S&P Capital IQ

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Arch Capital Group Ltd. NasdaqGS:ACGL

FQ1 2012 Earnings Call Transcripts

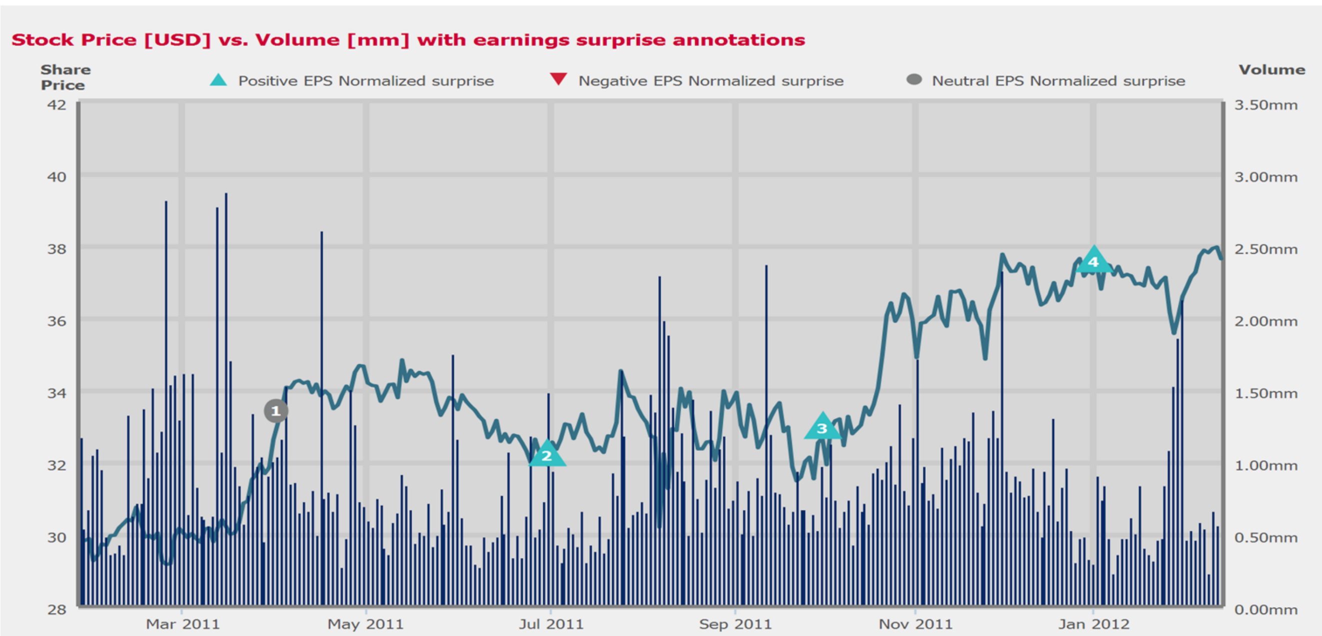
Thursday, April 26, 2012 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2012-			-FQ2 2012-	-FY 2012-	-FY 2013-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.72	0.82	▲13.89	0.79	2.92	2.90
Revenue (mm)	792.19	863.61	▲9.02	730.38	2842.64	2985.79

Currency: USD

Consensus as of Apr-26-2012 1:28 PM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ1 2011	(0.33)	0.06	NM
FQ2 2011	0.21	0.45	▲114.29 %
FQ3 2011	0.64	0.78	▲21.88 %
FQ4 2011	0.63	0.92	▲46.03 %

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

ANALYSTS

Ian Gutterman
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BofA Merrill Lynch, Research Division

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Presentation

Operator

Good day, ladies and gentlemen, and welcome to the First Quarter 2012 Arch Capital Group Earnings Conference Call. My name is Keisha, and I'll be your operator for today. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes.

Before the company gets started with its update, management wants to first remind everyone that certain statements made 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 will now like to turn the call over to Dinos Iordanou and Mr. John Hele. Please proceed.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you, Keisha. Good morning, everyone, and thank you for joining us today. We began 2012 with good results, improved production and a more positive outlook on market conditions. On an operating basis, we are in the $113.7 million or $0.82 per share, which on an annualized basis represents a 10.4% return on equity.

Our investment performance for the quarter including the effects of foreign exchange was good and it total 187 basis points and our reported underwriting performance was very good at the 90.1% combined ratio. This performance was aided by reserve releases from prior years, which came predominantly from short-tail lines. Cash flow for the quarter was strong at $144.8 million, which was lower than the first quarter of 2011 due in part to a higher level of paid losses.

Our book value per common share was $33.33, a 4.9% increase from December 31, 2011, and includes the impact of the new DAC accounting standard. The market environment continued to show improvement across the board. From a rate change standpoint, almost all of our lines move into positive territory with rate increases, which are slightly above loss trend.

In our U.S. insurance businesses, overall, rate increased on a weighted basis by approximately 3%, which is slightly above our weighted average loss trend. Globally, rates for our insurance businesses were up approximately 2% on a weighted basis.

In the traditional primary lines of business, we saw favorable rate movement with general liability up 7%, auto liability up 3%, umbrella liability up 6% and workers' compensation up 5%. As a specialty underwriter, our participation in these lines is limited, but I hope that these numbers gives you a flavor of the general market conditions that we are seeing.

There were 2 exceptions to our overall rate trends -- positive rate trends. Large accounts' health care is lagging other lines with a 7% rate reduction and executive assurance rates on the whole have remained essentially flat for the quarter. Even with the improvements in the rate environment, given the level of investment yields currently available, we believe that longer-tail lines still require substantial additional rate improvement to become attractive.

