Q2 2013 Earnings Call

Company Participants

- Albert Benchimol, President, CEO
- Joe Henry, CFO
- Linda Ventresca, Director, IR

Other Participants

- Amit Kumar, Analyst
- Brian Meredith, Analyst
- Charles Sebaski, Analyst
- Greg Locraft, Analyst
- Jay Cohen, Analyst
- Meyer Shields, Analyst
- Michael Nannizzi, Analyst
- Vinay Misquith, Analyst

Presentation

Operator

Good morning. Welcome to the AXIS Capital Second Quarter 2013 earnings conference call.

All participants will be in listen-only mode. (Operator Instructions)

Please note this event is being recorded.

I would now like to turn the conference over to Linda Ventresca, Director of Investor Relations. Please go ahead.

Linda Ventresca {BIO 5930519 <GO>}

Thank you, Laura and good morning, ladies and gentlemen.

I am happy to welcome you to our conference call to discuss the financial results for AXIS Capital for the Second Quarter ended June 30, 2013. 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, www.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 US. The international number is 412-317-0088. The conference code for both replay dial-in numbers is 10030850.

With me on today's call are Albert Benchimol, our President and CEO and Joe Henry, our CFO.

Before I turn the call over to Albert, I will remind everyone that statements made during this call, including the question and answer session, which are not historical facts, may be forward-looking statements within the meaning of the US federal securities laws.

Forward-looking statements contained in this presentation include, but are not necessarily limited to, information regarding our estimate of losses related to catastrophe policies and other loss events, general economic capital and credit market conditions, future growth prospects, financial results and capital management initiatives, evaluation and losses and loss reserves, investment strategies, investment portfolio and market performance, impacts in the marketplace with respect to changes in pricing models, and our expectations regarding pricing and market conditions. These statements involve risks, uncertainties, and assumptions which could cause actual results to differ materially from our expectations.

For a discussion of these matters, please refer to the Risk Factors section in our most recent form 10-K on file with the Securities and Exchange Commission. We undertake no obligation to update or revise publicly any forward-looking statements whether as a result of new information, future events or otherwise.

In addition, this presentation contains information regarding operating income and our consolidated underwriting income, which are non-GAAP financial measures within the meaning of the US federal securities laws. For a reconciliation of these items to the most directly comparable GAAP financial measures, please refer to the press release which can be found on our website.

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

Albert Benchimol {BIO 2023727 <GO>}

Thank you, Linda. Good morning, ladies and gentlemen, and thank you for joining us today.

Last night, we reported Second Quarter operating income of $50 million, or $0.43 per diluted share, an annualized operating ROE for the quarter of 3.9%. Our quarterly results were adversely impacted by very high frequency of unrelated small and mid-size cat and weather events in the US, Canada, Europe, and Argentina, aggregating to $140 million, net of reinsurance and reinstatement premiums. None of the event losses exceeded $35 million, and our analysis indicates that this is an issue of random frequency. We'll discuss the quarter's loss experience in more detail.

Notwithstanding the headline losses for the quarter, I believe the results should be viewed in the context of four key factors. The first is that while our portfolio has historical experienced some volatility, we've been well-compensated for that volatility over time as evidenced by our superior underwriting metrics.

The second is that this volatility goes both ways. Our First Quarter had extremely low cat and weather activity in contrast to the higher activity in the Second Quarter, such that our year-to-date results are actually quite healthy, with a lower year over year combined ratio, operating income of $2.36 per share, up 19% over the prior year, and annualized operating ROE of 10.9%. These results are indicative of the ability of our portfolio to absorb volatility, including that presented by a quarter such as this one.

The third point is that excluding the quarter's cat and weather losses, the core underwriting results were nevertheless quite strong. Both of our segments contributed solid core underwriting profits, as Joe will discuss later.

Finally, as we've discussed with you on previous occasions, we are committed to diversifying our portfolio so as to reduce earnings volatility over time and we are making substantial progress in this area. Both our insurance and reinsurance segments delivered strong and diversifying premium growth, with consolidated gross premiums written up 20% in the quarter and 17% year-to-date. Fully 80% of the growth this year has come from the lines other than property, marine, or catastrophe lines. Our accident and health and agriculture initiatives contributed almost half of the growth this year. Our property, marine, property reinsurance, and property catastrophe reinsurance premiums written were up 8% year-to-date, much of which was driven by rates, and our various auto PMLs have been relatively stable. So our diversifying growth initiatives are on track, and we expect these will deliver our desired reduction and earnings volatility going forward.

Diluted book value per share declined 4.5% during the quarter to $42.67, due to the predictably material negative impact of the significant rise in rates and widening of credit spreads that adversely impacted our investment portfolio this quarter. Some of this has come back in the last few weeks, but as of quarter end, we did take some pain in the portfolio. We remain committed to intelligent capital management, sustaining our financial strength, and benefiting our shareholders.

During the quarter, we were active in repurchasing our common shares, $228 million repurchased in the quarter. So far this year, we have repurchased 8.5 million shares, or 7.2% of the outstanding shares in the beginning of the year.

Importantly, we continue to execute on our strategy goals, bringing on new talent, expanding our franchise with growth in attractive lines and markets, both existing and new, as we build a broader more diversified portfolio. Market conditions are stable at attractive levels, or improving in many of our lines, and we are well-positioned to continue to take advantage of available opportunities.

I will discuss market conditions in more detail following Joe's remarks. Joe, over to you.

