versus the reported 19.6%, a difference of 3.3 points. The net drag on operating income from the VOBA/DAC adjustments was $14 million after tax or approximately $0.16 per share. We have added exhibits to both the press release and the supplement that detail this information for you.

With respect to the integration of Novae and our transformation program, we still expect to deliver $100 million in run rate savings by 2020, of which we recognized $10 million in this quarter, up sequentially from $7 million in the first quarter of 2018. These savings were essentially all related to the Novae integration. Non-operating reorganization expenses of $19 million were recognized in the quarter, associated with our transformation program and the integration of Novae.

Moving into the details of the consolidated income statement, the current quarter consolidated combined ratio was 93.1%, an improvement of 4.5 points from the second quarter of 2017. As I have mentioned earlier, it is important to note that the quarter benefited from the absence of the amortization of some acquisition costs. The as-if combined ratio of 96.4% is a 1.2 point better than the comparable period last year. The more than 1.2 point improvement is driven by a 2.3 improvement in the current accident year loss ratio ex-cat and weather, driven by business mix largely related to the addition of the Novae book, favorable impact of rate over trend across a number of lines, partially offset by non-cat/weather losses in the insurance property book and large loss experience in the reinsurance book.

We reported favorable prior period development of $60 million in the quarter, of which $24 million came from insurance and $36 million from reinsurance. This includes a reduction in our estimates for the catastrophes of 2017. There was increase in the acquisition cost ratio of 2.1 points, primarily driven by business mix associated with the addition of the Novae book. There was a 1.9 point improvement in the cat and weather loss ratio, and an improvement in G&A ratio. This was offset by a lower level of favorable prior year reserve development.

As we have stated before, the addition of the Novae book to the legacy AXIS book has resulted in lower loss ratios or higher acquisition ratios due to the characteristics of the Novae portfolio. During the second quarter, the consolidated G&A expense ratio of 13.9% improved by 1.2 points compared to the second quarter of 2017. There were some timing differences in the quarter, and a normalized ratio would have been 14.1%. Fee income from strategic capital partners of $11 million was broadly consistent to the prior year.

As we will now discuss in detail, we're delivering more profitable underwriting in both insurance and reinsurance. The insurance segment reported an increase in gross premiums written of $262 million in the second quarter. The increase is mostly driven by $291 million of premium associated with the acquisition of Novae. The legacy AXIS insurance book decreased by $29 million or 4%. This decrease was primarily driven by a decrease in property lines following our exit from the onshore energy business and the retail U.S. P&C business. This decrease was partially offset by an increase in professional lines, driven by new business across a number of business units. Insurance net premiums written decreased by $102 million - increased, I'm sorry, by $102 million compared to the same period in 2017.

Excluding the impact of Novae, the net premiums written decreased in the quarter, reflecting the decrease in gross premiums written, together with an increase in premiums ceded in property and professional lines. The reported current quarter combined ratio was 90.4%. Again, we think the best way to look at this ratio is adjusting for PGAAP. So adjusting for $38 million of acquisition costs, the as-if combined ratio would be 97%, which is almost a 4-point improvement over the same period last year.

The insurance segment current accident year loss ratio, ex-cat and weather, of 57.2%, improved 3.6 points. The improvement was driven by mix of business largely related to the Novae book, favorable rate over trend actions, and lower attritional loss experience in liability and professional lines.

On the other hand, as we have seen across the industry, the quarter was hurt by an unusual increase in the frequency of property losses. The insurance segment's acquisition cost ratio on an asset basis was 22.3%, an increase of 7.4 points over prior year. The increase was predominantly driven by the addition of the Novae book to the AXIS portfolio. As we noted before, the Novae book has a lower loss ratio and a higher acquisition cost ratio. Pre-tax catastrophe and weather-related losses were $23 million, primarily attributable to weather events this quarter, compared to $41 million in the same period in 2017.

The reinsurance segment reported an increase in gross premiums written of $26 million in the second quarter. The increase is driven by $33 million of premium associated with the acquisition of Novae. The legacy AXIS reinsurance book decreased by $7 million or 1%, primarily attributable to a decrease in liability and catastrophe lines, partially offset by an increase in credit/surety lines. Reinsurance net premiums written decreased by $58 million compared to the same period in 2017. The decrease in net premiums written reflected the decrease in legacy AXIS gross premiums written, together with an increase in the premiums ceded in accident and health, catastrophe, and agriculture lines.

