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Arch Capital Group Ltd. NasdaqGS:ACGL

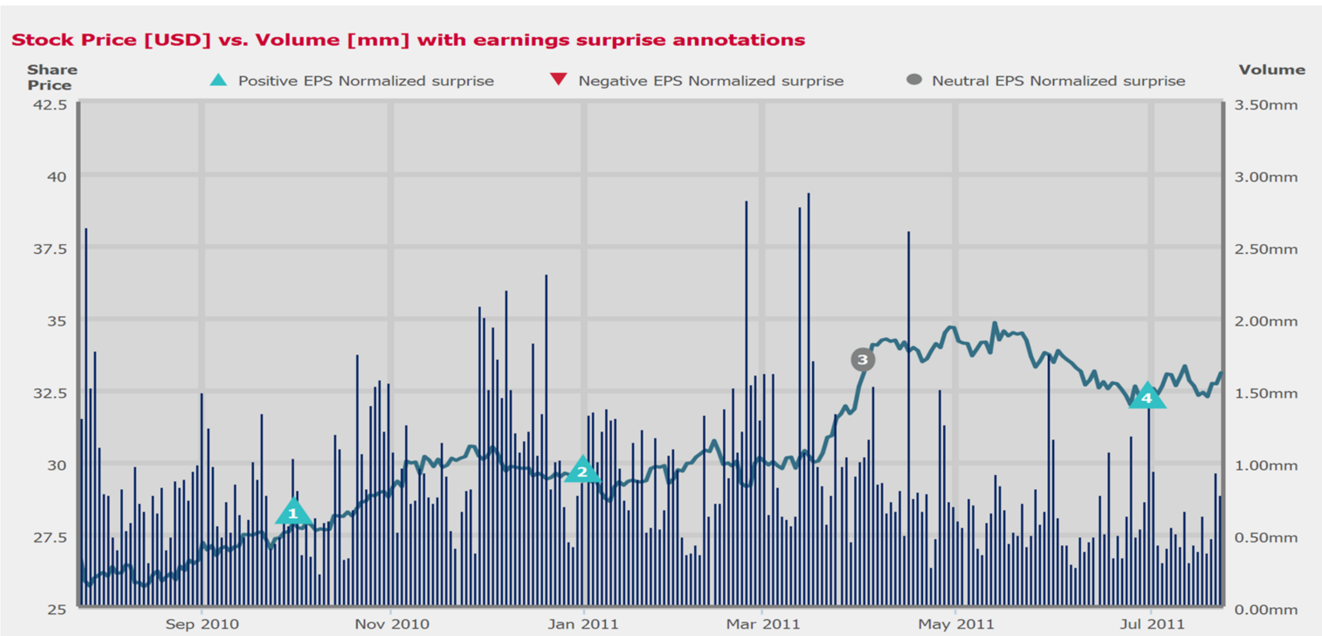
FQ3 2011 Earnings Call Transcripts

Wednesday, October 26, 2011 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2011-			-FQ4 2011-	-FY 2011-	-FY 2012-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.64	0.78	▲21.88	0.80	1.97	2.79
Revenue (mm)	677.16	691.38	▲2.10	555.98	2744.64	2798.27

Currency: USD
Consensus as of Oct-26-2011 1:41 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2010	0.71	0.85	▲1 19.72 %
FQ4 2010	0.79	0.86	▲2 8.86 %
FQ1 2011	(0.33)	0.06	NM
FQ2 2011	0.21	0.45	▲3 114.29 %

Call Participants

EXECUTIVES

Constantine P. Iordanou
Chairman and Chief Executive Officer

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

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Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Third Quarter 2011 Arch Capital Group Earnings Conference Call. My name is Fab, and I'll be your operator for today. [Operator Instructions] As a reminder, this call is being recorded for replay purposes.

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

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

The company intends the forward-looking statements in the call to be subject to the Safe Harbor created thereby.

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

I would now like to turn the conference over to your hosts for today, Mr. Dinos Iordanou and Mr. John Hele. Please proceed.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Hello, everyone, and thank you for joining us today. Our third quarter results were satisfactory when we take into consideration the difficult market conditions that we operate in. Significant catastrophic activity continue in the third quarter. However, the level of this activity and resulting in trouble damages were only slightly above our average expected cat load for the quarter.

As you may recall, the first 2 quarters experienced cat activity and resulting losses that were significantly above average. Our total net catastrophe losses for the quarter were about $60 million, with $46 million coming from the current quarter events and $14 million related to net increases in loss estimates from the first and second quarter events.

Our underwriting teams continue to execute our soft market strategy by emphasizing small accounts over large ones and focusing more on short-tail businesses. The market is showing signs of slight improvement. However, we still see more opportunities for adequate profitability in the short- and medium-tail lines of business rather than the long-tail business. As more and more competitors are factoring into their pricing the skimpy returns available on new money investments, eventually pricing levels for long-tail lines will improve, at least we hope so. In the meantime, we're continuing a defensive approach for these lines of business. As a result of these strategies, our mix of business continues to shift towards more short-tail and medium-tail, while our long-tail business on a trailing 12-month basis remains approximately 25% of our book.

Our annualized return on average common equity was 10.4% on a reported basis, including a slightly negative effect of above-average cat activity and aided by prior year reserve releases. We continue to believe that in the current market environment, we are earning high single-digit ROEs on an underwriting year basis. This is essentially the same level of ROE performance we estimated for the 2010 underwriting year, with slightly less earnings from investment income offsetting by slightly better underwriting results generated by adjustments to our mix of business.

Our investment performance for the quarter, including the effects of foreign exchange, was a total return of negative 23 basis points as September was a difficult month in the financial markets. As a result, our book value per share for the quarter increased slightly from $31 per share to $31.20 per share while book value per share from the year ago -- from a year ago, grew by 5%. From an underwriting point of view, we recorded a 94.3% calendar quarter combined ratio, which is an excellent result for the prevailing market conditions. Cash flow from the quarter remains solid at $310 million as claim trends remain favorable.