Joe Henry {BIO 13390626 <GO>}

Thank you, Albert. Good morning everyone.

The first half of 2013 at AXIS has seen two very different quarters. Our cat and weather-related loss experience was extremely light in the First Quarter this year, delivering one of our strongest quarterly underwriting profits in the last five years. In contrast, as Albert noted, in this quarter, we experienced a high frequency of natural cat and weather-related losses impacting our portfolio.

First half results are a better measure of our underwriting portfolio's performance this year. For the first six months of 2013, we generated underwriting income of $181 million, an annualized ROE of 14.7%, and an operating ROE of 10.9%. Moving into the details of the income statement, our Second Quarter gross premiums written increased 20% to more than $1.2 billion with growth emanating from both of our segments.

In our insurance segment, our top line was up $106 million, or 15.7%, reflecting a continuation of the trends noted in the First Quarter. Significant growth in our accident and health line contributed almost half of the increase for the quarter. For the year-to-date, accident and health premiums are up 78%.

In liability, our growth in the US wholesale excess casualty market continued this quarter, given the significant improvement in the rate environment and selected areas. Growth in our professional lines business in Europe, Canada, and Australia continued to drive growth and professional lines overall and an element of renewal timing also contributed but to a lesser extent. Property premiums were broadly comparable quarter over quarter, as growth from rate and new business opportunities largely offset continued reduction of cat-exposed business written through MGAs and a shift of the renewal date for one significant contract.

In reinsurance our top line was up $99 million or 29.3%. Agriculture contributed half of this increase, with a significant amount of this year's January 1 US business binding later than usual. For the year-to-date our agriculture premiums are up $122 million to $135 million. Outside of our agriculture initiative, remaining growth in reinsurance this quarter was driven by increased participation in the US excess umbrella market where cedants are benefiting from a more attractive rate environment.

Our catastrophe premiums also increased, partially driven by expanded relationship with one cedent in Florida and other new business in the United States. This was partially offset by the impact of rate reductions and the depreciation of the yen against the US dollar at the April 1 renewal date.

Our consolidated net premiums written were up 24%, exceeding the growth rate for gross premiums written. The corresponding two-point reduction in our cedent premium ratio for the quarter was driven by a number of factors. The most significant factor was growth in business for which we do not see significant premiums specifically our accident and health line and our reinsurance segment.

Changes in reinsurance purchasing for our insurance segment also contributed. This included reductions in the quota share session rates for significant portions of our professional lines and liability books, a reduction in the cost of our property excessive loss protection, and higher retentions for both property and marine. Our net earned premiums were up 11% for the quarter, with growth in insurance and reinsurance driven by our accident and health and agriculture initiatives respectively.

Our Second Quarter consolidated current accident-year loss ratio increased 8.7 points to 72.4%, primarily driven by the high frequency of small and midsize natural cat and weather related events globally. In insurance, the accident-year loss ratio increased 12.4 points, with 11.9 points of this attributable to natural cat and weather related losses. We recognized $90 million or 21.1 points of net losses related to cat and weather, inclusive of payments to reinstate reinsurance protection.

In insurance, these losses primarily emanated from tornados and hailstorms in the US and flooding in Argentina and Canada. While none of these events significantly impacted results in isolation, the combined impact was meaningful to the quarter's results. Comparatively, the Second Quarter of 2012 was impacted by $35 million of net losses related to Second Quarter US weather events. Adjusting for the impact of these cat and weather items the accident-year loss ratio was relatively flat, with a higher level of risk losses in the quarter offsetting favorable impacts of rate.

For the first half of 2013, the current accident-year loss ratio for insurance is 68.0%, up only slightly from 66.7% for the comparable period in 2012. Adjusting for the impact of cat and weather related losses the accident-year loss ratio for insurance was down 3.5 points as rate, mix, and experience benefited the ratio.

The Second Quarter current accident year loss ratio for our reinsurance segment was up 5.8 points to 66.3%. We recognized $50 million of natural cat and weather related losses net of reinstatements, primarily related to European and Canadian flooding. This contributed 9.7 points to the accident-year loss ratio, whereas the 2012 net losses related to Second Quarter US weather activity contributed 4.2 points. Adjusting for the impact of cat and weather related losses, the Second Quarter ratios were comparable, as higher loss ratios book for agriculture offset improvement in rate and experience. Adjusting for the impact of cat and weather items for the first half of the year, the current accident-year loss ratio for reinsurance improved by 1.6 points to 56.3%.

In the quarter our results continued to benefit from net favorable development which aggregated $42 million. Short tail classes in both segments contributed $32 million of this balance primarily reflecting better than expected loss emergence. In addition, we continue to give weight to actuarial methods that reflect our favorable experience for liability reinsurance business, a process that commenced last quarter. This contributed a further $22 million of favorable development for the quarter, primarily related to the 2004 through 2007 accident years.

We strengthened our reserves for professional liability insurance lines by $14 million this quarter. This action was driven by recent developments on certain global financial credit crisis claims and was partially offset by the recognition of favorable experience for professional lines business not impacted by the global financial crisis. We've historically taken a cautious approach with respect to the 2007 through 2009 accident years affected by the global financial crisis, given that development patterns are expected to differ significantly from other years. We've been carefully monitoring both market trends and individual case developments in the quarters and years that followed and it was the latter that drove us to strengthen our reserves this quarter.

