S&P Global
Market Intelligence

Arch Capital Group Ltd. NasdaqGS:ACGL

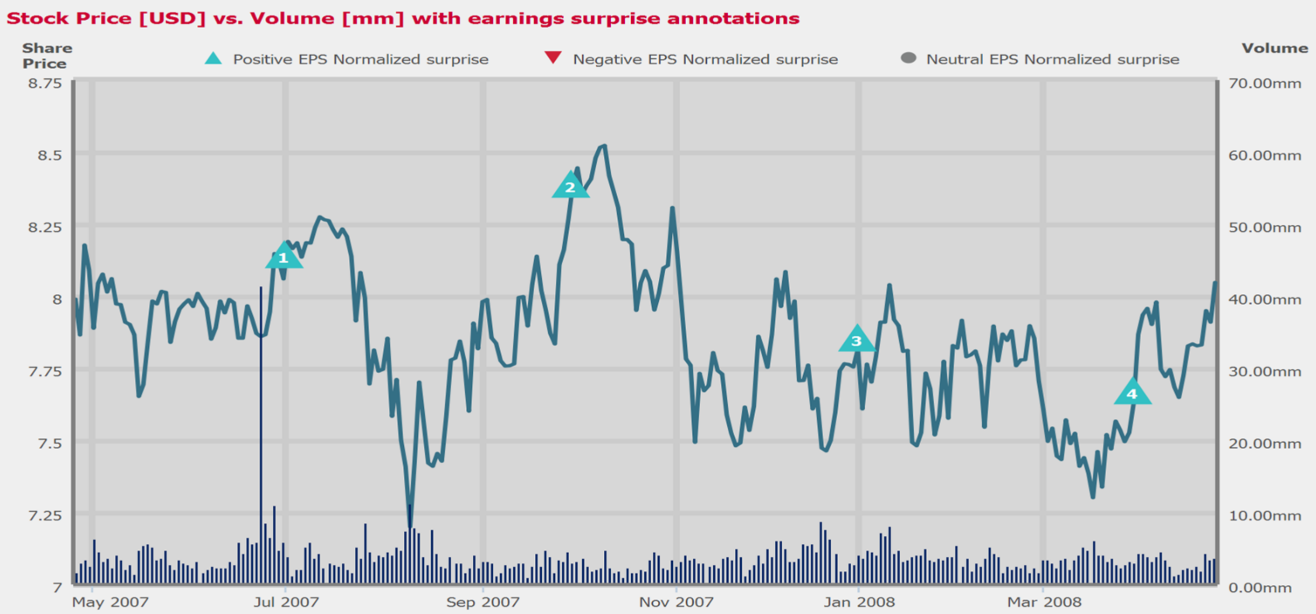
FQ2 2008 Earnings Call Transcripts

Friday, July 25, 2008 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2008-			-FQ3 2008-	-FY 2008-	-FY 2009-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.29	0.31	▲6.90	0.23	1.14	1.12
Revenue	-	-	▲(6.43 %)	-	-	-
Revenue (mm)	733.30	686.12	-	672.03	2764.77	2660.27

Currency: USD
Consensus as of Jul-25-2008 12:44 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2007	0.28	0.31	▲10.71 %
FQ3 2007	0.26	0.32	▲33.33 %
FQ4 2007	0.31	0.35	▲12.90 %
FQ1 2008	0.30	0.31	▲3.33 %

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Call Participants

EXECUTIVES

Constantine Lordanou

John D. Vollaro

ANALYSTS

Brian Meredith
UBS

Daniel Johnson
Citadel Investment Group

Jay Cohen
Merrill Lynch

Joshua Shanker
Citigroup Smith Barney

Matthew Heimermann
JP Morgan

Susan Spivak-Bernstein
Wachovia Securities

Vinay Misquith
Credit Suisse

Presentation

Operator

Good day, ladies and gentlemen and welcome to the Second Quarter 2008 Arch Capital Group Earnings Conference Call. My name is Lacy, and I'll be your coordinator for today. At this time, all participants are in a listen-only mode. We will be facilitating a question-and-answer session towards the end of this conference. [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 in today's press release and discussed on this call may constitute forward-looking statements under the Federal Securities law. These statements are based upon management's current assessment and assumptions and are subject to risks and uncertainties.

Consequently, actual results may differ materially from those expressed or implied. For information on the risk factors and other... for other risk factors that may affect future performance, investors should periodic reports that are filed by the company with the SEC from time-to-time.

Additionally, certain statements contained in the call 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 this call to be subject to Safe Harbor created thereby.