In our reinsurance sector, rates continue to improve significantly in many areas throughout the world on a readjusted basis in the property and property cat lines, while all other lines remain basically unchanged, although our Reinsurance business benefits from an improvement in the underlying rate increases our clients achieve.

From a premium production point of view, we're seeing some benefit from an improving rate environment as more accounts meet our return standards. On a consolidated basis, gross written premiums were up 10.6% and our net written premiums were up 13%. The Insurance Group was up approximately 8.4% on a gross basis and 9.2% on a net basis. The Reinsurance Group was up 18.8% -- 14.8% on a gross basis and 18.4% on a net basis. This increase has resulted from new opportunities in U.K. motor business that we spoke about last quarter, global property and property cat business and new participations on professional liability lines.

Substantial rate improvements in global property catastrophe markets allowed us to participate in a more meaningful way around the world for the first time in our history in areas such as Japan, Australia and New Zealand.

Group-wide, on an expected basis, the business we wrote in the first quarter of this year will produce, based on our estimation, an underwriting year ROE in the range of 9% to 11%. During the quarter, we did not repurchase any of our shares. As we mentioned last quarter, this decision was influenced by several potential opportunities that were presented to us, 2 of which we were successful in closing early in the second quarter.

We're pleased to welcome our new colleagues at Credit & Surety team, which has joined us and will work out of our Zurich office in our Zurich operations. Historically, this group, has written $80 million to $100 million of net premiums, although there is no assurances on how much of this business will be able to renew on Arch paper. Today, we are pleased with the way the customer base has to the transaction and the financial strength of Arch.

We were also successful in closing an attractive mortgage reinsurance quota share contract. This contract which covers new prime originations from October 1, 2011, to December 31, 2012, enables our cedent to expand their available capacity in a very attractive market for mortgage insurance. Since mortgage insurance is earned over many years and a significant portion of the underlying business is written on a monthly basis, most of the premium will be recognized in our income statement over the next 3 to 4 years. Both of these transactions were unusual and neither contributed to premium volume in the first quarter. We continue to have a number of potential one-off transactions, in our pipeline. However, these type of transactions require long lead times and generally, the biggest obstacle to close them still remains the wide spread between the bid and asked. As always, we are looking for opportunities to expand our underwriting capabilities organically.

Today, we have been successful in several of our attempts. We view these as investments in talent and capabilities for the future and we're beginning to benefit from these initiatives. While the degree of success of these additions in the short term will depend on market conditions, we're confident that over the long term, they will prove to be successful and will contribute to the value of our enterprise.

Our philosophy on capital management has not changed, we prefer to deploy our capital in our business and absent the ability to do so, to return it to our shareholders. Although the current operating environment is encouraging, we still do not have a clear visibility on the degree of improvement in market conditions or on our ability to close some of the deals that we are working on. As a result, we will continue to take a wait-and-see attitude with respect to share repurchases until we see the future with more clarity.

Before I turn it over to John for more commentary on our financial results, let me give you an update on our cat PMLs. As of April 1, 2012, our largest 250-year PML for a single event were $860 million and is in the Gulf area. And it represents approximately 19% of common shareholders equity. Northeast stood at $826 million and our Florida Tri-County PML now stands at $608 million or approximately 13% of common equity, which gives us an ample capacity for the upcoming Florida renewal season in June and July of this year. With that, I'll turn it over to John and after his comments, we will take your questions. 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 in the quarter was 81% versus 79% from a year ago, reflecting the relative growth in the Reinsurance segment. Our overall operating results for the quarter had a combined ratio of 90.1% with 3.4 points or $23 million of current accident year cat-related events, net of reinsurance and reinstatement premiums, compared to the 2011 first quarter which had a combined ratio of 110% reflecting the 28.2 points or $179 million of cat-related events, a gain out of reinsurance and reinstatement premiums.

The 2012 first quarter current accident year cat events included the February and March U.S. windstorms and the Southeastern Australian floods. In addition to these natural catastrophe events, the 2012 first quarter combined ratio reflects 3.7 points or $25 million for the Costa Concordia marine event and the Elgin oil platform event, net of reinsurance and reinstatement premiums. The Costa Concordia event was estimated at $19.6 million at the lower end of our previously announced range as we now expect a total industry loss of approximately $1 billion. The 2012 first quarter combined ratio also reflected 7.1 points or $48 million on estimated prior year favorable development compared to $58 million or 9.2 points in the 2011 first quarter. The net favorable development in the 2012 first quarter was driven by the Reinsurance segment with approximately 60% due to favorable development on short-tail lines for more recent underwriting years and 40% due to medium and longer-tail lines from early underwriting years. The net slight adverse development in the Insurance segment in the 2012 first quarter reflected an increase in loss picks to the claim development on a specific subset of our casualty book in older accident years and a small number of international D&O claims from recent accident years in our executive assurance book. Such adverse development in the Insurance segment was substantially offset by better than expected claims emergence in property and other short-tail lines. Our loss estimates for the 2010 and 2011 cat events did not change materially in the 2012 first quarter.

In the Reinsurance segment, the 2012 accident year combined ratio, excluding cats was 82.80%, higher than the 75.3% in the 2011 first quarter, primarily due to the Costa Concordia and Elgin events noted above. The Reinsurance segment's results also reflect changes in the mix of business with a higher contribution from the U.K. motor business and some specific opportunities in medium and longer-tail lines.