Consistent with our historical practice, we reacted swiftly to unfavorable claim emergence for certain underlying reserve classes while exercising a degree of caution while realizing the impact of favorable experience. We are very comfortable with our overall reserve position for quarter-end for professional lines insurance with $1.1 billion for IBNR for all years, of which $234 million is related to years impacted by the global financial crisis.

Our G&A expense ratio decreased 3.1 points relative to last year. This is primarily due to the $34 million of costs associated with our senior leadership transition embedded in G&A last year. Adjusting for the transition costs last year, the increase in G&A of 80 basis points was primarily driven by increased staffing and office costs attributable to the continued expansion of our global platform over the past year, as well as timing issues and certain one-time expenses.

Turning to the investment portfolio, the total return of our investment portfolio was a negative 134 basis points in the Second Quarter, primarily reflecting mark to market adjustments on fixed income securities. This quarter's pretax unrealized loss of $295 million was principally due to changes in valuation for fixed income securities driven by rising interest rates and widening credit spreads. Net investment income was $83 million for the quarter, up from the prior year's quarter, $74 million. The most significant driver of the quarter over quarter increase was our other investment portfolio which contributed $12 million during this quarter versus a negative $2 million in the prior year.

Net investment income from our fixed maturity portfolios, including cash and investments, was $76 million for the quarter, down slightly from $78 million in the prior year quarter. The reinvestment yield in our fixed maturity portfolio increased during the quarter from 1.7% to 2.4% due primarily to the upward shift in US Treasury rates. Cash and invested assets totaled $14.3 billion June 30th, up from $13.9 billion a year ago.

At June 30, 2013, our fixed maturities weighted average credit rating was unchanged at AA-. During the quarter, our fixed maturity portfolio duration increased to 3.5 years, compared with 3.1 years at the beginning of the quarter, and 2.8 years a year ago. The increase in duration during the quarter is mainly due to the reduction in the anticipated prepayment speeds on our mortgage-backed security holdings. The strategy for our fixed maturity portfolio is unchanged and emphasizes spread sectors, the largest being corporate and US agency mortgage-backed securities.

In order to reduce the impact of rising US Treasury rates, we have increased allocations to local currency, emerging markets, sovereign date and floating rate CLO debt in recent quarters. We also incorporated tips into our portfolio to reduce the impact from unexpected increases in inflation and increased our municipal bonds holdings this quarter due to attractive after-tax returns. Equities and alternatives now account for 11.1% of total cash and investment assets versus 10.4% a year ago. We expect these investments to provide attractive returns during periods when our fixed maturity results are suboptimal.

In summary, the investment portfolio performed in line with expectations during the quarter, and remains comprised of a diversified set of strategies with a focus on mitigating the negative impact of interest rates on the portfolio. While rising rates and spread widening adversely impacted our book value this quarter, a theme for the entire industry, our capital position remains strong. We closed the quarter with common equity of $4.9 billion and total capital of $6.6 billion. The change in the quarter includes net income available to common shareholders of $72 million, an after tax mark to market reduction in our investment portfolio to $267 million, and stock repurchase and dividends of $257 million.

During the quarter, we repurchased 5.1 million common shares for the total of $228 million, leaving us with $409 million of remaining authorization under our reinsurance program. For the year-to-date we have returned 151% of operating earnings through share repurchases and dividends, and that's a total of $418 million. If market and financial conditions remain the same, we continue to anticipate returning close to 100% of our annual earnings to our shareholders through regular dividends and share repurchases, although we expect to slow our repurchase activity during the Atlantic wind season.

We also issued $225 million of series D preferred shares which pay a 5.5% dividend. We used a portion of the net proceeds to fund the redemption of the $100 million 7.25% series 8 preferred shares outstanding. This, in combination with the other preferred transactions executed over the past 18 months, reduced the weighted average dividend rate on our preferred equity capital based by 99 basis points to 6.385%.

Our strategic expansion opportunities continue to progress and we remain optimistic about our prospects. We believe that our diversified global franchise and strong balance sheet will continue to allow us to take advantage of market opportunities as they emerge.

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

Albert Benchimol {BIO 2023727 <GO>}

Thank you, Joe.

We continue to be positive on market conditions for AXIS. Other than in a few isolated lines and markets, pricing remains stable or increasing for most of our book. The pace of improvement, however, has slowed since the First Quarter.

Within our insurance segment, the overall AXIS insurance rate change for the Second Quarter of 2013 stands at plus 3%, down slightly from 5% last quarter. Rates are continuing to increase across most classes and geographies other than the same few notable exceptions. Our US division, which is dominated by our wholesale E&S property and casualty business continues it show the strongest rate improvement. Overall, rate changes this quarter was plus 6%, down from plus 9% last quarter.

This deceleration of the US is primarily driven by E&S property. This stabilization follows on nine consecutive quarters of rate increases aggregating to 15%, something rarely seen in our careers. We expect the accounts with the recent loss activity, winter flood concerns or accumulation issues within a specific geographic region will continue to see price increases through another renewal cycle.

Casualty business in the US division, which is primarily E&S umbrella business, continued to show double-digit rate increases nine quarters after rate increases began. Overall, in the US, we are continuing to see more challenging risks flow away from standard carriers and back into the E&S markets, providing us with a greater flow of submission, higher new business conversion rates and improved retention ratios.

In our international division, most classes monitored continue to indicate rate increases. The average for our London-sourced specialty lines within this division is essentially flat this quarter, down from plus 4% during the First Quarter. The comparison between quarters is exaggerated by the marine liability class which showed a large increase in the First Quarter, and by the large proportion of offshore marine business written in the Second Quarter which gave up some rates, following a two-year period of good pricing and the line losses. Once again, aviation and terrorism are stubbornly continuing their downward trend at a pace consistent with last year's.