The reported current quarter combined ratio was 90.7%. Again, we think the best way to look at this ratio is adjusting for PGAAP. So adjusting for $2 million of acquisition cost, the as-if combined ratio would be 90.9%, which is a 1.2 point improvement over the same period last year.

The reinsurance segment's current accident year loss ratio ex-cat and weather of 65.5% improved 0.6 point from 66.1%. The improvement was largely driven by rate over trend in the motor and property books, offset by mix of business with a benefit of the lower loss ratio in the Novae book was offset by higher motor premiums, which carry a higher attrition loss ratio, as well as a modest increase in non-cat/weather losses.

The reinsurance segment's acquisition cost ratio on an as-if basis was 23.4% (00:17:24), a decrease of 1.8 points over the prior year. This was primarily driven by loss sensitive features. Pre-tax catastrophe and weather-related losses were $15 million, primarily attributable to U.S. weather-related events in the quarter. This was compared to $9 million reported during the same period in 2017.

I would like to provide some insight on our new cat covers that were put into place in May. Our new covers, which utilize both the traditional and ILS reinsurance markets, bring our PMLs back on the similar levels we reported prior to our acquisition of Novae, with a better balance of frequency and severity protection.

Our covers cross all of our peak zones and event types around the globe. As a quick example of how our cat protection has improved, we would see an approximate $100 million reduction or approximately 15% to 20% decrease in retained losses from the 2017 hurricanes under our new covers.

We think that protecting our capital is critical, but when components of enhanced earnings protection are available at economically attractive levels, it's prudent to leverage those opportunities. Net investment income of $110 million for the quarter was comparable to $106 million in the second quarter of 2017, with an increase in income from fixed maturities securities attributable to a larger investment base from the acquisition of Novae and Aviabel and an increase in interest rates. This was partially offset by a decrease in income from alternative investments attributable to credit funds returns, which were negatively impacted by the weakening of the euro against the U.S. dollar.

Diluted book value per share declined by 0.10 point (00:19:10) in the quarter to $52.47, principally driven by net realized and unrealized losses on investments.

With that, I'll turn the call back over to Albert.

Albert A. Benchimol {BIO 2023727 <GO>}

Thank you, Pete. I'll spend a few minutes reviewing market trends, and then we'll open the call for questions. We continue to see an improved pricing environment. In insurance, the average rate change in the quarter was almost 4% across the entire book. While this is less than the 5% increase observed in the first quarter, I would note that two-thirds of the delta is due to business mix renewed in the respective quarters. Specifically, property lines, which have experienced stronger increases, made up a much larger percentage of renewals in the first quarter.

Our average rate change year to date was over 4% across the insurance book. Within our U.S. insurance division, we achieved average rate change of over 7% in the second quarter, as compared to more than 11% in the first quarter. We continue to see double-digit improvement in both E&S property and excess casualty, while primary casualty and programs were up in the mid-single digits.

Our average rate change year-to-date was over 9% in the U.S. P&C book. In our London-based international insurance division, the average rate change for the second quarter was a bit over 3%, as compared to 4% in the first quarter. While a number of lines exhibited smaller rate increases in the second quarter, there were still many lines showing positive momentum. Encouragingly, 89% of business renewed at flat or better terms in the quarter.

Our average year-to-date price change was close to 4% in our international division, with specialty lines increases about 1 point stronger than professional lines. Within our U.S. professional lines division, market conditions are stable with about 1% increase in average rates, consistent with our experience in the first quarter.

As usual, primary lines are stronger than excess layers. Strongest was primary D&O reacting to elevated industry loss activity in that line. And I would note that we're not a major underwriter of primary public D&O. Across all insurance lines and geographies, we're continuing to focus our efforts on growing our business, where we see opportunities for profitable growth. We remain aggressive in pushing price where it's warranted. As I noted last quarter, this has resulted in lower retention ratios, but our emphasis is on profits, not volume.

Turning to the reinsurance market, conditions are generally following the positive trends in primary lines. In many cases, quota share treaties are renewed at lower ceding commissions. However, pricing for excess of loss treaties is more subdued as excess capacity remains a challenge. In our Europe, Middle East and Africa division, the market is improving modestly and at a slow pace. Pricing was generally flat in the second quarter, with some pockets of improvement in liability and motor.