In the Insurance segment, the 2012 accident year combined ratio excluding cats was 99.7%, basically the same as the 99.9% a year ago. The expense ratio was 32 points in the 2012 first quarter, substantially unchanged from a year ago with a slightly higher acquisition ratio reflecting a higher level of commissions related to prior-year reserve development, offset by a lower operating -- other operating expense ratio, which benefited from the higher level of net premiums earned.

Net investment income in the 2012 first quarter decreased to $0.52 per share or $74 million compared to $0.59 a share or $80 million in the 2011 fourth quarter. Our embedded pretax book yield before expenses was 2.76% in the 2012 first quarter compared to 2.98% in the 2011 fourth quarter. As compared to the 2011 fourth quarter, the spread over treasuries for many of our selected new investment asset classes reduced during the 2012 first quarter, thereby reducing the investment income potential for new investments.

We also now have a larger portion of our assets that have a lower yield for greater opportunity for total return. At the current yield curve, with a 3-year treasury at 40 basis points and continued relatively lower spreads, we are now reinvesting on an overall blended basis at between 2% to 2.5% yield, but expect the total return to help with some upside. We continue to remain short with the duration of 2.75% on a high-quality investment fixed income portfolio, which protects our capital in rising interest rate periods but also further contributes to lower investment yields. The total return of portfolio was 1.87% in 2012 first quarter compared to 82 basis points in the 2011 fourth quarter. Excluding foreign exchange, it was 1.6% in the 2012 first quarter compared to 95 basis points to the 2011 fourth quarter. While certain components of total return are not reported in after-tax operating income, the total return generated in 2012 first quarter was significantly in excess of the available fixed income yields and helped increase book value per share.

Our exposure to Eurozone countries is a gain listed in the supplement with minimal exposure to the current countries of keen interest.

Foreign exchange losses were $21 million or $0.15 per share in the 2012 first quarter. However, when compared to the net 27 basis points return from assets held in foreign currencies booked into shareholders' equity, the approximate net impact of foreign exchange was a positive $12 million or $0.09 per share to book value.

Our effective tax rate on pretax operating income in the 2012 first quarter was a benefit of 1% compared to an expense of 0.8% in 2011 first quarter. The effective tax rate on pretax income was an expense of 1.1%. The tax rate was impacted by realized gains, which are excluded from operating income.

In the 2012 first quarter, we implemented the new accounting standard for deferred acquisition costs, which reduced our reported book value at December 31 by $36 million or $0.27 per share. The new accounting policy had an immaterial effect on operating earnings and was adopted retrospectively so comparisons for prior periods will be on the same basis. In the first quarter, book value per share was negatively impacted by $0.25 per share due to the exercise of options, primarily related to grants made in 2002, which were about to expire.

Notwithstanding such items, book value per share increased 4.9% due to operating their needs total return on investment. We did not buy back any shares in first quarter due to potential business opportunities as Dinos has mentioned.

In April, we issued $325 million of Series C preferred shares with a 5-year non-call period. We also announced the call of our $325 million of Series A and B preferred shares at par. The net savings and coupon cost is 120 basis points per year or $3.9 million. Taking into account all cost for issuance over the 5 -- amortized over the 5-year non-call period, we expect to save a net 63 basis points in annual costs over the next 5 years.

Our total capital increased to $5.2 billion at the end of the 2012 first quarter, up from $5 billion at the end of 2011. Our debt plus hybrids represents only 13.8% of our total capital, given us significant room to raise additional capital in the future at our targeted rating. We have an excess capital position that we hope to put to work at some point in the future.
With these introductory comments, we are pleased to take your questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Keith Walsh with Citigroup.

Keith F. Walsh
Citigroup Inc, Research Division

First question around executive assurance. You mentioned pricing has been -- in our last quarter call, I guess, pricing difficult for several years there. Now you've got some adverse development. It appears the premium level has remained at a similar rate or similar amount. Can you just talk about some of the changes maybe you've made in the underlying types of business within this line? Why you think it may be a better book going forward. I got a follow up.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Okay. The -- we mentioned these in prior calls, too. Our emphasis has moved from -- we're doing less FY business and less commercial today and we're more in this small-to-medium size enterprises and private and not-for-profit. We try to -- even though the volume is being steady, I think there is less of the former and more of the latter in our book of business. The reserve adjustment that you mentioned, it was -- it's part of our usual concept of how we'll reserve the company. Early on, we get a claim or 2 even though we do have ample, IBNR, a lot of cases we choose not to adjust IBNR downwards and we allow that claim to go through. So it shows as adverse development from the prior year. But I think that's a prudent way of doing it. At the end of the day, nobody's sticking hand in their pockets and taking our money. So if in future the quarters, we don't need it, it's going to flow through. So we're still cautious on the executive assurance sector. And in due course, I think we would like to grow that business but we haven't rang the bell yet.

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

Keith, also the comments often on EA are about the U.S. market in terms of rate. And the reserves, they all came from an international policy form that it's from a small specific group.