After eight consecutive quarters of rate increases that aggregated to an accumulative 19% pricing increase, our global property class written out of London took a breather last quarter and was essentially flat. The international P&C lines within the international division, which includes our Canadian and Australian P&C operation, are showing rate change of plus 1% down from 3% in the First Quarter. In our professional lines division, overall rate change is plus 1%, down from plus 3% in the First Quarter. Most classes monitored continue to indicate rate increases but generally at a lower rate than in the First Quarter.

In the US, price remains more consistent on primary business than in excess layers. Private company D&O and ancillary lines pricing held firm in the quarter. Outside the, US rate change remains more patchy with continued good improvement in Australia but financial institutions and commercial D&O in Canada and Europe are showing declines in the low single digits.

Moving on to reinsurance, in the most recent midyear renewals, dominated by property renewals in the US, pricing was under pressure. High-margin Florida accounts experienced the most significant rate pressure. This pressure falls off from historically high pricing levels achieved in recent years, levels which served to attract significant additional capital. From our perspective, much of this business remains attractive, especially as the increased Southeast exposure improves the capital efficiency and return on risk of our overall portfolio. We've been focusing on this for some time, and are comfortable that our portfolio today delivers more attractive expected profitability on a risk-adjusted basis than the portfolio we had a year ago. Our base is a much stronger one from which to navigate the vagaries of the market.

Non-property renewals have been mixed. Generally, the gradually improving primary pricing environment I just described is offset to some degree by increasing competition from reinsurers. This is often manifested in increased ceding commissions. Although we are seeing increases in those ceding commissions, in most cases, the net result is a net positive rate to AXIS Re as the underlying rates are increasing at a faster pace than the ceding commissions.

Approximately 14% of AXIS Re's 2012 expiring premium was renewable on July 1. At this renewal we estimate we wrote about $260 million of premium, about 4% more than the expiring. Growth and select opportunities and casualty reinsurance offset minor reductions elsewhere in the portfolio. Within property, reductions and catastrophe writings were somewhat offset by growth and property per risk and quarter share as well as in engineering.

I'm confident we're making the most of current market conditions. We believe we've been successful in growing our business in the most attractive areas and pursuing diversified growth in select specialty areas across both of our segments. In insurance, we've improved penetration of the E&S lines with new business production this quarter doubling relative to the Second Quarter of last year. We've progressed our initiatives in the renewable energy, design professionals and environmental professional liability, UK professional indemnity lines, and Australian and Canadian op operations. Of note -- our accident and health initiative gross written premiums in the first half of this year already exceed those for the full year of 2012 by 13%.

In AXIS re, following the activity and agriculture reinsurance in the US which marked the first half of the year, we are now working on expanding those relationships as well as the upcoming China and India renewals. We're also progressing on our third-party capital management efforts, and have also begun executing on opportunities to hedge our reinsurance portfolio at attractive prices.

We believe we are executing on all critical elements of our strategic plan. AXIS's a strong underwriting performance of the last decade was achieved with a focus on complex volatile lines. At the core of our strategic plan is to continue to execute well in underwriting these risks, reducing volatility where we can, but understanding that we have to accept some quarterly volatility in return for a better annual result in volatility. Nevertheless, we will look to further mitigate that overall portfolio volatility and to further enhance overall annual outcomes by diligently executing on select portfolio-accretive initiatives in less volatile specialty areas.

Our year-to-date annualized operating ROE of approximately 11% is the more appropriate measure of our performance this year thus far. While this is a good result, it still does not reflect the full leverage of all the major strategic initiatives in progress at AXIS, and we remain committed to continuing to deliver top quintile annual results with industry average annual volatility for the benefit of our shareholders.

And with that, I'd like to open the lines for questions.

Questions And Answers

Operator

(Operator Instructions) Our first question will come from Charles Sebaski from BMO Capital Markets.

Q - Charles Sebaski {BIO 17349221 <GO>}

Good morning. A couple of questions.

The first one on capital management activities. I thought I recalled last quarter kind of the guideposts for repurchases was an earnings-plus concept that I think Joe you said here you're kind of at an up to earnings. I wonder if there's any change based on growth or anything else.

A - Joe Henry {BIO 13390626 <GO>}

No. Joe, there is no change. You know, we -- we're opportunistic to the same policy that we had before. Obviously, at this point in time our repurchases are in excess of our income. We take this a quarter at a time. We'll lay back during the Third Quarter wind season but take another look at this in the Fourth Quarter of the year.

Q - Charles Sebaski {BIO 17349221 <GO>}

Okay. Then on the insurance division, I was hoping to get a little bit more color on the volatility and the return aspect. -- the $90 million of cat losses in the quarter, I think, took a lot of us kind of by surprise given that it seemed to be -- not an above average cat quarter in general. I was just wondering if we could see if there's anything that's been changed in the portfolio, if you're either at lower levels on the primary basis or anything year over year. It just seems the only time you've been at this level of cat losses has been when there's been major hurricane activity.

A - Albert Benchimol {BIO 2023727 <GO>}

Charles, you're right. It is, in fact, the highest loss quarter in the insurance division since we've had -- without major activity. But we've looked at this many different ways. And we've looked at the average number of risk losses that we've had from different sources over time. And this is truly an exceptional quarter in both the number of events, as well as the severity of the individual events.