In our North American reinsurance division, pricing was also relatively flat – excuse me. We're seeing improved performance among our regional and middle market accounts. Ceding commissions are generally flat to down, although we still see certain players hungry to grow at expiring ceding commissions. The property market remains challenging, as rates continue to be at levels that we believe are unsustainable. In Asia, we're seeing improved profitability but based on our own underwriting actions.

On the other hand, pricing for catastrophe lines written out of Bermuda was disappointing, particularly the Florida renewals. Even some loss-affected accounts were able to renew flat. Overall, the Florida renewal was completed at an average rate change in the low single-digits in large part due to the strong appetite shown by the collateralized reinsurance market.

As to our own portfolio, overall, in both insurance and reinsurance, conditions are still moving in the right direction. While in the prior quarter, I advised that that rate was ahead of trend on a written basis, this quarter, rate was also ahead of trend on an earned basis, leading to a small favorable impact in the loss ratio. We're hopeful to see this trend continue into future periods. I'm cautiously optimistic on the outlook despite excess capacity, as some leading indicators point towards further discipline. We continue to believe that stresses in the market are such that more improvement is inevitable.

I'm encouraged by recent actions such as Lloyd's compelling syndicates to address unprofitable business, the increasing number of carriers exiting lines or markets and the significant Re underwriting and costing (00:24:28) programs announced across our industry. I see these developments as signs that management teams are recognizing that in a world of excess capacity, we must take control of our own profitability rather than wait for some mythical market turn. What this tells me is that improvements in results will not be generalized across the industry, but rather limited to companies with the discipline, commitment, and talents to make the right decisions and follow through with the required actions.

I'm confident AXIS is one of those companies. While we have plenty of work ahead of us, we have a head start as we've been on this journey for some time now, and we're showing encouraging results. I'm bullish about our prospects. We continue to execute on our strategy, and our core underwriting results are improving as we exit unprofitable business and increase our relevance in attractive lines, where we can hold leadership positions. We're also just beginning to see the results from our acquisition of Novae, which has strengthened our position in a number of markets.

Our differentiated market positioning, underwriting actions, and progress along the targeted $100 million of cost savings by 2020 provide a clear path to continued improved performance and superior results for our stakeholders.

And with that, we'd be happy to answer your questions. Operator, please open the lines.

Q&A

Operator

We will now begin the question-and-answer session. The first question comes from Elyse Greenspan with Wells Fargo. Please go ahead.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Hi, good morning. First off, I just have to say, I do appreciate all the additional disclosure that you guys provided in the press release and supplement this quarter, so thanks for that. My first question, on the 2017 hurricanes, Pete, you mentioned that there were some takedown on the losses. Can you quantify that, and how much was that from insurance and reinsurance? And then some other players in the space have seen a pickup in losses, especially in Florida with reopened claims for Irma. Have you guys observed that, and was that originally reserved for in your current estimates?

A - Peter J. Vogt {BIO 17059745 <GO>}

Yeah. Elyse, we had $60 million in favorable prior period development. Of that, $31 million was related to the 2017 catastrophes. And of that $31 million, $17 million came from insurance and $14 million came from reinsurance. I'd say overall, we're very comfortable with our reserve levels as they are; we're looking at the storms in total. And just to add some color, I'd say, we just saw a slight uptick in Irma, but we saw some significant reductions coming from the other storms.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay. Thank you. And then in the segments, you had pointed to, I think, in both insurance and reinsurance, non-cat/weather losses in both of the segments. Can you quantify the impact? And then since there is a lot more - the seasonality is a little bit different in terms of the margins, would you expect...

A - Peter J. Vogt {BIO 17059745 <GO>}

Yeah.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

...with the Novae deal - sorry - would you expect sequential improvement in the segments in the back half of the year? And maybe that's more of an insurance versus reinsurance question.

A - Peter J. Vogt {BIO 17059745 <GO>}

Yeah. Let's take the two segments, Elyse. On the reinsurance side, we really didn't see a lot of what would I call non-cat/weather property coming out of the reinsurance side. It was actually focused in a couple other areas there. However, on the insurance side, we really did see an uptick in that non-cat/weather-related stuff. I would put it at about on the insurance loss ratio, probably about 3 to 4 points, Elyse, more than we expected to see in the quarter.