The broad market environment is showing slight improvement across the board. From a rate standpoint, most lines of business moved into positive territory. The exceptions were in executive assurance and medical malpractice, where we're still seeing rate reductions in the rate of 1.5% to 2% for malpractice business and approximately 7% for executive assurance. Even with this slight improvement in the rate environment, significant more rate is needed in many lines in order to achieve adequate returns. For us, adequate returns is returns that produce 15% return on equity. In our view, based in part on the level of interest rates currently available, the longer-tail lines need quite a bit more improvement in rate to become attractive.

From a premium production point of view, our gross written premiums were up 3.4%, and our net written premiums were up 8.7%. The Insurance Group was up 1.6% on gross written premiums and 9.6% on net. The shift to smaller accounts, and in essence, lower limit policies, affects the net-to-gross relationships as we retain more net for this type of business.

The Reinsurance Group was up 9.1% on a gross basis and 6.7% on a net basis. The entire increase is attributed to additional premiums from short- and medium-tail lines of business. Long-tail lines continue to represent a smaller portion of the Reinsurance segment book of business.

In the current environment, even after the implementation of RMS 11, which impacted our capital requirements, we still are left with a very strong capital position. As always, we will prefer to deploy all of our available capital towards our underwriting activities. Unfortunately, the market, at this point in time, does not yet give us the opportunity to do so. As a result, we expect to continue our share repurchase program as we continue to accumulate additional excess capital through earnings.

Before I turn it over to John for more commentary on our financial results, let me update you on our cat PML aggregates. As of September 1, 2011, under our version of RMS 11, our 1 in 250-year PML from a single event was $972 million or 23% of common equity. This amount is for Gulf wind exposures while the Northeast wind PML was at $870 million, and the Tri-State County Florida PML was at $750 million.

With that, I'm turning this over to John for more commentary on our financials. John?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Thank you, Dinos, and good morning. On a consolidated basis, the ratio of net premium to gross premium was 80%, slightly higher than the 77% a year ago, which is due to a change in the mix of business and some modifications in U.S. ceded reinsurance treaties. Our overall operating results for the quarter reflected a combined ratio of 94.3% compared to 90.4% for the same period in 2010. The 2011 third quarter included $60 million or 8.7 points of current accident year cat activity, net of reinsurance and reinstatement premiums, compared to $24 million or 3.9 points in the 2010 third quarter.

The 2011 third quarter storms, including Irene and Dennis flooding, had a gross impact of $51 million and a net impact of $46 million. The re-estimation of the 2011 first and second quarter cat events are the Australian floods and Cyclone Yasi and the New Zealand earthquake made up most of the additional $11 million gross and $14 million net added to the third quarter provisions for the 2011 cat events. We had little net impact from the Japanese earthquake and in corn [ph] revisions, and have already reserved a material portion of that exposure. In addition to the cat activity, we experienced slightly higher attritional property claims in the quarter.

The 2011 third quarter combined ratio reflected 8.5 points or $58 million of estimated favorable prior year reserve development, net of related adjustments, compared to 5.9 points or $37 million in the 2010 third quarter. The prior year development in the third quarter of 2011 reflected net favorable development primarily in property and other short-tail lines, as well as in the Reinsurance segment Casualty business, mainly from the 2002 to 2006 underwriting years. Moreover, we gain experience better-than-expected claims emergence on most lines.

The 2011 third quarter current accident year combined ratio, excluding large cat events and net favorable development, was 99.9% in the Insurance segment consistent with recent quarters. In the Reinsurance segment, it was 83.8%, slightly higher than recent quarters due to non-cat attritional additional property losses. The 2011 third quarter expense ratio of 32.1% was 1 point lower than in the 2010 third quarter, resulting primarily due to the higher level of net premiums earned in 2011, as well as nonrecurring contingent commission income in our Reinsurance business, which more than offset a higher level of acquisition expenses related to favorable prior year reserve development.

On a per share basis, pretax net investment income was $0.60 in the 2011 third quarter compared to $0.59 for the same period a year ago and $0.63 in the second quarter of 2011. Our embedded pretax book yield before expenses was 3.09% in the 2011 third quarter, down from 3.52% at year end, which primarily reflects lower reinvestment rates. During the quarter, we slightly lengthened the portfolio duration to 3.17 from 2.87 at the end of June 2011, with longer-dated treasuries to capture some of the expected gain from lower treasury rates.

Total return of the investment portfolio was minus 23 basis points in the 2011 third quarter compared to a positive 165 basis points in the 2011 second quarter. Excluding foreign exchange, it was a positive 38 basis points in the quarter. The total return in the third quarter benefited from good returns in treasuries offset by negative returns on foreign exchange, equities, corporate fixed income due to widening credit spreads and some alternative assets.

Our alternative assets include bank loans, global and emerging market bond and multi-asset funds and energy investments. A substantial portion of this negative foreign exchange, credit spread, equity return and alternative asset return has reversed since September 30 to October 25, which demonstrates the volatile investment environment we now face and expect to face for the foreseeable future. We continue to maintain the vast majority of our investable assets in a very high quality fixed income investment portfolio with an average credit rating of AA+.

We recorded net foreign exchange gains of $60 million during the 2011 third quarter, mainly due to the strengthening of the U.S. dollar. These gains resulted from revaluing our net insurance liabilities required to be settled in foreign currencies at each balance sheet date. However, this should be compared to the minus 61 basis points to total return from foreign exchange on our investment portfolio, which offset this income statement gain in the equity section of the balance sheet, which together with the liability gain, resulted in approximately a net $10 million reduction in book value.