You're right. It wasn't a single event but I think that's also an important part of the situation. These were a number of smaller claims. The largest one individually being the La Plata energy loss related to the floods in Argentina. But other than that, it was all small claims in the single millions mostly.

It just happened everywhere. It happened in Calgary, it happened all over the US weather, it happened in Argentina. And I will also say that the number that we've provided includes a fair amount of IBNR again cumulative amounts of PCS events for a full year.

So I don't know how other individuals are reporting this, but we had 14 different PCS events in the Second Quarter. And according to our practice, recognizing that very often a lot of these attritional PCS losses don't get announced in the quarter that it's experienced, our practice is to set up an amount of PCS-related IBNR to anticipate for the notices we expect to receive in the next quarter. So it is a large number, but we have not had any change in our underwriting. In fact, a large number of the accounts where we've had losses were accounts that we've had for several years that have performed well that have benefited from improvements in terms and conditions.

Rest assured that we are spending a lot of time looking at this. As of now, our conclusion is that this is random volatility. But again, we will continue to further analyze this and, obviously, if there are any lessons to be learned we will be sure to incorporate them in our planning for 2014.

Q - Charles Sebaski {BIO 17349221 <GO>}

Can you tell us on the insurance side of the business what an ROE profile is that you're writing to currently, sort of the go forward if there's a benchmark? I realize there's a lot of different lines, but -

A - Albert Benchimol {BIO 2023727 <GO>}

Oh, my God, there's such a large number of lines. You about I think it's fair to say that if you look at where we were in the last couple of years at least, you'll find that on a gross basis, the primary insurance results were about flat with the -- sorry the gross reinsurance results were about flat with reinsurance. However, over the last couple of years, the reinsurance charges that we were paying actually were large such that the net results that had ROE results for our insurance division was modestly lower than the reinsurance.

What we've seen over the last 12 to 18 months or so is a change where the ROE, because of the fundamental pricing on the insurance side, is improving, and the costs of our reinsurance coverage is declining, we're actually saying the ROE of our insurance division improving meaningfully. Now, our overall book is still averaging approximately 10% right now, ROE. And so I would say that overall, it would be about a 10%, perhaps a little bit better target ROE for the insurance book.

Q - Charles Sebaski {BIO 17349221 <GO>}

Excellent. Thank you very much.

A - Albert Benchimol {BIO 2023727 <GO>}

One more comment I want to make is the volatility of that book is the insurance division. Again is one that we've experienced for the entire duration of our company, and not in any one year did our insurance division report a combined ratio ne excess of 100.

Q - Charles Sebaski {BIO 17349221 <GO>}

Excellent. Thank you.

Operator

And the next question will come from Greg Locraft of Morgan Stanley.

Q - Greg Locraft {BIO 4221265 <GO>}

Hi. Good morning.

I want to do follow upon the pricing versus loss cost situation. I give you -- you were very forth right, the pricing's decelerated 1Q to 2Q, and what I am wrestling with is how will that flow in the margins over time? You've shown excellent margin improvement in recent periods, recent years, how should we be thinking about that as pricing is decelerating across the board?

A - Albert Benchimol {BIO 2023727 <GO>}

I think by and large if you're looking at it from most of our lines, certainly the property lines, the umbrella and excess lines, most lines of business were continuing to see pricing ahead of trend. The one area where it's clearly not there yet is professional lines. We're averaging 1% and, obviously, our actuaries are not putting up a 1% loss trend number. That said, loss trend number we put in our pricing for the last couple of years has as you know overestimated actual loss trends. But at 1% we would say from an actuarial basis, professional lines are still lagging and in all our other lines of business are confident we're at least at loss trend or better.

Q - Greg Locraft {BIO 4221265 <GO>}

Okay. So we can still see margin expansion. Great. On professional lines, you all mentioned the -- the reserve addition. I wanted a little more color on the reserve addition on professional lines. There's been a lot of growth there. It's the biggest reserve bucket. Can you maybe help us a bit more on what exactly is recurring in that area, what you're seeing? It sounds like it needs more rate too.

A - Joe Henry {BIO 13390626 <GO>}

Well Albert already commented on the rate, Greg. But let me sum it up this way. First of all, you know we're an excess writer for the most part in professional lines. We do some primary but most of our portfolio is excess. We took some action in the Second Quarter on four credit crisis claims and two noncredit crisis claims which, for the most part, are now reserved at policy limits. We do not expect this to have a material impact going forward.

We did disclose there was $14 million of net adverse development in the quarter. That's actually a combination of $36 million worth of adverse development on credit crisis years offset by $22 million in favorable development and professional lines on noncredit crisis years. So $14 million is a net strengthening. But these cases that I'm referring to, these six cases resulted in our decision to take an action. You know we're always conservative in taking the bad news first, but we don't expect this to continue. If we do, we feel that the overall strength of our reserves in professional lines will enable us to handle it.

A - Albert Benchimol {BIO 2023727 <GO>}

Let me add to that a couple of things. Greg, first of all, you refer to the large base of premiums, of IBNR and professional lines. And I think we tried to make the point that we have in excess of $1.1 billion in IBR and we're very comfortable with that, and it was only with regard to a couple of cases we want to do increase but we in fact released reserves in other non-global crisis years. So we are remaining very comfortable with the totality of our professional lines book and when we get one or two bad cases, we will take that.