Keith F. Walsh
Citigroup Inc, Research Division

Okay. That's helpful. And then just on the Florida renewal. I mean, you guys have substantial room within your PMLs as you indicated earlier. We've heard mixed things I guess on the 6 1 renewal so far in the supply and demand side. What would be your view there? And is the rate adequate enough -- forget about the rate increases, the rate adequacy there that you'd want to deploy a lot of capital on the 6 1 renewal. What kind of implied are we talking about?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, we always priced the cat business at ROE's north of 15% because that's a risky proposition. You take in a lot of the volatility off your client's books of business. So you're expected ROE has to be high. Now, not knowing -- it's a bit too early for rates to settle down but we expect to be a good season for Florida. And as you know, we have the room, we presented the PMLs to you. So depending on the rate environment, we probably try to take advantage of the market opportunities that they presented to us. But I can't predict. We don't try to predict the future. We just react to it when -- react to the opportunities as they are presented to us. So -- but I'm optimistic that we're going to get rate increases [indiscernible] 11 that is affecting that. There is supply and demand issues. So at the end of the day, I think it will be a good environment.

Operator

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

Ian Gutterman
Adage Capital Management, L.P.

I guess first your comment about business you run in the quarter, 9% to 11% returns. I mean that's better where it's been but it's okay. Is that really enough to justify growing double digits in the quarter or is it...

Constantine P. Iordanou
Chairman and Chief Executive Officer

If you see where the growth came -- let me go back. On the rate increases alone, you're gaining just slightly because I said we're only slightly above trends. So call it a push to slight positive. So the improvement in the ROE is due to the growth that we've seen in some segments. For example, the property cat area that we have grown, it's not priced at 9% to 11% ROE. So it's the weighted average that is going up by giving a point or 2 but it's coming from the new segments. And I can tell you, we're not going to write the mortgage insurance at 9% to 10% ROE. That has to -- everything we do that is new to us got to meet our return characteristics of 15% better than that. So you have to take -- you have to take it from that point of view. So the overall book is improving, but it's improving because of the new opportunities which the price with a better ROE than the existing book we have we're defending.

Ian Gutterman
Adage Capital Management, L.P.

I understand. I assumed the marginal opportunities were higher than that. I guess I would have thought to fund those marginal opportunities, maybe you would have taken a finer brush to the renewal book that would have some of the mid-single-digit returns and maybe try to let some of the business go to people who are being more opportunistic these days growing.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, listen, you have to be in the market, there is customer relationships, there is market relationships, there is distribution relationships. We try to defend as much of our book as possible, with the eye that we have to have an adequate return, which is on us with our investors and we try to tell them what we believe we're underwriting this business to. Yes. Listen, we don't get into granularity, but I have business that we're running today that they were very low single-digit ROEs. And the reason we haven't got out of them is because this is not like light in the room with a switch on the wall and you flip it on and you flip it off. You've got to take the long-term view. Some years you might accept lower ROEs because over the 10-year period of time, it will give you a lot of opportunities in the future. So it's not as simple as on and off.

Ian Gutterman
Adage Capital Management, L.P.

Understood, understood. Fair point. Just to follow up on Keith's question on the executive assurance growth. You mentioned it's the small and the mid, the private, not-for-profit. And I understand historically, that's good book, but I think Chubb and some others have raised concerns at the performance and that segment is getting very competitive and just trying to see loss top up. How comfortable are you that this is the right time to be growing that book?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, we know the issues. I think we have very good underwriters. It's the -- it's employment practices liability that is the major issue with the privately held and some of the not-for-profit. We have a lot of confidence in our underwriters to making good judgments and good selections on that book. So it's true with anything that you do. If it was so simple, everybody will be doing it, right? So we understand the issues, people are all over it and we still like those sectors.

Ian Gutterman
Adage Capital Management, L.P.

And then last one and then it's back to the back of the class. The insurance book, the adverse development, I understand there's always sort of one-offs. But just if I look over time, that book is showing a lot smaller development in your Reinsurance book. And it tend have this occasional course where things top up. And yet it's been written over time to a higher accident year combined, even normalized. So it seems like it's a less profitable business in your Reinsurance and yet it also has less development over time. Why is that? Why is the book your developing come from Reinsurance and not Insurance?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's narrowed to the -- and I think it's a combination of 2 things. It's the sector, most of it is contractors. I think the strain that the economy has brought up on them and the sector itself, especially in some difficult state like New York is what caused some of the not as good a performance I would have expected from a specialty, a casualty book, because these are the books that perform extremely well in the 86, 87, 88 cycle and then later on. In this cycle, specialty, casualty and umbrellas and even some of the excess liability didn't horn in as much and it didn't give as much of profitability that I would have normally expected. Our book has diminished to almost nothing. But in the meantime, when I see signs that I need to be cautious with the reserving, we're not shy about putting it up because of the end of the day, it's the prudent thing to do in order for you as the market turns to know what the true profitability of this business is that is going to help you pricing as you go into the future. If you're not recognizing what the true profitability is, you might be misguided when it comes to making decisions going forward. So I spend a lot of time, I'm a frustrated actuary. I think I'm a decent underwriter but a frustrated actuary. They won't admit me to the Academy. They want all these exams to pass. But I spent a lot of time with the actuaries and I get personally involved in understanding what their selections are going to be, why they're going to be and we spend a lot of time with the claims department talking about what they see, what kind of cases, and what's the outlook. And we're cautious about it. Listen, look at our record. We released over $1 billion of reserves over time. And every time we do a little adjustment here and there for $5 million or $10 million, everybody has 42,000 questions.

Ian Gutterman
Adage Capital Management, L.P.

No, I understand. It's just most of that $1 billion or whatever that is has come through Reinsurance. I've never quite a figured out why. And it seems that Reinsurance business -- I know of issues of you reserved that more conservatively initially, or if it's just the way loss trends worked out? It's just hard to figure that out from here but...