For the 2011 year-to-date, our effective tax rate on pretax operating income was a benefit of 3.3% and 1.5% on pretax net income. The cat activity this year and low investment returns have resulted in a beneficial net tax position. Our preliminary estimates of the implementation of the new DAC accounting standard required on January 1, 2012, should not materially reduce our book value and should not have a significant impact on our operating earnings for 2012. These estimates are still preliminary and may change depending upon the final implementation of the standard.

Our balance sheet continues to be conservatively positioned with total capital of $4.9 billion at September 30, up from $4.8 billion at June 30. In the quarter, we purchased 0.7 million shares for $20.8 million at an average price per share of $31.77, a ratio of 1.02 to the average book value. Our debt plus hybrids represents 15% of our total capital, well below any rating agency limit for our targeted rating. Our book value per share ended the quarter at $31.20, up 1% from last quarter and 5% from a year ago.

In the calculation of our target capital position, we have now implemented our version of RMS 11. The implementation of RMS 11 by Arch, which reflects the application to model with our own internal back testing increased S&P A+ required capital by approximately 5%. With the implementation of RMS 11, which, in our estimation, should reduce overall model error. At this point in time, we have changed our target capital to be a AA level by S&P, which is a 2-notch buffer over the A+ rating. As of September 30, our actual capital is in excess of our target capital.

With these comments, we are pleased to take your questions.

Constantine P. Iordanou
Chairman and Chief Executive Officer
Fab, we're ready for questions.

Question and Answer

Operator

[Operator Instructions] And your first question will come from the line of Jay Gelb from Barclays Capital.

Jay H. Gelb
Barclays PLC, Research Division

I just want to follow up on the last comment from John about the capital position. I know in the past you've given us a sense of where you feel Arch's excess capital position is currently. Can you give us an update there?

Constantine P. Iordanou
Chairman and Chief Executive Officer

As we said, with the implementation of RMS 11, the 5% number was approximately $200 million. So if you take into consideration that $200 million has been eliminated, our position will be approximately $200 million less of what we had before plus the earnings for the quarter, which we added. So in essence, our excess capital position hasn't changed that significantly.

Jay H. Gelb
Barclays PLC, Research Division

Okay. So would it still be $100 million to $150 million plus whatever you have in retained earnings going forward? Is that the right way to think about it?

Constantine P. Iordanou
Chairman and Chief Executive Officer

And don't forget, maybe a bit more because our new standard now if I would calculate excess capital is the 2 notches above our rating algorithm. So we're an A+ company. We calculate capital at the AA level. And then including the additional requirement that RMS 11 gives us on the PML. And then anything above that, we consider excess capital. So we're in a very strong capital position, and that's the reason we are going to continue with our share repurchasing plan. Until the market turns and then we can write a lot more premium. But as you've seen from my comments, even though things are improving not to the level that we're going to step on the accelerator big time.

Jay H. Gelb
Barclays PLC, Research Division

That makes sense. So in the second and third quarter, share repurchase typically flows for Arch as we get into wind season? Should we expect buybacks in 4Q to be similar to the pace that they were in the first quarter?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, yes. There is a lot of variables. Price-to-book, where the euro is trading, et cetera. But yes, our most heavy -- the heavy share repurchasing traditionally has been the fourth and first quarter for the reasons that you have already mentioned. In the third quarter because of the significant expected cat activity, we don't do many share repurchases. So yes, I would say we're going to go steady as we go as we've done in prior years.

Jay H. Gelb
Barclays PLC, Research Division

Okay. And then other people have asked this question on other conference calls in terms of the stabilization of commercial P&C insurance rates. Can you say this, the current situation is similar to what we saw in 2000 where we had a persistent level of slightly improving rates over time?

Constantine P. Iordanou
Chairman and Chief Executive Officer

If you press me for a comparison, Jay, and my memory is still good. I mean, I'm getting older, but I still have good memory. This looks like second quarter of 2000 to me. I have that same feeling. If you go back and you look at what happened with the prior cycle, we're starting to see some positive [ph] in rates in the second quarter of the year 2000. Don't forget, that continue for the third quarter and fourth quarter of 2000. It accelerated a bit in '01, but we didn't really had a true market turn until the first quarter of '02. So even in those days, it took, what, 7 quarters before we really got an acceleration. But there is no denying that when we look at our data -- and don't forget Arch is not -- we're not a huge company like Travelers or ACE or TRV that they have much broader basis for their comments. Ours is what we see on a $3 billion book of business, not a much bigger book of business. We see, in every sector, improvement, even in those that we still giving up rate, we're giving up a lot less rate this quarter than a quarter ago. So you can sense it. It's a gradual improvement, and it's across all lines. The only 2 negative lines we had for the quarter, it was in the malpractice area, as I've said in my prepared remarks, and in the executive assurance, in the D&O area. Everything else was either flat, slightly positive or in the mid-single digits rate increases, which is, listen, from where we were coming, I'll take it.

Operator

Your next question will come from the line of Mike Zaremski with Credit Suisse.

Michael Zaremski
Crédit Suisse AG, Research Division

Any more color on the loss cost trends, specifically in reinsurance, the accident year x cats jumped kind of quite a bit.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Okay. Loss trends are benign. That's a broader comment. We usually measure that by frequency and severity in most of the lines. And they do it both in our Reinsurance business and the Insurance business, we try to get underneath and measure it on the underlying business, because that's the only place that you can measure those trends. Having said that, we have segments of business that have volatility by nature. Property fac is one. Of course, the cat business, et cetera. For the quarter we have -- we did experience higher than normal, what we would call attritional losses. Some of them there were flood losses. Some they were fire losses. But in essence, we have experience. And that, it will flow through the numbers, and you might see that quarter after quarter. But it doesn't look to us like it's a trend. It's more as to what happened in a specific quarter. I mean, John...