Sequentially, again, we don't see a trend in this. So, with all the underwriting actions we've been doing on our property class as well as the sequentiality of the seasonality, I would suggest that we should see – we are expecting to see that improve over the next coming quarters.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay, great. And then in terms of the – your net gross (00:29:00) fell to 61% in the quarter. You guys highlighted a lot more reinsurance that you've been purchasing. Is that about like the run rate that we should model going forward, or will it be lower going forward, just any color there?

A - Peter J. Vogt {BIO 17059745 <GO>}

Yeah. Again, Elyse, I'd take a look at that and split it between the two segments. On the reinsurance side, there were some – I'd call it one-time transactions in the second quarter, as well as some catch-up for some treaties, like our backdated 1/1. So on the reinsurance side, I think if you're going to look at a ceding percent, looking at the year-to-date number would be a better way to look at it. And on the insurance side, you had a ceding percentage of about 42% in the quarter. We did put as part of our reinsurance buying (00:29:48) a new quota share treaty in place on some of our property book. So that is probably a pretty good number on a go-forward basis for the insurance side.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay, great. And one last question. You guys highlighted on still the $100 million of cost saves you expect to come out by 2020. So is the right way to think about that that we should take about the $700 million of pro forma G&A that you guys had set for 2017 for the two companies, and just think that $100 million will come out of that number when we get to 2020?

A - Peter J. Vogt {BIO 17059745 <GO>}

Yeah. I would suggest that we're looking at this two ways, Elyse. One is on the absolute dollar basis and the other is on a ratio basis. But if you start with the $700 million and you take $100 million off of that, that's a good start. But I would suggest that there will be some inflationary pressures on the rest of the expenses by the time we get to 2020. I expect those inflationary pressures to be more than offset by our ability to put new business and additional growth on the book in an efficient manner to not have to grow that the rest of the expense base.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay. Thank you very much. I appreciate all the color.

A - Peter J. Vogt {BIO 17059745 <GO>}

You're welcome.

Operator

Okay. The next question comes from Kai Pan with Morgan Stanley. Please go ahead.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you and good morning. My first question on premium growth is, is it (00:31:11) down about 20% in each of your business on constant currency basis and ex-Novae, part of that probably is ceding commission. Could you talk a little bit more about the premium gross trends, and I understand you repositioned your portfolio, but will that – sort of are you more careful in term of what you write, or we expect go into two possible growth (00:31:34) going forward?

A - Albert A. Benchimol {BIO 2023727 <GO>}

I think what you're saying is optimization of our portfolio, and we're continuing to do that. I think that obviously, we were very happy to see significant growth that came through to us both from the Novae acquisition, as well as in individual lines of business. But some of those changes that you've seen are a reflection of actions that we've already announced. So, the exit that we announced from onshore energy at the end of last year is, in large part, driving what you're seeing in the reduction in the legacy AXIS portfolio.

In the reinsurance portfolio, there were a loss of a couple of treaties, and there was, as you saw in our notes, some timing issues both with regard to pushing a renewal of a large casualty treaty, as well as writing less multiyear treaties. So I wouldn't read into these numbers anything new. As I said, we've already indicated the driver of the reduction in insurance, but by and large, we are happy with where our book is; we will continue to optimize the portfolio. We're not afraid to walk away from business if it doesn't meet the returns we want, but we're also seeing some nice opportunities, and then we expect that that will drive some new growth opportunities for us.

Q - Kai Pan {BIO 18669701 <GO>}

But just to clarify, those reposition or optimization of the portfolio when run (00:33:00) through the rest of the year, and then next year you are starting for – sort of like on comparable basis, what will be probably more growth trajectory?

A - Albert A. Benchimol {BIO 2023727 <GO>}

I think generally that's right. But what I can't tell you is what the opportunities will be at the moment. As you know, I'd say that our job is to optimize our portfolio at each opportunity. But my expectation is that today we are a stronger company upfront. We have more relevance, better relationship with our producers, we have more commitment around the lines that – where we are a leader and profitable. We've made some nice investments in lines that have strong growth potential, including cyber, including non – sorry – renewable energy.