Management also would like reference some non-GAAP measures of the 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... your presentation over to your host for today's call, Mr. Dinos Lordanou and John Vollaro. Please proceed.

Constantine Lordanou

Thank you, operator. And good morning, ladies and gentlemen and welcome to our second quarter earnings call.

Against the backdrop of very competitive underwriting environment in an extremely volatile investment climate, we are very pleased with the performance of our operating units and the results that we have achieved. Our book value per share including the effects of our share repurchases increased to $57.49, a 21.3% increase from the end of the second quarter of 2007.

Our after-tax operating income for the 2008 second quarter was $2.82 per share, which represents a 20.5 annualized return on average common equity. Even though our premium production is down and our book of business is maturing, our cash flow from operations continue to be strong at $256 million for the quarter.

John will give you more detailed analysis of our financials in few minutes, but before I turn it over to him, let me comment on the market environment as we see in our two businesses; insurance and reinsurance.

On the underwriting side, the market continues to be competitive without any meaningful change from what we saw in the first quarter of this year. As underwriters of specialty lines, where technical knowledge expertise and experience are key to underwriting performance, we believe we have a strong team of underwriters that gives us a competitive advantage. We're pleased with the discipline that all of our units are demonstrating in this difficult market environment.

From an investment perspective, the extreme volatility that affected the credit markets has had minimal affect on our portfolio. Our subprime exposures are relatively small on both the asset side of the balance sheet and also the liability side of our balance sheet.

Our Reinsurance Group's net premiums declined by 13.5%, predominantly due to market conditions. Average rates continue to decline at the low double-digit level, with terms and conditions generally holding except for persistent request by cedants for increased ceding commissions. We have refused to participate on 3D accounts, where the negative arbitrage to us was significant. This has cost us some business, but it is the right thing to do.

Our casualty lines, which include professional liability and D&O were down 21%, and our marine and aviation lines were down 9%. On the other hand, our property and property cat book was down only 6%, and this is due mainly to a large two-year cat contract written in the second quarter of 2007 that makes the year-over-year comparison difficult.

We the termination of our Flatiron facility, we have the opportunity to choose to increase our participation on existing business. Where we believe the returns are most attractive, we have increased our participation, but we have always remained within our risk management limitations.

Our Property Fac operations, which we started approximately year and a half ago, are gaining good acceptance in the marketplace. In June of 2008, we received 1,477 submissions from 96 different client companies. This is an all-time high for us.

For the second quarter, we bound approximately 1,100 certificates and $12 million in premium. Our Gulf Re joint venture has received the appropriate licenses, and an A minus rating from A.M. Best, and is off the ground as of June of 2008.

Now, let me turn to our Insurance Group. Our insurance operations saw a reduction in net written premium of 6.7%. Rates were down 5% to 10% in most lines. Two exceptions were our program business, in which rates were basically flat; and our professional liability book, which saw a 1% reduction for the quarter. Our program and professional liability books of business are predominantly comprised of small accounts. We find this sector more attractive than the large accounts sector.

The other exception was in our executive assurance unit, where financial institutions, D&O moved to a plus 11% rate increase, and commercial D&O rates decreased moderately to a minus 6% for the quarter. Over capacity and lack of major catastrophes continue to put great pressure on rates in the property lines, with rates going down 24% on average for the quarter.

From a volume point of view, we recorded growth in our construction and national accounts business, which is to a great extent comprised of large deductible and retrospectively rated policies, as well our program business.

All the other lines declined at high single to low double-digits, except for casualty, which declined more than 40%. In this division, our casualty division, we predominantly write all of our excess and umbrella business and our primary surplus lines business, which is under pressure not only from other competitors, but also from the stand of markets that they're moving to write E&S business on an admitted basis.

Before I turn it to over to John, let me upgrade you on our PML aggregates. As of July 1, are running at 250 year event from a single event, expressed as a percentage of common equity was approximately 23% with Tri-County, Florida, and northeast windstorm continue to be our largest exposed zones. This is a slight increase over the 22% we reported in the last quarter.

With that, let me turn it to over to John to go through a detailed discussion of our financials. John?

John D. Vollaro

Thanks, Dinos. Good morning everyone. As usual, I'll briefly walk through the key components of our financial results, starting with the top line. Dinos has already commented on some detail on premium volume, but there are a few additional items that are noteworthy.

On a trailing 12 months basis, premiums written by the insurance segment represented approximately 68% of our gross volume and 60% of our net volume; while property and other short-tail lines now represent approximately 44% of our net premium volume.