Greg, you also made reference to the growth in recent years. I think that that's what commenting on. If you look at where we've been, historically, this company had a large exposure in financial institutions. That's one of the areas that we do quite well in. And we had some US-based D&O and professional liability. Most of the growth, if not all of the growth that you will have seen in the last three years have been in diversifying lines and in diversifying countries. We expanded in our European professional liability, we expanded in Australia, we expanded in Canada. We went down-market, including things like -- design professionals. We've expanded and diversified the professional liability book. It hasn't been simply growing in those existing lines where we've been before.

Q - Greg Locraft {BIO 4221265 <GO>}

Okay. That's great color. Thank you very much.

Operator

And the next question will come from Michael Nannizzi of Goldman Sachs.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Thank you. Just one quick question on the balance sheet.

So it looks like financial leverage is picking up. You raised a bit of debt. You're buying back stock ahead of earnings, and we have these marks in the portfolio that are hitting the net equity line. How should we think about the level that you want to maintain in terms of financial leverage? Are you all baked-in in terms of AOCI? Or did you look at it ex-AOCI, and how might further marks impact your view? Thanks.

A - Albert Benchimol {BIO 2023727 <GO>}

Yes. The general answer to your question is that we try to keep our financial leverage, and that is debt and preferred stock to total capital at or below 25%. We have crept up in the Second Quarter. When we did the preferred offering, our leverage was a little bit less than it is now mainly due to the unrealized depreciation in the portfolio.

But we're pretty confident that if interest rates increase at a reasonable rate over the next couple of years, we can offset any unrealized gains in the portfolio with improvements in investment income and improvements in operating income.

So just coming back to the beginning, where we are is probably pretty -- where we are is really where we're comfortable being. We'd actually like to bring that down over a period of time. Does that help?

Q - Michael Nannizzi {BIO 15198493 <GO>}

Sure. The question -- the outlook for rates is higher. So that makes sense. If your view is right and moderate change in rates does come true, then that makes sense. But would that imply if we do see a big rise in interest rates, that you're going to curtail your share, your capital, deploying your buy back activity in order to kind of manage to that 25 or below?

A - Albert Benchimol {BIO 2023727 <GO>}

I wouldn't say necessarily that would be the case. And again, if you think about the margins that we'll earn on our underwriting income as well as increased investment income. And just simply how the markets are reacting. In the last two to three weeks, our portfolio's come back about $60 million from the unrealized position we were at the end of the quarter.

So there is some volatility in rates. We wouldn't necessarily curtail our stock repurchase program. But our overall policy, as we said before, is to basically repurchase shares and dividends up to 100% of our operating income. So that's really what we're going to stick to.

Q - Michael Nannizzi {BIO 15198493 <GO>}

One last thing. Magnitude-wise, you lost about just under $300 million in AOCI in the quarter and your run rate investment income is about $100 million and change, $80 million in the quarter this time. I'm just trying -- it's just math.

I'm just trying to understand the math of if you have -- you're being smart and you're managing to a 25, then should we say well, let's look at where the total capitalization is, let's look at where the debt is and based on wherever that ends up, I'm not stating a view on interest rates but I'm just asking like if that happens, and it pushes you above 25, simply out of your control in terms of what happens in the rate market, how are you going to perceive that? Is that something you're going to manage towards or are you going to kind of look at -- you're going to peel the marks out and focus on something else?

A - Albert Benchimol {BIO 2023727 <GO>}

That's a fair question and the way we look at it is in multiple areas.

It's not an absolute hard line that we will stop buying if we hit the 25. But I think there's two or three areas here. One is we look at our -- we look at our leverage on our GAAP balance sheet. But it's not the only kind of leverage that we look at. We look at our economic capital, we look at our rating agency capital, we look at all of these issues and in all of these cases we determine the amount of excess that we have. And if the excess remains constant, then that's something that we need -- gives us some room to acquire.

From a purely economic balance sheets perspective, as you know, the GAAP balance sheet does not reflect the net present value of the reserves, whereas on an economic balance sheet, a rise in interest rates reduces the net present value of your liabilities so the economic equity actually doesn't go down as far as your GAAP equity.

The other thing is that although our leverage quote unquote has increased in -- with the recent preferred offerings, this is about as good a level of leverage that you can have. These are perpetual preferreds, and we tend to think of the perpetual preferreds as having significantly less debt-like criteria and that also goes into the consideration.

So longer term, we believe that 25% is an appropriate level and cap for our leverage but that doesn't mean that over a short period of time, we've got the kind of adjustments and volatility and interest rates that we will have, that we will let that be our only determinant.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Great. Thank you.

Operator

And the next question will be from Jay Cohen of Bank of America, Merrill Lynch.

Q - Jay Cohen {BIO 1498813 <GO>}

Thank you. A couple questions. The first is I seem to -- pick up in your commentary, you're talking about your cedent reinsurance, that you had ceded less in your property business. Correct me if I'm wrong but the question I would have one reasonable strategy would be gee if property reinsurance price something getting better shouldn't you be ceding more, could you just talk about your strategy there.

A - Albert Benchimol {BIO 2023727 <GO>}

That's a good question. It's the per risk versus the cat.

I think it's fair to say that cat reinsurance is getting cheaper and we are in fact buying more cat reinsurance. The issue is with regard to the per risk. We've done a fair amount of analysis around that, and we've determined that we were literally ceding away too much of our profits and diversification benefits within the lower layers. So we've -- modestly increased the retentions on the per risk layers. And also on professional lines and casualty we've reduced the quota shares.