I think the efforts that Steve and the Reinsurance team are doing on the reinsurance side should provide us with more opportunities. So, we're on the front foot. We're looking to grow, but we will make the right decisions based on the opportunities that we see in the market.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. Thank you for that. And then (00:34:01) you mentioned U.S. professional line, maybe there are some hot spots, but in general, where do you see the inflation trend relative to your expectation? Which area you should be sort of like most concerned about?

A - Albert A. Benchimol {BIO 2023727 <GO>}

Actually, we're spending a fair amount of time monitoring every single one of these lines of business. I would tell you that if there's one area that we are looking at, and which in fact is impacting our appetites today, it's in the excess casualty in the U.S. We think that there is real inflation there. We're very cautious about low levels of excess, because we think that with recent inflation, the frequency of penetration into low excess layers should be higher, and we don't believe that pricing is fully reflecting that yet. So we're very cautious in that area.

To us, that's probably the one that I worry about the most, or that we're focusing on the most. I would say that in every other line of business, we're not surprised with what we see. We're not surprised with what we're seeing in the primary layers of D&O. And as I noted in my prepared remarks, we've exited substantially most of the primary D&O markets, so the inflation that we're seeing there is not affecting us, and the performance in the excess layers continue to be good.

There, in the past, have been one or two risks that have given us a loss, but we don't see anything systemic there. We don't see any real issues around the property lines generally. Obviously, motor axle (00:35:37) was an issue in Europe, in particular the UK last year, but the pricing has certainly addressed that, and we're actually pleased with the pricing we're seeing on the motor axle (00:35:46). So I would say, by and large, things are looking good. As I mentioned, rate is ahead of trend now on both a written and an earned basis, and we're making sure that we're reacting properly, in particular in U.S. excess casualty.

Q - Kai Pan {BIO 18669701 <GO>}

Great. Last one, if I may, on capital management, you're achieving like double-digit earning ROE in the last two quarters. You're going to generate $100 million cost savings through the next couple years. I just wonder, in term of your capital (00:36:17) position, when do we expect the share buybacks will return?

A - Albert A. Benchimol {BIO 2023727 <GO>}

That is perfectly tied to your first question, which is where the growth opportunity is going to be next year. So to the extent that we see significant growth opportunities, that might reduce the amount of buybacks that we'll be looking to do. If we see less growth opportunities, then obviously that will increase the amount, but as you know, we look at share repurchases on an annual basis based on the plan and our positioning, and I think as we get closer to evaluating 1/1 conditions and our plan, we'll be giving guidance at that point.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you.

Operator

The next question comes from Brian Meredith with UBS. Please go ahead.

Q - Brian Meredith {BIO 3108204 <GO>}

Yes, thanks. I got a couple questions for you. First, I'm just curious, UK primary motor insurance prices have actually been coming down pretty substantially. Does that all impact to your reinsurance business, how do we think about that?

A - Albert A. Benchimol {BIO 2023727 <GO>}

Well, we have both primary and excess of loss. So, they're affected on a pricing basis differently. Most of the primary quota share business that we write tends to be on a sliding scale basis. So we tend to target a fixed technical ratio. And by and large, our experience tends to be very close to that fixed technical ratio, so we don't see much there.

With regards to the excess, we absolutely have been achieving pricing increases, in some cases, 30%, 35%, 40%. Through the second quarter, we've now seen the second renewal post-Ogden, so you'll recall, we started to see pricing increases in the second quarter of 2017, and those treaties have now renewed in 2018, and we've seen prices hold. So we continue to believe that the UK motor axle (00:38:18) business is now back to where we want it to be.

Q - Brian Meredith {BIO 3108204 <GO>}

Great. And then just curious on the A&H business, growth slowed down from the first quarter. Is that something we should see here kind of continuing going forward?

A - Albert A. Benchimol {BIO 2023727 <GO>}

Well, we certainly continued to see growth. We're very excited about what we are doing.

Q - Brian Meredith {BIO 3108204 <GO>}

Yeah.