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

And in fact, if you go back, Mike, and look quarter-by-quarter, like 8 quarters, you'll see in the Reinsurance segment when you take out cat losses and favorable reserve development that, that number's bouncing around a bit quarter-to-quarter. And as we move to more shorter-tail businesses and more property, you're going to see that things that aren't classified as a cat, but we still have above average storm activity toward the U.S. and in other places. So that's what you're seeing is this bouncing around.

Michael Zaremski
Crédit Suisse AG, Research Division

Okay. That's helpful. And lastly, I see you've been kind of lengthening the duration of the portfolio at 3.2 years now. Could you -- are you guys expecting to continue extending? And can you remind us the duration of the liabilities average book?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, I don't think we have -- we're going to continue to be rather short. That extension, it was more a reaction to Fed comments and what we expected the yield curve to go to. So it was more tactical in its execution rather than a change in philosophy.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Yes. Our average duration is 3.6, 3.5 for the liabilities. So we're still shorter than our overall liabilities. But in the third quarter, we felt that the rates were going to come down. So we, tactically, as Dinos said, lengthened with treasuries, which was paid off because rates did come down by the end of September.

Operator

Your next question will come from the line of Keith Walsh with Citi.

Keith F. Walsh
Citigroup Inc, Research Division

Dinos, in your RMS 11 update comments, I just wanted to be clear. Were the PMLs you gave consistent with the view on the 2Q call of 10% to 30% increases? And then I've got a follow-up.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. Yes. Don't forget, we never use any off-the-shelf product in its purity. We have our own proprietary adjustments that we do based on our own experience, et cetera. And as I said in prior calls, even way back in the '04 and 05 storms, we were making adjustments to models. It is not just the RMS model. It might be the AIR model, which we also use, so we do pay a lot of attention to these outside models. But at the end of the day, we make underwriting decisions, and we take risks based on our own models.

Keith F. Walsh
Citigroup Inc, Research Division

Okay. And then just on the excess capital. I think you'd alluded to that you prefer buybacks to writing new business, at this point, is what it seems like from what I heard but...

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, no, our preference is to write more business. However, I'm not going to write more business unless I get adequate returns. What I said is in the current market environment, it doesn't allow me to be looking for 15%, 20% growth, and that's the kind of growth you need to start eating up your excess capital. So not having that opportunity, then I've got to return capital to shareholders. And right now based on where our share price trades, we still believe that buying back shares is the best way to return that capital back to shareholders.

Keith F. Walsh
Citigroup Inc, Research Division

Right. I was going to ask you, what type of rate increase do you think you need to see when that switches over, when writing new business becomes more attractive on an ROE business, on an ROE basis relative to the buyback?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it depends a lot on the business. I'll give you an example. Let's take -- we're not a big workers comp writer, right? But our monitors show that in the comp line, we're getting -- the very little we write, we're getting 6%, 7% rate increase. We don't get excited until we get to probably 30% rate increase. Because if you do the math, you need 30%, 35% rate increase for the comp line based on the yields we get on new money invested and a 4-year duration ground up to take that 117 -- or 115, 117 that the industry is performing at and bring it down to the mid-90s. Because you need mid-90s in order to get to the mid-teens ROEs even on that line. So our evaluation as to what we write by line of business type of accounts goes through this analysis. What's the rating environment, not only just year-over-year changes but on an absolute basis, what is the profitability associated with it and how much more can we get in the marketplace if the rates -- they're adequate. Of course, there's limitations to that. I can tell you we feel that in the cat business rates are adequate but PML limitations doesn't allow you to write more than x. So from a risk management point of view, we write up to our risk tolerance. So when I look line by line and where we see opportunities, we see opportunities. You see a little bit of growth in our business. But it's not broad-based that allows me to deploy all the capital that I have.

Operator

Your next question will come from the line of Joshua Shanker with Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

You said that executive assurance is getting a weaker pricing, but it seems like you're still growing there. The pricing still very attractive?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Don't forget, in executive assurance there is -- we view it in 3 sectors, right? We have financial institutions. We have commercial D&O, and then we have what we call private company, not-for-profit, et cetera. And in Europe, we write a lot of small, medium-size enterprise, which a lot of it is private enterprises, et cetera. The latter part is where we're growing, and that's the part of the business that we like. It fits with our strategy of writing smaller accounts and we believe the profitability for that segment of the D&O business is the best.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

And so the rate that, Dinos reference, was for large commercial D&O, which would -- which were shrinking on here.

Joshua David Shanker
Deutsche Bank AG, Research Division

And then offset by opportunities in the smaller sectors?

Constantine P. Iordanou
Chairman and Chief Executive Officer

That's exactly.

Joshua David Shanker
Deutsche Bank AG, Research Division

Okay. And the second, not too much on workers' comp, or it is on workers' comp, but you did try out the national accounts business a bit. And in your experience, how sticky is that business? And if you guys eventually find it attractive how early do you have to be to get into it in order to participate in the upside?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it's sticky business, and is a high-service business. Because at the end of the day, most of the risk is taken by the client, right?

Joshua David Shanker
Deutsche Bank AG, Research Division

Well, not on the national comp, the workers' comp in general. If rates got better, would you have to take a loss initially to participate in the profit upside?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, we don't think so. Some people might. We don't think so because if -- the market only goes up because there is more demand. And when there is demand, if you're a company with an A+ rating, good service capability and good market reputation, I think you will get your fair share. We might be fools, but we believe in that. I don't believe the fact that we're not writing as much guarantee workers' comp today will inhibit our ability to participate in the future.