But the net of it all is even with the overall net improvement in many lines in reinsurance, the net of it all is that the changes in the ceded reprogram are anticipated to provide both, A, higher annual results, and, B, lower annual volatility to the overall portfolio. The one area where there is the most reduction in costs, which is cat, we have in fact acquired more reinsurance protection.

Q - Jay Cohen {BIO 1498813 <GO>}

That's really helpful. Second question is, if we look at the Third Quarter, it feels like every other day there's some catastrophe, man-made typically, with train crashes and other things. Do you have any sense at this point if there's any major exposures you have for instance the Canadian train crash seems to be the biggest one out there?

A - Albert Benchimol {BIO 2023727 <GO>}

Yes. It almost makes you worry it take the train these days. I don't disagree with you., obviously, we monitor these, everything that we see today gives us -- we are concluding given the data that we have today there is nothing material that we've seen happening in the quarter for us.

Q - Jay Cohen {BIO 1498813 <GO>}

That's great. Thanks, Albert.

A - Albert Benchimol {BIO 2023727 <GO>}

You're welcome.

Operator

And the next question is from Vinay Misquith from Evercore.

Q - Vinay Misquith {BIO 6989856 <GO>}

Hi. Good morning. The first question is on the margin improvement year-over-year. According to your last year results, it was roughly flat. I believe you mentioned some large one-off loss including cats. If you could help us understand -- so should we be looking at the first half of the year accident and (inaudible) cat and sort of trending that forward and assuming that's going to be modestly improving because of rate?

A - Joe Henry {BIO 13390626 <GO>}

Yes Vinay, I think that's a good assumption. If you concentrate on the Second Quarter for a minute, as far as the insurance is concerned, we had about a point impact on a loss ratio from rate. And as I think we mentioned in the First Quarter call that we expected during the year to have a 1% to 2% improvement in our accident year ratio other as a result of rate increases. About half of that has earned through the first half of the year.

However, we did have an increased incidences, as Albert described, of risk losses, which offset to some extent the benefit that we would have seen coming through rate in the accident year loss ratio. So I think a much better way to look at this is the six months rather than just the Second Quarter itself.

On the reinsurance side, for the most part, the rates that we're achieving are keeping pace with trend. So really no major change there.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. That's helpful. Second question was on the reserve development. If I understand it right, you added about $36 million to the professional liability book, so the pro forma number from this quarter would have been actually about $78 million of favorable, is that fair to say?

A - Joe Henry {BIO 13390626 <GO>}

That's correct.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. And there's no -- so the reason being because the base of reserve development has fallen off recently, so I'm just curious as to whether you're seeing something different now versus the past or is it just because these one-time issues?

A - Joe Henry {BIO 13390626 <GO>}

Yes. As you know, we don't comment about the future relative to reserve development. But our reinsurance prior year development was really what we've experienced in the past so there's really been no change there. And as far as insurance is concerned, with the exception of this professional line situation that we refer to, our prior year development was more or less where it's been.

Q - Vinay Misquith {BIO 6989856 <GO>}

So that's helpful. Then one last question on the net investment income, the income from fixed majority investments was up 5% quarter over quarter. Just curious what's happening there. It was about $75 million this quarter. Was it about $70 million last quarter?

A - Joe Henry {BIO 13390626 <GO>}

Right. We have an investment in Treasury and inflation-protected securities or TIPS, and you know that we've got some CPI adjustments that flow through that, so investment income in those areas fluctuates from quarter to quarter. If you need specifics, we can give you that but basically that's the overall answer.

Q - Vinay Misquith {BIO 6989856 <GO>}

But this quarter is the normalized rate you would think or a bit higher than normal?

A - Joe Henry {BIO 13390626 <GO>}

Bear with me a second. I have it somewhere here. Yes. It is about $2 million higher this quarter than normal.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. Thank you.

Operator

Our next question will come from Meyer Shields of Keefe, Bruyette and Woods.

Q - Meyer Shields {BIO 4281064 <GO>}

Thanks. If I could turn again to the professional liability -- when you talk about the $22 million of favorable development excluding the credit crisis issues, what asset years are those from?

A - Joe Henry {BIO 13390626 <GO>}

I believe it was spread out. Just give me a minute and I will -- bear with me here. I'm looking through a table.

So most of the strengthening that I referred to in the credit crisis years came from 2009, but the beneficial impact really came from actually the years 2007, 2006, 2005, and really spread out among a number of years. And as well as 2010.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay.

A - Joe Henry {BIO 13390626 <GO>}

2005, 2006, 2007 and 2010.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay, that is helpful. Albert, you talked about more -- how do I characterize it -- lower rate increases in the number of lines of business. Can you talk about why you think that is actually going on? Is that new competitors, old competitors being more aggressive or some other factor?

A - Albert Benchimol {BIO 2023727 <GO>}

I think in many cases each line of business has its own psychology. I think on the primary side we have a number of quarters now of increases and it could be that there is a little bit of satisfaction as we are now. It could be it is just an anomaly of the accounts that we renewed this quarter. That is particularly the case I would say when we look at the international book, where depending on the concentration of the line of business that you are in, the preponderance of the renewals if that book of business is up versus down.

As I mentioned in the First Quarter, the international book of business was favorably affected by significant increases in the marine liability line. Over 20% of our premiums are renewable in the Second Quarter, in international, in the offshore energy and that has had a very good pricing and excellent results and so here we started to see some declines in the result of that.