A - Albert A. Benchimol {BIO 2023727 <GO>}

So I think that reinsurance growth in A&H was strong. The reason it was less strong in insurance is that we're seeing good growth in the U.S., but not so in Europe. So, we're seeing less opportunities for us in Europe in A&H, and that's what's affecting it. But other than that, I will say, the team's done a great job of kind of repositioning themselves within our insurance and reinsurance segments, and they're continuing to engage with the market, and I'm continuing to expect both continued growth and continued improvement in underwriting results for A&H operations.

Q - Brian Meredith {BIO 3108204 <GO>}

Great. Great. And then just last question, just going back on the expense, maybe you can just remind us here, initiatives. Are we expecting that some of these savings is going to be reinvested back in the business? So is there kind of like an underlying kind of expense growth number that we should be thinking of, call it, 3%, 4% with inflation that'll kind of offset some of this $100 million that'll be coming through?

A - Albert A. Benchimol {BIO 2023727 <GO>}

Well, to Pete's points earlier, absolutely. So if you were to take...

Q - Brian Meredith {BIO 3108204 <GO>}

Yes.

A - Albert A. Benchimol {BIO 2023727 <GO>}

...the $700 million down to $600 million, you would expect that that $600 million would be growing by inflation no matter what. But I will say that the $100 million that we announced is net of additional investments that we're making in the business, so we're actually targeting gross savings in excess of $100 million. We intend to allocate a good chunk of those savings in our business in developing our staff, in new tools, and the $100 million is what we're targeting on a net basis.

Q - Brian Meredith {BIO 3108204 <GO>}

Very helpful. And then lastly, just curious on the additional reinsurance that you guys bought to the quarter, understand some to excess, some is - is some quota share. Should we consider that margin - accretive margin neutral, or does it hurt margin at least initially?

A - Albert A. Benchimol {BIO 2023727 <GO>}

Well, from our perspective, it's ROE accretive, which is really what matters.

Q - Brian Meredith {BIO 3108204 <GO>}

Right.

A - Albert A. Benchimol {BIO 2023727 <GO>}

The big change for us is that last year, we bought a lot of event cover, but we didn't buy aggregate cover. And this year, we have both events cover and aggregate cover. So we think it's a much more balanced book of business, I mean, reinsurance protection.

Q - Brian Meredith {BIO 3108204 <GO>}

Great. Thank you.

A - Albert A. Benchimol {BIO 2023727 <GO>}

Welcome.

Operator

The next question comes from Meyer Shields with KBW. Please go ahead.

Q - Meyer Shields {BIO 4281064 <GO>}

Great. Thanks. Good morning. Albert...

A - Albert A. Benchimol {BIO 2023727 <GO>}

Morning.

Q - Meyer Shields {BIO 4281064 <GO>}

...just a couple of quick questions. One, if I understand your comment correctly, the insurance pricing excluding business and exchanges (00:41:16) slowed down a little bit, and I guess my question is, should we be concerned at all that it didn't accelerate?

A - Albert A. Benchimol {BIO 2023727 <GO>}

I'm not sure that concerned is the right word, because I think what we're dealing with is an environment with a fair amount of excess capacity. What I am seeing is that where pricing is warranted, it's happening. So there's a real clear correlation in our book with where are we getting increases and where do we think we need them. So, I think the market is, in my mind, behaving in a rational way. We never expected strong double-digit across the board increases. But as I mentioned to you, I do believe that we're going to continue to see pricing increases.

And frankly, if this industry can deliver mid-single-digit increases, two, three, four years in a row, color me happy, because that's a good way of doing it. Where it's necessary, and you see that in E&S, we're continuing to see double-digit earnings growth, in U.S. casualty, excess casualty, that's had some issues around motor business and other factors, we're seeing double-digit rate increases. So we're getting the rate increases where we need them. And as I mentioned, on the specialty side in London, I would say a third of the lines actually showed higher rate increases in the second quarter than in the first quarter.

(00:42:55)

... place excess concern (00:42:57).

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. No, that's perfect. Thanks. That clarified things a lot. And second, I'm trying to understand the thought process, where we're seeing heightened, I guess, litigation activity or social inflation in some professional lines. When you're not seeing it in particular products, but you're seeing it in what might be adjacencies that have similar exposures, how do you evaluate the possibility that - I don't know - lawyers that are targeting large (00:43:30) will target other professional liability lines?