Operator

Your next question will come from the line of Matthew Heimermann with JPMorgan.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

A couple of questions. One maybe just to start out on kind of the changes we're seeing in macro pricing. I guess when I think back to -- you said this kind of reminds you of 2Q 2000. So just indulge me for a second here. But at that point in time, there was a lot of big recognition that reserves were inadequate. And while it took, to your point, 6 to 7 quarters for rates to rise enough so that the returns on capital were adequate, the rate increases and exposure gains that were available were significant enough to really allow companies to grow 20%, 30% even 50%. In some cases per annum, over a couple of years span. So I guess my question is, if this plays out in a more kind of incremental fashion relative to the 6 to 7 quarters it took last time to get your return on capital to kind of target level, how long do you think it takes this time?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, that's a tough question. I don't know. First of all, your comment is correct. There was, in the year 2000, there was a recognition that maybe reserves were short for the entire industry, not a real problem for most companies in the current environment. Having said that, I think, there is more and more recognition today by management, and eventually they reflect that in their underwriting strategies, that we've got to be in a very low-yield environment for quite a bit of time. At least there is nothing in the horizon that says that we're going to go back to the 5%, 6%, 7% returns on the investment portfolios that we were experiencing 10, 12 years ago. So there is different dynamics that cause the adjustment in pricing. I believe there is a recognition today by senior management. And in essence, they are starting to push it down into the underwriting teams, that we need underwriting profit in order to get adequate returns, and I think that's why they're adjusting in price. How long will it take? I don't know. If I was very good at that, I'd be in Vegas.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

I guess the follow-up question to that is, do you have a sense in terms of the -- whether based on what you're doing internally or what your best guess is based on what we're seeing in the market, what type of interest rate assumption you're seeing push down? Is it where portfolio yields are today? Is it where new money rates are today? Is it somewhere in between?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it depends by company. I don't know. You have the ability to ask different companies what they do. I can tell you what we do. We only factor risk-free rate of return in new money, when we do both, we establish rates and also when we compensate our underwriting teams on incentive compensation. Any under- or over-performance from that by the investment department does not affect those calculations, either for incentive compensation for our people and/or for rate making.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

That's fair. And then, John, when you were discussing excess capital, it sounded like when you were talking about the buffer to the AA that the target rating that you ran your buffer against potentially had changed. Did I hear that correctly? And if so, what was the previous target?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Yes, we used to have a buffer where we took into account the 1 in 250 PML less the future earnings from that. But that was based a lot around model error and the potential for a large cat. And in thinking about this, the fact we have gone to RMS 11, which we think is now a better calibrated model, at least how we see it and how we've implemented it. And in thinking about how we want to hold a buffer, we sort of like the overall AA or a 2-notch buffer because that reflects all the risk that we're taking in the firm. So we've sort of a better buffer now, we think about it overall, versus a one-dimensional buffer, which is only the cat event. And so that's how we want to think about it at this time and run the company on.

Constantine P. Iordanou
Chairman and Chief Executive Officer

The only rule, it was my rule, and it was simplistic. I said I want to begin the year and end the year with a cat, a major cat event with the same capital. So I took potential earnings for the year, my PML and then the delta, I said, if I have an excess capital, I'm in good shape. Now I think we're getting a little more sophisticated in our calculation, and it might change in the future. And if it does, we'll always tell you as to how we calculate it. But right now, we feel pretty comfortable that we calculate required capital until internally. Management's required capital is 2 notches above what the rating agencies want us, and we count excess capital anything above value.

Operator

Your next question will come from the line of Dan Farrell with Sterne Agee.

Daniel D. Farrell
Sterne Agee & Leach Inc., Research Division

Could you just comment on your view on new business versus renewal business and the gap there. We had a company early today, said that they thought the gap was closing.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I don't have all -- we measure that. So I'm going to go -- and I apologize. I didn't know I was going to get the questions, otherwise I will have the specific numbers in front of me because we have a monitoring system that compares what we get on new business versus our renewals. In most areas today, your new business is anywhere from -- if renewal business is at 100, it's anywhere from 94 to 100. But clearly, we're getting less rate on new business than we're getting on our renewal business. And but I don't have those numbers right in front of me to give you more specifics. It varies by line of business. But on average, I would say in a scale of 100, new business is at 94, maybe 95, and then renewal business, it will be at 100.

Daniel D. Farrell
Sterne Agee & Leach Inc., Research Division

That's helpful. And just one other quick item. You mentioned that the increase in the net to gross is driven a little bit by business mix and shift to smaller accounts. Is that something we should continue to see, of the net to gross shift up over the next few quarters?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, we're aiming for that. But, I mean, we might have reached saturation in our ability to continue changing that. Because don't forget, we're not abandoning the large account business because in a good market, that's where you make a lot of money. We're just more careful about pricing it today. And in essence, competition takes some of these accounts. We never really went out and told any of our clients, any of the brokers that we do business, don't send us a large account business. It's just we're not as competitive on that. And in essence, over time, it becomes less and less part of the book. I wish I can find the rates to grow that business because anything that we put out from a quotation on any account is something that we're happy about. Because if we're not happy about it, we shouldn't be doing it. Right? So it's how much the market returns back to us. And that's been our attitude. Yes, the recognition that smaller accounts perform better in the soft cycle is not only by us, it's probably by the entire P&C world. But at the end, do you really have the infrastructure to be able to do that? And over the years, I think we build good infrastructure that allows us to do it.

Operator

Your next question will come from the line of Doug Mewhirter with RBC Capital Markets.

Douglas Robert Mewhirter
RBC Capital Markets, LLC, Research Division

I just have 2 questions. First, on the revenue side. Do you have any -- based on the mix of pricing and demand and maybe exposure units you're writing, are there any, I guess, economic signs or tea leaves that you're seeing, or indications whether it seems to be there's more health in the economy or it's maybe at a standstill or things are still kind of dragging on the demand side?