Constantine P. Iordanou
Chairman and Chief Executive Officer

We have a signal. We don't want everybody to know about it, the way we fight the business. But also you got to see that the Insurance Group is very well reserved. We give you enough in the supplement to -- and the schedule appears for you to look at it.

Operator

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

Michael Zaremski
Crédit Suisse AG, Research Division

The mortgage insurance contract, what type of volumes are you guys thinking? And is that a relatively new mortgage insurance or one that's been around for a while?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, the -- our cedent has been around for a long time and they partner with us because they see the opportunities, we see the same opportunities and they wanted to do more with our help. They have a lot of capability of their own and a lot of capacity of their own, but they want to still -- the market was demanding more and they want to do more. It expands their ability to have more customer relationships. It's all new business. It's going to be newer originations from October 1 of '11 to the end of contract. And I don't know if they're going to renew or not, but it ends at the end of '12 and it's for their prime book. And the underwriting environment, the underwriting guidelines and the environment, they're all extremely positive for that. So we're excited. As far as the volume is concerned, this has potential to be over the life of the contract, $80 million to $100 million. But as you -- there is some contracts that they pay upfront and some that is part of the monthly mortgage payment. And it's kind of a recon [ph] and earn kind of a pattern. And usually, you might get 65% to 70% of the premium over the first 3 to 4 years and then the rest of it trails all the way out to maybe -- I mean, it can go over 30 years. But in essence, the average mortgages is outstanding for about 7 or thereabouts. So hard to give you more specifics than that because we don't know either if they're going to originate them and we're going to take our slice as a quota share participant and then we'll account for it as it comes in.

Michael Zaremski
Crédit Suisse AG, Research Division

Okay. And then lastly, John, in your prepared remarks, I think you alluded to some type of investment portfolio repositioning. But I'll admit I didn't quite follow. Is that correct or no?

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

Well, there's 2 things. Spreads to treasuries over most asset classes, single A bonds, mortgage-backed securities, commercial mortgage-backed securities all narrowed quite a bit first quarter '12 versus last year. So that affected how we reinvested in our general blend of investments. We also are tending to put some more investments now into some funds that we view will have some more potential upside, but have perhaps lower investment yield right now because they may be accounted for it at fair value option. We have more investments if you look at the balance sheet accounted for at fair value than compared to, say, a year ago. And so that all -- come to quoted number might be a little less but the total return should be a little better.

Michael Zaremski
Crédit Suisse AG, Research Division

So what types of investments are those then?

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

Well, we've got some interesting investments, some funds where we're doing some mortgage servicing or some interesting loans that are going out. So we are participating in -- these are $15 million, $25 million, $30 million type single investments. But if you add them up, we're getting -- we think these over the longer will give us some better upside return than 40 basis points from 3-year treasures.

Operator

Your next question comes from the line of Jay Gelb with Barclays.

Jay H. Gelb
Barclays PLC, Research Division

I just want to get a sense first on the Costa Concordia loss, is that included in your cat numbers or no?

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

No. The cat is a natural catastrophe event and Costa Concordia is a man-made mistake. So -- but we wanted to break that out for you to have it clear for you.

Jay H. Gelb
Barclays PLC, Research Division

Okay. And was that at all in the Insurance segment?

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

Costa Concordia happened between Reinsurance and Insurance. Just to be clear for you on a net basis, Costa Concordia was about $6 million in Reinsurance and the $13.6 million in Insurance. And the Elgin was all in the Reinsurance.

Jay H. Gelb
Barclays PLC, Research Division

I'm sorry. What loss is that?

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

That Elgin oil platform. It's in the North Sea. I think it still had natural gas going into the air, it's not on fire anymore. It seems to be under control. They're building their relief well, and we have a bid up just against that.

Jay H. Gelb
Barclays PLC, Research Division

Okay. Can you talk about the PML you're looking to deploy for the Japanese earthquake season? I guess it's always earthquake season, but for the 4/1 renewals.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Right. In Japan, our PML went almost from nothing to about now about $260 million.

Operator

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

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

A couple of quick questions. Just back on the executive assurance. I guess what surprised me there was I think you've spoken the portfolio is staffed adequately. But I was just surprised by the level of growth. And I didn't know if there is some new distribution relationships that turned on that potentially bolstered the numbers as just an easy comp with last year. That was the issue more than the trend that I was struggling with.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, in the U.K., we have a new team so that will be new distribution relationships and a new underwriting team came about, John, what? 18 months ago?

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

Yes. Last year and then they're getting up to speed now as renewals come up. And they fell to the SME businesses in U.K. and Europe.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Right. So other than that, it's just our existing staff and what we see in the marketplace.

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

Okay. That's fair. I think I just underestimated how that team would mature. I guess the other thing, as you mentioned in the commentary in the press release that you took down -- that you did not -- I think I read this right, you let a retro purchase from last year lapse. And I guess I can't remember in all honesty whether that retro purchase was optimistic or kind of part of the core program. But I was just wondering with how that -- I know it's nonpeak zones, but how much protection that actually afforded you?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it wasn't big, it was -- I think it was a balance between what we have down in Florida versus in the Northeast. And sometimes we'll look at those opportunities. We might do a swap with somebody else that it might be a little bit over line in Florida and might be a little over line in the Northeast just to balance our PMLs. But it's not significant. These things are -- usually what we do is in the $25 million to $50 million range. So on the scheme of things, when you're putting out $800 million, $860 million PML, not, not significant.