A - Albert A. Benchimol {BIO 2023727 <GO>}

I think it's something that we do as part of our study of our markets. So it's - one of the nice things that you should always be looking at is what kind of seminars are lawyers giving to other lawyers about what the new trend is. That's always a good indicator of where you're going to see some trends grow. We're obviously looking at a number of factor, including increasing litigation funding, which might give certain lawyers more courage to pursue cases. Those kinds of things, we incorporate in our pricing and reserving.

And as you know, our practice has been, for as long as I remember, to incorporate in our pricing and reserving loss cost trends that are over the longer term, which certainly have been higher than what they've been recently. So we continue to reflect for that in using what we consider to be prudent loss cost trends to each line of business.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay, that makes sense. Thank you very much.

Operator

Okay. The next question comes from Josh Shanker with Deutsche Bank. Please go ahead.

Q - Josh D. Shanker {BIO 5292022 <GO>}

Yes, thank you. Albert, I was listening to your comments about the reinsurance purchasing you called as kind of one-time in nature. Why wouldn't you be making the same type of purchases next year, and were there any retrospective or loss portfolio transfers done in this purchasing?

A - Albert A. Benchimol {BIO 2023727 <GO>}

I think I'm not sure that I recall the context of the one-time in nature.

A - Peter J. Vogt {BIO 17059745 <GO>}

I think we did mention, Josh, on our reinsurance side, we did do a special fronting deal, that showed up as reinsurance. That was just a specific deal, Josh, that I would suggest is not part of our core purchasing of reinsurance. I'd say what we'd purchase on a core basis, you can see us continue to look at on a go-forward basis.

Q - Josh D. Shanker {BIO 5292022 <GO>}

(00:45:27) if I'm thinking about 2Q 2019, is this going to recur one year from today?

A - Peter J. Vogt {BIO 17059745 <GO>}

No. I mean, I can't tell you; that just happened to be a one-off specific opportunistic deal that we did in the reinsurance side. They come and go as they show themselves in the market, but I wouldn't say you're going to see it again in second quarter of 2019. There's nothing specific about it.

A - Albert A. Benchimol {BIO 2023727 <GO>}

Yeah, look, this is – precisely, this is a third-party capital partner of ours...

A - Peter J. Vogt {BIO 17059745 <GO>}

Yeah.

A - Albert A. Benchimol {BIO 2023727 <GO>}

...that had an opportunity to do something, and we're very happy to help them. Obviously, in a broad $2.5 billion reinsurance portfolio, we're going to have a few transactions up and down. But to your point, Josh, to the extent that we find continuing attractive opportunities to purchase reinsurance, we will certainly do so. There may not – we may not renew every single one of those transactions.

I will tell you, we did do one transaction in the quarter that had a retrospective or retroactive nature to it. It was actually a small transaction between ourselves and Harrington. And the reason for doing that frankly was for us to build the muscle memory around creating LPT expertise within ourselves and Harrington as an opportunity to offer that as a product going forward. But we did not need to – within AXIS to make any purchases of retroactive reinsurance.

A - Peter J. Vogt {BIO 17059745 <GO>}

Yeah, I was going to mention that, Josh. We did do an LPT between ourselves and Harrington Re in the quarter, that all occurs on the balance sheet, so that didn't affect the ceded premium written or anything like that. So it doesn't – that didn't affect any of the ratios you may be looking at.

Q - Josh D. Shanker {BIO 5292022 <GO>}

And that's Harrington ceding to you, or you ceding to Harrington?

A - Peter J. Vogt {BIO 17059745 <GO>}

Us ceding to Harrington.

Q - Josh D. Shanker {BIO 5292022 <GO>}

Okay. And can you just give a little complexion around the nature of the European market versus the U.S. market? Are they generally equivalent, or do you think the U.S. market has better opportunities going forward, or where do you think geographically the opportunities lie?

A - Albert A. Benchimol {BIO 2023727 <GO>}

I think we find attractive opportunities in both markets. So I will tell you that right now, obviously, we feel that the liability and the motor business in Europe is good for us, and so we've been growing that. I think in the U.S., we like what we're doing in surety, we like what we're doing in regional and middle market accounts. We still need to see more work certainly in professional lines and liability. We've spoken about that. So I think what we're doing is we're focusing not simply on the lines of business, but increasingly on our core accounts.