Constantine P. Iordanou
Chairman and Chief Executive Officer

As I said, we're not such a large company to have a broad view. You're asking a very broad question. I can tell you based on the limitations that a company writes only $3 billion on annual basis is that in the construction sector, which I think we have a good market share book, we don't see yet an uptick. I keep talking about it, but I think that business is still hurting quite a bit, and we don't see the demand upticking. In some other areas, we've seen a little bit of demand uptick, but it's not broad enough to draw broad economic conclusions about what's going on economically in the country. But if I had to guess, and this is my guess, is I think we're just continuing to drift. The demand has not really increased to allow us to get more premium or more revenue because of increased demand.

Douglas Robert Mewhirter
RBC Capital Markets, LLC, Research Division

Okay. That's helpful. And my second question deals with a different topic. I noticed the massive flooding in Thailand hit the major part of the new cycle now. And insured loss estimates seem to be climbing quite a bit. They started about well below $1 billion. I think there might even be ones up as high as $2 billion industry loss. I mean, is that a broader event that would impact the overall reinsurance market? I'm not quite sure of how the market's structured in Thailand. Are there a lot more local companies, or would you see those losses trickle into the general global Bermuda, Europe, Lloyd's type market?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I'm not the right person to answer this question because we have so little in that part of the world that I haven't really spent time studying it or so. But I'll do a little research on your behalf. And then if you call Don, on a subsequent call, it's an industry question, so we can comment on it. I'll shed some light to it. But I got to get back to my cat teams. All I can tell you is we don't have much exposure in that part of the world.

Operator

Your next question will come from the line of Court Dignan with Fidelity.

Court Dignan
Fidelity Investments

Actually, I had a question pertaining to the capital allocation, and maybe it's for John. So I know some people are getting pretty excited about what's being said about pricing conditions in certain markets. But I actually thought Dinos did a pretty good job of summarizing the situation pretty well in his opening comments, which is it doesn't really seem to be any seminal change in the total return economics of the business when you give to sort of proper consideration to all the factors. And I guess my question is that, given where your shares are currently trading, it looks like you're basically buying, let's call it, a 6.5% to 7% incremental earnings yield. And obviously, the repurchases aren't accretive on a stated book basis, and I guess that to me makes it a little hard argument to say that they're accretive on an intrinsic basis. So what point do you consider shifting focus towards dividends, either regular or special, and away from buybacks?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Yes. Well, we...

Court Dignan
Fidelity Investments

And I have one follow-up.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Because we will always want a 3-year payback in how we think about this, and at these expected returns, we'd have to go above 1.2 to make it much longer than 3 years in terms of the not getting the payback. So if we're just trading just a little above our book value for the average book value for the quarter then we still like share buybacks.

Court Dignan
Fidelity Investments

Okay. So...

Constantine P. Iordanou
Chairman and Chief Executive Officer

Our economic ROE calculation is, as I said in my prepared remarks, is still high single digits, when you put -- and I think we have something on our website. We have a grid that tells you potential ROE on the left and up on top, multiple to book, and where the 3 year in recovery ends. And right now, I don't know if it's 1.2 but it's 1.18 or something like that. And basically, until you guys give us more credit and shares go beyond 1.2x book, it's not much for us to think about, but...

Court Dignan
Fidelity Investments

I guess I added like 1.25 of book excess, yeah, but that's helpful. I have one follow-up, if I can?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Go ahead.

Court Dignan
Fidelity Investments

Along the lines of the great question posed by Matthew Heimermann of JPMorgan, I guess I struggle a little bit with the 2Q 2000 and subsequent 6 to 8 quarters analog. Although I'm sure it made Jay Gelb's day. We can kind of debate the numbers back and forth, whether it be the industry is having an article on net reserves or spread adjusted cash flow or, however, you want to look at it. I guess qualitatively, though, I look around and I just don't see sort of the frontiers and reliances out there. I guess the question is, are they out there and I'm just not seeing it? Obviously, I wouldn't ask you to name names. Obviously, that analog, there's an event in New York that mattered as well. But I guess it's in analog, I think, I struggle with. And I also kind of think back to banking, and 2007, 2008, when people were always saying, Oh, yeah we're going to have a downturn. But if you look at the early 90s, S&L crisis, and now this -- the worst it gets. But the other reality is, is that the last cycle very rarely provides an adequate analog for the prospective cycle.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Every cycle is different, and it happens for different reasons. Yes, the probability of companies going bust is probably a lot less today than it was in the year 2000 because usually companies go bust on reserve deficiencies, not a recognition that, I can't get much yield on new money invested and, in essence, I've got to improve my underwriting so I can get underwriting profit, et cetera. I think what's driving a bit of improvement in the pricing is the realization that investment yields are so low that we've got to start thinking about underwriting profit. I can tell you in the entire '90s, nobody ever care if you were publishing 100 combined, 102, or 104 in a business that it had 6%, 7% return on, with a 2.7 to 1 leverage and a 3.5- to 4-year duration. I mean, when you do the math, it's pretty good returns. And also in those days, the capital requirements if you go and you seem to be spending a lot of time on the math, the rating agencies, they were allowing us on a premium-to-surplus ratio to write a lot more premium to surplus. As things evolve and they got more sophisticated and the capital requirements have continuous increase and now the yields are going down, you have a much different environment. So I wasn't -- I'm not predicting that this is -- the question was what does it feel like? And I said -- my comment about second quarter of 2000, it was the first time in those days for different reasons that we saw the market starting to increase rates and improve rating environment. And I see a consistency in that between second quarter data that we have and third quarter. Everything is lifting up a little bit. If it was negative, it's a little bit negative. If it was 0, it got to positive. And if it was slightly negative, it got to 0. So that's the only comment I'm making. I can't predict the future. I don't know, this might be like a jet on their runway and he's trying to lift off and it might be a false alarm, maybe hit a little bump because they didn't have a flat runway and it will come down again. I don't know. But we'll see. Time would tell.