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

Okay. That's fair. And then just when I think about where the portfolio today versus reinvestment rates. If I'm doing my math right, it feels like -- if you're saying reinvestment 2% to 2.5%, I mean, it feels like, if I'm doing the math right, you're within 15% basis points of that. So is it fair to think about you kind of having -- being close to the end of the reinvestment pressure at this point?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I would think so. I think we're finding a lot of opportunities to -- the combination of what we do with the high-grade fixed income as -- and these alternative investments we do. If you blend it, it will give you better returns than that. The problem sometimes is we have with the structures of some of these, some of them they get accounted on an equity method. So in essence, if I wasn't part of the fun and I had it on my own, it might have been considered as investment income. But because I'm more a part of a fund, it comes in as realized or unrealized gains. So I know it makes it difficult for you because you got to model us. But we're more focused on total return because I get paid to move book value per share up. That's what I get paid to do. So at the end of the day, these operating earnings versus net earnings and all that, it's all well and good as long as book value per share keeps going up.

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

No, that's fair. And I was focused more on the recurring side. The only other question I had was just...

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

I would just like to add that the very high quality stuff that we tend to put a lot in can be often towards the lower of that 2% to 2.5% range. And would stay in short as well. So if spreads stay down and we stay at 40 basis points or Lord knows it could be worse. I think it's very hard to forecast this right now in today's economy with so much going on. So I just -- but we're trying to take a balanced approach, as Dinos said, and go for total return which we expect to be in the 2% to 2.5 range. But where we actually end up each quarter going forward is going to be as things pull out.

Matthew G. Heimermann

JP Morgan Chase & Co, Research Division

Okay. So fair. So you might be close to the arithmetic mean but that doesn't mean you might end up at the bottom depending on what risk rewards looks like. Okay. And then just, Aeolus been a contributor of the other income line over the last couple of years. But obviously, the size of the investment left in that vehicle has declined. So I'm just curious if there's any guidance you could give us and how we should think about maybe the other income line changing on a go-forward basis forward to the past? And I'm obviously thinking kind of last 3 quarters, not the couple, the 1 or 2 quarters where we had...

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I mean, we gave you the numbers. The remaining investment, call it book value, Aeolus is only approximately $10 million left. And basically, I will put a runoff period of -- because we haven't reinvested on the new fund. So this is the old one and it's maybe another 3, 4 quarters and it's going to go to 0, right? We probably -- if they have no losses recognized as income, and if there is losses might go the wrong way. But it's been a very successful investment. We invested $50 million. It was 5 years ago. We already received $83 million in -- so we made over 6% on our money over the 5-year period and we still have potentially another $10 million of book value that -- once they close their books, it will return. But it's going to be within the end of this year, maybe early next year.

Operator

Your next question comes from the line of Josh Shanker with Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

Dinos, coming from the PML in Japan or John, that has a 4/1, I assume?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes.

Joshua David Shanker
Deutsche Bank AG, Research Division

Okay. And I know you're not here to speak for Aeolus. But to what extent was the 1Q loss a lag in reporting? To what extent is there unfavorable development? Is there anything from the tornadoes in the end of February or early March associated with that?

Constantine P. Iordanou
Chairman and Chief Executive Officer

They're not focusing on that kind of exposures.

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

And the number we reported is the quarter lag. That's their fourth quarter '11.

Joshua David Shanker
Deutsche Bank AG, Research Division

Okay. So maybe you don't have a big problem with the tornadoes that hit -- some have larger issues. Would this be the kind of risk that would have pierced Reinsurance 5 years ago?

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

What do you mean by that?

Joshua David Shanker
Deutsche Bank AG, Research Division

It seems to me -- look, we have some huge tornadoes last year. These were sizable but not nearly like the 2Q 11/1. And I'm surprised that a number of companies are reporting cat losses associated with them on the Reinsurance side. Did people buy more protection after Q2 '11 on tornado or those kind of losses? Or it might just -- it just feels I'm wrong and this would have been...

Constantine P. Iordanou
Chairman and Chief Executive Officer

I mean, tornadoes, it's a peculiar animal as far as I'm concerned, because depending who you're supporting, small companies versus small mutual versus larger companies and what their retentions, you might be as a reinsurers might be attaching relatively low attachment points. And it's kind of random event. They might hit a whole neighborhood and you'll see that happens to have a lot of exposure there and all of a sudden it's going to get into the reinsurance layers. So there is no good modeling on tornadoes, there is no good predictability. You might price the business well and still get hit because you just got unlucky that the tornado hit in the county that you wrote one of those county mutuals and they got most of the losses. Now, what we try to do is try to balance the book by having spread of risk and understanding that we're going to get hit occasionally on tornado losses because that's the nature of the business. So I -- it's not a surprise to me that some reinsurers are getting hit with tornado losses. And you see to be kind of a random event that one might get hit and another one might not be because that's the way tornadoes affect from the loss point of view.

Joshua David Shanker
Deutsche Bank AG, Research Division

And as the Midwest gets more attraction because of tornadoes, do you think the markets would have been picking up more new [indiscernible] risk?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I don't know the connection between the tornadoes and new [indiscernible]. It's...

Joshua David Shanker
Deutsche Bank AG, Research Division

Only geographic.