And as you may recall, we announced this in late May, part of our redesign of the reinsurance is to add our global specialty division, which will include strategic partners, focus on strategic partners, which are top accounts. So we're going to be focusing very hard to ensure that we provide a broad range of treaties and services to our larger accounts. So it's not just geography, not just lines, but it's also around enhancing the value of our top relationships on the reinsurance side.

Q - Josh D. Shanker {BIO 5292022 <GO>}

Excellent. Thank you.

Operator

Okay. The next question comes from Ian Gutterman with Balyasny. Please go ahead.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Hi, thank you. Most of mine were asked. So I'd just follow up, Albert, on Kai's question when you discussed excess liability and avoiding the lower excess, because I presume because of the defense costs risk as we're seeing, litigation pressure, I guess my question is, what about the flipside of that, which is, it seems we're also seeing more severity in cases. So, I would think going up high also poses risk, because you obviously get less premium, and if we see some of these massive verdicts (00:49:37) continue, the whole tower goes down, so you get less premium for essentially the same loss. So, how do you evaluate – I understand why you won't' want to be low, but isn't there also in this environment risk to being high?

A - Albert A. Benchimol {BIO 2023727 <GO>}

Yeah, but that's why we have underwriters. I mean, they're focusing...

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Sure.

A - Albert A. Benchimol {BIO 2023727 <GO>}

...on these issues. But bottom line, 10 years ago, excess casualty attach was at $1 million (00:50:02). Today, excess casualty attach is at $1 million. It ain't the same world.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Okay. Sure.

A - Albert A. Benchimol {BIO 2023727 <GO>}

We think excess casualty should attach to $2 million or $3 million. And so I think that if you're pricing it and you're looking at it the same way, you're going to get a lot more frequency and severity in that early layer than you would have had 10 years ago, and we just think that either it should be priced properly, or we should push ourselves a little bit further up.

I fully agree with you with the concept of where do you want to be if a loss is going to hit the entire tower, you might as well get more premium for that. But as I said, I'm very, very proud of the talent that we have in our underwriting staff and they do a really good job of identifying where in the tower they feel most comfortable in terms of risk and return. But my comment was really about the fact that we need to attach more like at $2 million, $3 million, $4 million before we – to get the same kind of risk return that we used to have at $1 million.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

And I assume part of that is because of defense costs creep?

A - Albert A. Benchimol {BIO 2023727 <GO>}

Yeah, defense costs creep and just social inflation.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Yeah. Exactly. Okay. Great. That's all I had. Good luck. Thanks.

A - Albert A. Benchimol {BIO 2023727 <GO>}

Thank you.

Operator

We have a follow-up question from Elyse Greenspan with Wells Fargo. Please go ahead.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Hi. Yes. I had a follow-up question on investment income. So, Pete, you had alluded to they're not being one-timers, I guess, away from alternative portfolio in the quarter, but your fixed – your investment income was actually up about 16% year-over-year if you back out the other investments, also up nicely sequentially. So is the Q2 level, I guess, (00:51:47) is that the right investment income to think about modeling going forward?

A - Peter J. Vogt {BIO 17059745 <GO>}

Yeah. I guess I'd give you a couple facts there, Elyse. Our book yield on a fixed income is up to 2.8% in the second quarter. I mean, sequentially, that's up from 2.7% in the first quarter, and our new money yield right now is 3.4%, and in Q1, it was at 3.2%. So, all directions on the fixed income portfolio are trending a bit higher.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay. So if anything, sequentially, we might continue to see uptick in the investment income from here?

A - Peter J. Vogt {BIO 17059745 <GO>}

Yeah. In the fixed income portion of that, yes, I would agree with that, Elyse.

Q - Elyse B. Greenspan {BIO 17263315 <GO>}

Okay. Thank you very much.

Operator

Okay. Seeing no further questions in the queue, this concludes our question-and-answer session. I would like to turn the conference back over to Albert Benchimol for any closing remarks.

A - Albert A. Benchimol {BIO 2023727 <GO>}

Thank you very much, operator, and thank you to all for participating in our call. As you can see, we're very proud of the progress that we've achieved. We're not declaring victory. We still have a lot of work to do, but the results to date are very encouraging. So we look forward to reporting to you further progress in future quarters. Thank you very much.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.