Court Dignan
Fidelity Investments

I guess just one follow-up to that. I mean, with the benefit of hindsight we can go back and we can actually conclude that a number of still remaining companies, still prominent companies, were actually technically insolvent in the second quarter of 2000. Some that are going to report in the next 24 hours or so. And I just -- do you think that anyone fits that description today? Because it seems like that it would be much harder to make the case.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Listen, my job is to run Arch. I spend most of my time worrying about Arch. I haven't done extensive analysis in other companies, looking at their schedule piece and their reserves. I don't spend my time worrying about others. So you've got to do that homework, and you can draw your conclusions. But one general comment, and then we'll move on to the next question, is I think the industry, in general, is not significantly under-reserved like it was in the year 2000. And in my history in the business for the last 35 years that I spent as a career, usually companies go bust when they're grossly under-reserved. And that does not exist today. So if I have to predict that, I don't see a lot of insolvencies left and right.

Operator

Your next question will come from the line of Vinay Misquith with Evercore.

Vinay Gerard Misquith
Evercore ISI, Research Division

So since Court has exhausted all the cycle-down questions, let me just go back to basics on your business. The first question is on the buyback. And it seems that, at least looking at your PML, you have maybe about $250 million of excess capital based on your 1 in 250 PML. So curious as to how much of stock you'd be willing to buy back? So given the flexibility that you want to maintain, should the pricing in property cat remain strong Jan 1?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Like I said, we have excess capital. I'm not confirming how much. You calculate how much we are. Also we have the earnings for the fourth quarter. So that's in addition. That is growing. And like I said before, Vinay, is it depends what I'm trading. If I'm getting these lousy multiples that I'm getting today, I'd be more anxious to be buying more, because I think I'm creating value for my shareholders. If I get a reasonable multiple for what we are, I might slow that down a bit and even consider other forms of returning capital. Right now, though, where the market is, I'm going to be more patient because I don't know if January 1, it might be a much better environment. And if it is, I don't want to miss it because I said, Oh, I don't have enough capital. If I'm going to earn -- if I'm going to err, I'm going to err on having more capital available than less. But having said that, I don't see that. That's why we like share repurchases, because you can change what you do on a weekly basis. If I write a check for an extraordinary dividend, the minute it goes out, I can't it back. Where with share repurchases, I can accelerate it or I can decelerate it based on as I monitor the market condition. So I will stick with the comments that I said, that our fourth quarter will be no different than what we've done in prior quarters if you go a year ago or 2 years ago and 3 years ago.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

And, Vinay, I think we sleep a little better at night having some buffer because it's still a pretty volatile world out there with Europe. And although the U.S. economy appears to be a bit more detached from it, it's still a pretty volatile market out there.

Vinay Gerard Misquith
Evercore ISI, Research Division

Sure, fair enough. The second question is on the future sort of accident year margins. That's improved in the insurance operations this quarter year-over-year, and it's been improving for the last couple of quarters. So is that business mix issues? And also and reinsurance guys seem to be running more cat business, more property business. Should we look at the combined ratio on an accident-year basis going down for both Insurance and the Reinsurance segments going forward?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, 2 things are constant. Your first comment on insurance is correct. I think the change in the mix moving away from, either limited some volatility because they're writing a lot more in small accounts and also they have moved into short-tail business. And then, of course, on the Reinsurance side, as we write more and more property cat and property fac, et cetera, we're introducing a bit more volatility. We like the business long term, but it will give you quarter-to-quarter volatility because attrition losses might go up and down. Yes, it's a better margin business, right? Because that's what we believe today the best margins are. And for that reason, we gravitated to that. I'd rather take the volatility with a better margin because, over a long period of time, I'm going to do better for the shareholder. But even with that, even we believe a better mix that we have, the way we calculate things, we're still high single digit ROEs. Nothing really to get totally excited about, right?

Operator

Your next question will come from the line of Ian Gutterman with Adage Capital.

Ian Gutterman

Adage Capital Management, L.P.

Two follow-ups. First, what made the Gulf past Northeastern Florida as your peak PML, was that mainly RMS 11, or did you reshape the portfolio?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, it was purely model driven.

Ian Gutterman
Adage Capital Management, L.P.

Got it. Okay, great. Next couple of questions are follow-ups. On the change in the capital center to AA, does that give you more or less excess capital than if you had kept the old standard for this quarter of PML?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It was approximately the same. It depends what you do with the cat. We model it. It's no big difference. I think it's more sophisticated way of thinking about it. Now if I'm at 19% of risk tolerance of my PML, one gives me more, if I'm at closer to 25% the other one gives me more. So it depends how you run it and where you are on the PML.

Ian Gutterman
Adage Capital Management, L.P.

Got it. Okay.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Right? Because that was, in the old model, that was the determining number. If I pushed it way up on the PML then earnings and the delta was the -- it require more. And now in my -- on the other hand, if my -- if I take a little less PML, it changes that.

Ian Gutterman
Adage Capital Management, L.P.

Got it. Does it also reflect sort of where we are in the cycle? I guess I'm thinking the yields and liquidity years worth of earnings. If accident returns are low, you obviously get less contribution from that than if accident returns are higher.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, you're raising a much more intriguing question, which the way I would tell you is that in a market -- if let's say we're in the very good part of the marketplace, I will not keep any cushion. I will write all the way to my required capital by the rating agency because I have so much confidence in the business we write and this profitability, why keep excess capital and not really maximize returns for shareholders? So that's when we said we step on the accelerator and we write all the business we can. So this is for now and for the market environment that we're operating today. And I think it's prudent in the way we think about it, and it gives me comfort. Listen, my #1 priority is I want to sleep at night, right? I don't want to be turning and tossing. So if I feel good about sleeping at night, then I think I have the right measurement. And right now, believe me, we have enough excess to make me feel good about where we are.