Constantine P. Iordanou
Chairman and Chief Executive Officer

New [indiscernible] for us is very hard to model. As a matter of fact, it's the only zone that from a PML point of view, we use the 1 in 500 and not the 1 in 250. That's a peculiarity we have. We sometimes were a little more strange than others. But on the tornado side, all I tell our guys that we do most of their tornado exposure out of a Morristown Reinsurance office is we try to get a good spread and not have concentrations and get unlucky. Because concentrations will give you 2 things, either no losses or significant losses. We don't like significant losses, which is it shows us as a company to be worse than our peers.

Operator

Your next question comes from the line of Meyer Shields with Stifel, Nicolaus.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

If I can start with a question for John. It looks like the impact, when we look at the -- I'm sorry, the reserve development in the Reinsurance segment, it looks like on a net basis. Reserve development slightly favorable, but there was a much bigger impact on acquisition expenses. And I was wondering whether you've changed the relationships with your distribution force so that, that sort mismatch can't -- is not likely to recur going forward?

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

No. The impact on acquisition costs was because it ceded relationships with adverse development, so with less credit coming in from profit-sharing on Reinsurance contracts. So that's why the adjustment went.

Constantine P. Iordanou
Chairman and Chief Executive Officer

It works both ways, actually. Sometimes, favorable development might give them profit commissions. Right. There is a cause on the acquisition side too. So when you move the loss ratio, you got to look at these contracts and sometimes, it's a good thing for us but also we have to pay some of it as profit commission back to clients.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Right. But here it looks like you're paying maybe $10 for every dollar.

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

Right. The credit system because we're unfavorable, we would have had proper commission credit come in. Now it's going back out.

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Okay. I get it. This is a question, I guess for Dinos, is one indicator of -- or one potential indicator of further rate improvement would be companies that are behind the scenes, maybe in some trouble and looking for a bailout from better capitalized insurers. And I'm wondering whether you're seeing any change in that over the past couple of years?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Meaning coming for severance relief?

Meyer Shields
Stifel, Nicolaus & Company, Incorporated, Research Division

Or just looking to be acquired.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, we've seen both. We've seen companies looking for partners. And it doesn't mean all of them are in some sort of financial difficulty. Sometimes it does make sense from building industrial-strength to merge a couple of companies. But also we've seen companies, both in Europe and here, looking for kind of transactions that in my view the kind of surplus relief kind of transactions, don't have enough capital, can't access the capital markets but through a major reinsurance contract might net down the unmet exposure. So in essence, they get a pass from the rating agency. So we've seen both. We haven't had any transactions because like I said, they bid and ask. A lot of them, they want to do these transactions sometimes and their starting point is like 7%, 8% ROE. I don't want to waste my time. My cost of capital is higher than that and I'm not going to do transactions just to put capital to work at 7%, 8%, 9%. If I'm going to do these transactions they got to be in the double digits. And we've done -- we've made proposals on a few at 12% ROE and we couldn't get to close any of those.

Meyer Shields

Stifel, Nicolaus & Company, Incorporated, Research Division

Okay. It looks like if we look at the cohort of sellers in the aggregate they're not desperate yet.

Constantine P. Iordanou
Chairman and Chief Executive Officer

No. On the other hand, I don't think the capital markets are responding to them because I don't see a lot of them going out and trying to raise funds, I don't know, 8%, 10%. The reason they're in the reinsurance market for this kind of transactions is because they don't believe that capital markets probably will respond to them.

Operator

Next question comes from the line of Vinay Misquith with Evercore.

Vinay Gerard Misquith
Evercore ISI, Research Division

So just a quick, broad 50,000-foot question. Given that we've seen pricing stabilizing in many lines, of course, pricing is not up significantly in non-cat exposed lines. But are you seeing some incremental opportunity in this normal property and casualty lines other than cat-exposed lines?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. We've seen some on the Professional Liability sector. We've seen us binding on some treaties depending on what the underwriters are and what of the book of business is, et cetera that we wouldn't have done maybe 2 years ago. And I think that's the improved environment. So we've seen that. The other thing we've seen is -- don't make a lot out of this, I'm just going to share a statistics with you. Our E&S submission activity quarter-over-quarter, it was up 9%. This is first quarter of '11 versus first quarter of '12. So we've seen the signs that standard markets are looking at their books and what traditionally should have been maybe in the E&S market, they're throwing it in the E&S market. And we've seen that activity. We're binding more on the property side on the E&S, not as much on the liability side yet because we still don't like the rates as much. But we've seen that movement. As a comparison, our year's statistics from 2010 to '11 for the full year, the E&S submission growth was only 2%. So one quarter doesn't tell a whole year so I don't get overly excited especially. But I think overall, we're seeing a little more of an opportunity for us to underwrite some business and make the cut, so to speak, where a year or 2 years ago they wouldn't.

Vinay Gerard Misquith
Evercore ISI, Research Division

Fair enough. And was the level of price increase do you think are necessary within the industry? Or you think it's more interested in writing more business both on the casualty side and non-cat exposed property?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I think you got to go line-by-line and sometimes state-by-state. Like, we're not a big comp right there but workers' comp needs a lot of work. And you got to go back state-by-state. In some cases, you need 20% or 30% additional rate in order to make it at the 15% ROE. I think the umbrella business needs -- has a long way to go still. 6%, 7%, 8%, 10% rate increases ain't going to do it. So you got to go line-by-line. I don't have all my cheat sheets here. The way we run the company, I think we share that with most of our investors is that, we have a green, yellow, and red lights on different books of business. And I think we're starting to see some red go to yellow and some of the yellow go to green. But it's not significant yet. And we do that granular analysis when we sit with our profit centers, when we do the profitability reviews and review the business plans, which we start with the market environment what we think the market pricing is. And if we, the question we try to answer, if we are the average underwriter, no better, no worse than the industry, do you want to be in the sector? And how much would you write? And would you give it a green light? That means write as much as you can? Or would you be a yellow, that means with caution, you can write. And if it's red, be very defensive.