If I were to say one thing it would be that for most of the lines of business that we are seeing, the changes are consistent with what we have been observing in terms of A, prior pricing and B, loss experiences. The one area that is still lagging is in professional lines. And there again there is a reason for that. The lower layers of professional lines which have been most affected by claims increases, including M&A litigation and so on and so forth, those lower layers are in fact seeing healthy price increases.

When you get to the excess layers, as Joe mentioned, we are mostly in the excess layers most of those players have in fact been protected about a lot of the losses. So the loss experience in a number of the excess layers have been quite good, which goes back to my comment about how we are feeling comfortable about the overall portfolio and how the loss trends that we have been pricing in our professional lines in fact haven't really come out in reported cases. And because of that the pricing improvement is lagging in the upper layers because the losses haven't shown up in the upper layers. So most of what we are seeing fundamentally is consistent with loss experiences, loss turns that we have seen.

Obviously with regard to the reinsurance book, the biggest factor that we have seen is the substantial increase in capacity afforded by the capital markets, and that has, of course, reduced the amount of which is available to the reinsurers. Reinsurers have all that capacity they want to put to use. They are now putting it to use in the catastrophe world, so many of them are displacing that catastrophe into other lines, which is why we are seeing increased reinsurance competition in other lines. And as we mentioned to you that is reflecting itself, or manifesting itself in terms of higher ceding commissions. It is all consistent with the observations that we have had with regards to prior pricing activity and prior claims activity.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay. Thank you very much.

Operator

The next question is from Brian Meredith of UBS.

Q - Brian Meredith {BIO 3108204 <GO>}

Good morning. A couple of just quick questions here. First for Joe. I wondered, Joe, do you have what the spread is between what your reinvestment rate is, which I know you gave us, and what is maturing in your investment portfolio to give us a sense of what that looks like?

A - Joe Henry {BIO 13390626 <GO>}

Yes. It is, as of June 30, Brian, the book yield is 2.58%. Our yield to maturity, the reinvestment yield is 2.41%. So while we had some challenges in the past with the portfolio trending down to lower interest rates, the fact that interest rates have risen and actually we narrowed that gap pretty considerably.

Q - Brian Meredith {BIO 3108204 <GO>}

Got you. Then the second question, Albert, I'm curious. We heard from some other of the kind of leading property cat reinsurance companies that they took advantage of the attractive retrocessional rating environment right now of prices to improve their portfolio returns there. It doesn't look like you guys did that. Any reason why?

A - Albert Benchimol {BIO 2023727 <GO>}

One of the things that I mentioned is that we actually started to hedge our reinsurance portfolio using IOWs and other transactions of that type. And in addition, we have acquired protection on our aggregate book, on the annual aggregate excess of loss basis through a cat bond that we priced just yesterday. So we are definitely looking to manage our overall cat exposures and volatility.

Q - Brian Meredith {BIO 3108204 <GO>}

So we will see that come through in the Third Quarter?

A - Albert Benchimol {BIO 2023727 <GO>}

Yes.

A - Joe Henry {BIO 13390626 <GO>}

Yes.

Q - Brian Meredith {BIO 3108204 <GO>}

Okay. Great. Thank you.

Operator

Next we a question from Amit Kumar of Macquarie.

Q - Amit Kumar {BIO 15025799 <GO>}

Thanks. And two quick follow-ups. First of all, just going back to the discussion on individual risk losses in the insurance segment. Did you disclose what the number was in the opening remarks what that loss, how much did that add up to?

A - Joe Henry {BIO 13390626 <GO>}

No. We did not disclose it. And let me characterize it by saying that last year we had one risk loss in excess of $10 million in this period, in the current year we had a couple more. And really if you go back in our history we never really had a period where we had more than three so this is an unusual situation. We didn't disclose the exact amount but it had a small impact on, about a 0.7 impact, on our accident-year end loss ratio in insurance.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. That is actually quite helpful. The only other question I have is just going back to the discussion on the claims activity on the professional liability bucket. Would it possible to share what the total bucket of claims related to the credit crisis looks like, so that maybe we can think about it on a relative basis? And -- related to that is -- did something specifically change in those four claims in this quarter?

A - Albert Benchimol {BIO 2023727 <GO>}

I'm not sure that we can sit here and two through the individual one but I think what I can say is that for the global credit crisis years we did say that we had $234 million of IBNR related to that.

With regards to what happened this quarter, frankly, there were small number of cases that took a right turn in terms of moving in a direction opposite of how these cases were developing in the past, including one in which I think the judgment was overturned on appeal. There is a fair amount of volatility with regards to global financial crisis cases which is again why we he have always been slow in taking any action on those years because we were frankly we were expecting noise of this type.

So the favorable activity that we have seen in those years in the past we absolutely didn't want to respond to because we felt that sooner or later we would get the occasional surprise. The surprise has happened here and as Joe mentioned, rather than digging to the IBNR for these cases, we decided to take action and recognize those through the income statement and keep our IBNR protected for future development.

Q - Amit Kumar {BIO 15025799 <GO>}

Okay. That's all I have. Thanks. Thanks for the answers.

Operator

(Operator Instructions) I would like to turn the conference back over to Albert Benchimol, President and CEO, for any closing remarks.

A - Albert Benchimol {BIO 2023727 <GO>}

Thank you, operator and thank you all for being with us in -- on this quarter and we look forward to seeking to you again at the end of the Third Quarter. Bye-bye.

Operator

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