Ian Gutterman
Adage Capital Management, L.P.

All right. My last one is just a follow-up on the repurchase commentary. And, John, I'm actually looking at the sheet, and it looks like at a 9% ROE, it's 3.5 years at a 1.2x. So it looks like maybe the cutoff is something like a 117 or 118 or something and you're trading at 115. I mean we're basically there. So if the stock moves $1 higher from here, are we turning off the buyback?

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

Well, it's the average ROE over the period of time, not your trailing, because that's a September 30. And the 1.17 to 1.2 is sort of the upper end of the range, but we will continue to look at these options. But you've got to average it out over the quarter.

Ian Gutterman
Adage Capital Management, L.P.

Okay. So I guess what I'm getting at is, if the market continues to get more enthusiastic about pricing and the stock goes up another 10% or more, and you get to the point where the math doesn't necessarily work, what is the option? Is it dividend? Is it -- and assuming it's not a hard enough market where we want to grow a lot, where if we're sort of in this in between land where pricing's up maybe a little bit more than loss trend we don't grow a ton, the stock's too expensive buy back, what do we do with capital?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, listen, at the end of the day, it's not a hard and fast rule. That will require another discussion between us and the board. We told the board we only buy at under a 3-year or less recovery. If a special dividend, which is not something that I'd prefer, right, because it loses that flexibility that I talked about, that I can turn it up or down depending what I see in the marketplace. One of the things that makes us what we are at Arch, is the old pulling rate like it was a strategy. We're agile. We adjust to things, both from an underwriting point of view from what we do by line of business, et cetera. And that throws this into that category. If we get there -- listen, I haven't seen 1.2x book value for a long time. I keep dreaming about it. And when I see it, maybe we'll have another discussion and then we might make whatever determinations.

John C. R. Hele
Former Chief Financial Officer, Principal Accounting Officer, Executive Vice President and Treasurer

And then the other point is, what's the ROE on the business we're running in the quarter, and Jan 1 may be better, it may not be better. There's a lot of things -- your question is a lot of what ifs, and we've got to decide sort of almost when we get there.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Right.

Ian Gutterman
Adage Capital Management, L.P.

Got it. I guess the only thing I was thinking of is I wonder if, again, if we get into a situation, maybe hoarding capital is the right strategy and turning off the buyback would make sense because if we really are within 6 or 8 quarters of a market turn why not keep the extra capital rather than buying it back at a bad payback. Keep that capital so when the market does turn, you can write more business more quickly. And if there's a short-term direct on ROE, who cares?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Right. We agree with you. But give us a little credit, Ian. We model that. And the reason -- don't forget there is other ingredients on our capital structure that allows us quite a bit of flexibility. Our debt and hybrid to equity is very low. So even the minute somebody rings the bell and he says, You're getting on the straightaway and we're going to write a lot of premium, I have the ability to raise, I don't know, $0.75 billion to $1 billion of additional capital without diluting my common shareholders, which is the last thing that I want to do. I didn't buy all these shares back because later on I want to dilute it. So that calculation we do continuously to make sure that at never point in time -- at no point in time, capital restrictions would not allow us to write as much good business as we can get our hands on.

Operator

Your next question will come from the line of Ron Bodman with Capital Return.

Ronald David Bobman
Capital Returns Management, LLC

I had one question remaining. Dinos, why are large account executive assurance D&O rates stubbornly weak?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I wish I knew. I think -- I'm attributing to the class action activity is being benign. And for that reason probably some people, they get more optimistic that they're not going to have the significant losses emanating from these national class actions. Having said that, we made mistakes in other lines of business that makes us more cautious. For example, in the aviation business, commercial aviation, yes, we didn't have major airliners go down. But the pricing got to a point that, at some point in time, even 1 or 2 incidents will take something from thinly profitable to extremely unprofitable. And I'm suspecting that in the commercial D&O, maybe a slight change in environment. All of a sudden, you're going to have a lot of people with a lot of tears out there. So it's an attitude as to what do you view, where the overall rates are, and do you take into consideration what happened in the past? And do you put some thought process into the improved benign activity? But do you price purely that what's happening today, it's going to continue to happen in the future? That's the same issue we had with RMS 11, which you get a lot of different outcomes if you take to long patterns or if you take the short patterns, 3, 4 years and average that on cat activity. So you've got to make judgments. And in our judgment on the D&O world, I think rates there, they shouldn't be continue to going down. I think that business should stay -- we're not saying it's unprofitable. But we continue to give up rate, and we're giving it -- it's strong, but it's still negative. And that tells you a lot of people like that business in order for rates to continue to go down. There is a lot of capacity out there. But at the end of the day, we're starting to be very cautious about that.

Ronald David Bobman
Capital Returns Management, LLC

And since you brought it up, RMS I think also updated their European model middle of this summer. Is that going to change your -- have an impact on your pricing or rate expectations or desired rates for the January renewals?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It depends what the market reacts to. Don't forget, we were way underweight in European wind, and we were way underweight on Japanese quake and others because we didn't like the rating environment. It wasn't just purely -- I think the model changes might cause the supply/demand to improve. And if pricing goes up, it might give us more opportunities. But I'm not predicting that. I don't know when it happens. And if it happens, we'll react to it. But we continue to be underweight in European wind because of the rates we can get.

Operator

And there are no further questions in the queue. I would now like to turn the call back over to Mr. Iordanou for closing comments.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, thank you, Fab. Thanks, everybody, for bearing with us for 1 hour and 15 minutes, and we're looking forward to seeing you next quarter. Have a good day.

Operator
Ladies and gentlemen, that concludes today's conference. Thank you for your participation. You may now disconnect. Have a great day.