Vinay Gerard Misquith
Evercore ISI, Research Division

Fair enough. So in light of this, how do you look at the capital management? Do you think that the new opportunities in Reinsurance is sufficient for you to absorb all your capital that you'd be generating right now?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Not yet, but it's a question mark, because we're working on things that I don't know what the outcome is going to be. So it's very hard to answer that question. That's why I said I have a wait-and-see attitude. And I think this market is changing not because there is big balance sheet holes. This is not a balance sheet problem. It's not a reserve issue. Maybe some companies might have a little bit here and there that they might have to fix. It's mostly a return, market turn. If you scream out the, hey, we're having the bond from prior years and we're reading from reserve releases and you normalize cats, the accident year ROEs are not yet that good. So they need improvement and that's why you're seeing the market moving. But now it's true that we probably have less red buckets that we have before, yellow is growing and if you think slipping into green for us. So if you like my analogy is I think -- and I didn't do it percentage-wise, but I would say, it's still 35%, or 40% is in the red as far as we are concerned from an attractive point of view. I don't move, I like the market cycle when everything is green and yellow and nothing in the red, and we're not there yet.

Operator

Your next question comes from the line of Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

A couple of questions. The first is paid losses. I guess given the catastrophe activity of last year, I would've expected them to remain a little elevated and at least relative to premiums actually came down a little bit versus the last several quarters. And I'm wondering, have you paid out the bulk of those catastrophes from last year already?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Not all of it. I mean, we have paid some. I don't think of the cheat sheet here to go through. But I can tell you, we're pretty quick with responding to client's request for payment if there is no argument on dispute. We have a great reputation of paying on time. As a matter-of-fact, when we visited Japan, even though our exposure was very small, the Japanese congratulated us as to how quickly we were payers for their losses.

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

It's a mixed change, I think, Jay, is what you're looking at.

Constantine P. Iordanou
Chairman and Chief Executive Officer

But we can do an analysis and we'll try to get percentage for you.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Just moved the needle too much, but that would be helpful. The other question, give us your comments on the underwriting ROE that you think you're writing business at now which was improved a bit where you have been. I assume the bulk or much of that improvement relates to business mix versus pricing that's exceeding claims costs.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I think it’s both. Fixed business mix and also the lines that they're getting the rate increases are not losing ground to lost cost trend. So in essence, no line is getting worse and some, they're improving. So that combination plus the business mix meaning, where are we growing? Are we growing out property cat which is better than the numbers that we mentioned? It changes the weighted average. So I would characterize our 2012 as we start market contagion. And I'll make a fool out of myself trying to predict the future. But right now, as I see, we're probably, at least 1 point, maybe 2 ROE points better my underwriting year '11 is going to come in.

Operator

Your next question comes from the line of John Hall with Wells Fargo.

John Arthur Hall
Wells Fargo Securities, LLC, Research Division

I've got a question on the mortgage insurance, reinsurance agreement. From your comments, Dinos, it sounds like it starts in October, which means, I guess, if you closed it or signed it in April 2nd quarter, we should see 3 quarters worth of premium volume show up?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. You're going to see the fourth quarter, first quarter and the second quarter. But don't forget, this -- you've got to stretch it out for 16 quarters.

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

So you'll see written but earnings -- mortgage insurance comes very slowly over time.

John Arthur Hall
Wells Fargo Securities, LLC, Research Division

Okay. And is that going to be in the Reinsurance other line?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. Yes, that's where we're going to book it. Yes.

John Arthur Hall
Wells Fargo Securities, LLC, Research Division

Okay. And coincidentally, Radian put out a release transaction very similar to the one that you are describing, Dinos. And in their release, they said $50 million to $65 million of capital would be freed up. Any chance that sort of a similar number of capital that you're deploying here?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, we keep our confidentiality promises to clients. So we have no comment on that.

John Arthur Hall
Wells Fargo Securities, LLC, Research Division

All right. Fair enough. On the PML, you offered a number for Japan. How about Australia and New Zealand?

Constantine P. Iordanou
Chairman and Chief Executive Officer

John, you have those numbers here?

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

You know, it's pretty small, I don't have that handy right now.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Japan, as I said, we moved, we've got $260 million on the earthquake and we got about $75 million on the wind, Japan wind. I don't think either Australia or New Zealand, the bigger numbers on that.

John Arthur Hall
Wells Fargo Securities, LLC, Research Division

All right. You just did mention them. And then, I guess, finally to close things out, on the international mortgage insurance deal that you've referenced a couple of times in a couple of different quarters, what's the -- what's the log jam? What's the sticking point there?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Trying to -- I think we have agreements at a lower level and is working in our organization, on the lower level. So in their organization, they have to go through 4, 5 layers before they can. So that's what's holding it up. It's like an elephant baby pregnancy. Banks, sometimes, or building societies work in a much slower pace than we do.

Operator

There are no further questions in queue at this time. I would now like to hand the conference back over to Mr. Dinos Iordanou for any closing remarks.

Constantine P. Iordanou
Chairman and Chief Executive Officer
Thank you, all, for bearing with us. And we're looking forward to seeing you and talking to you next quarter. Have a wonderful day.