On a consolidated basis, the ratio of net to gross written premium in 2008, increase to approximately 77% from 69% in the 2007 quarter, primarily as a result of the non-renewal of the Flatiron treaty. On a reported basis, we ceded $7 million of written premium to Flatiron in the second quarter of 2008 and $116 million in the prior year quarter.

On an earned basis, premium ceded under this treaty amounted to $46 million in the second quarter of '08, in comparison with $73 million ceded during the 2007 second quarter. The overriding estimated profit commission recorded on the treaty with Flatiron are reflected as a reduction of the acquisition expense of the reinsurance segment, which improved the expense ratio of that segment by 230 basis points in the 2008 quarter, while the impact on their expense ratio on the comparable 2007 period was 310 basis points. The change in ceding commission was due to a lower level of earned premium in 2008.

The earned premium of business ceded to Flatiron was approximately $66 million at quarter end. We expect an additional $5 million to $10 million of written premium on existing contracts will be ceded to Flatiron. Most of the ceded premium yet to be earned and the related fees including profit sharing, if any, will be reflected in earnings primarily during the balance of 2008.

It should also be noted as Dino has pointed out that on a quarter-over-quarter comparison for the reinsurance segment was affected by a large cat contract, which was written for a two year term in 2007, while 2008 did not include any comparable contracts.

Turning to the operating results, underwriting income per share for the second quarter of 2008 was $1.39 in comparison with $1.60 per share recorded in the second quarter of last year. Our consolidated combined ratio was 87.1% in the 2008 quarterly period, which was 300 basis points higher that the comparable 2007 quarter. 2008 underwriting results were driven by the continuation of excellent underwriting results in property and marine business of the reinsurance segment as well as favorable development of prior year reserves.

The difference in combined ratio on a quarter-over-quarter basis resulted from increases in the both the loss and expense ratios. The increase in the loss ratio of 70 basis points was attributable to an increase in catastrophe and large individual risk losses in short-tail lines as well as to an increase in our loss fixed for intermediate and long-tail business. These effects were partially offset by an increasing the amount of favorable loss development as well as to the continuing shift in the overall mix of business towards short-tail lines, which relative to longer tail lines generally have lower loss ratios.

On a consolidated basis, favorable reserve development net of related adjustment to acquisition expenses totaled $55 million in the 2008 quarter compared to $32 million recorded in the second quarter of 2007. Approximately two-thirds of the net favorable development... of the development in a 2008 quarter was some short and medium-tail lines.

In general, reported, paid and claim activity across most lines of business remained at favorable levels and IBNR and ACRs were approximately 73% of total loss reserves at quarter end.

The consolidated expense ratio was 230 basis points higher on a quarter-over-quarter basis. Approximately 60 basis points of the increase was due to additional acquisition cost related to the favorable loss development.

In addition, the 2008 expense ratio includes charges of roughly $2 million for cost incurred in connection with actions that are underway to significantly reduce the operating expenses in the insurance... in the company's insurance operations. We expect further charges will be incurred during the next several quarters as these measures are implemented, but that over time they will have a beneficial impact on the expense ratio. The balance of the increase in the expense ratio results primarily from the effects of lower premium volume.

Turning to investment results, in the 2008 quarter, pre-tax net investment income per share rose by approximately 18% on a quarter-over-quarter basis to $1.78. On a sequential basis, net investment income per share declined slightly, primarily due to the fact, as we reported previously first quarter net investment income included interest income earned on a... earned related to a favorable arbitration decision.

The growth of investment income per share on a quarter-over-quarter basis was primarily due to a higher level of average investable assets. This increase primarily resulted from the continuation of strong cash flow from operations. This quarter's cash flow brings the total flow produced by the recapitalization of the company to approximately $9... since the recapitalization of the company to approximately $9.2 billion.

After reflecting share repurchases, which I will comment on in detail in a moment, investable assets rose slightly to approximately $10.3 billion at June 30th, and the portfolio remains healthy and well positioned. Taking into account yields, realized and unrealized gains, and income from certain investments accounted for under the equity method, the total pre-tax return of the portfolio was slightly negative for the second quarter of 2008, an acceptable result considering the substantial increase in interest rates during the quarter.

The average credit quality of the portfolio remained high at AA plus, and the reported duration decreased slightly in the second quarter to approximately 3.4 years.

The portfolio continues to be comprised primarily of high quality fixed income securities, with essentially no investments in hedge funds or private equity funds.

Our balance sheet remains in excellent shape and our financial flexibility remains strong, with total capital amounting to approximately $4.3 billion at quarter end, and with debt in hybrids representing approximately 17% of the total.

The increase in the third quarter is due to the fact that, in May, we funded $100 million of our investment commitment to Gulf Re, utilizing our revolving credit facility. The cost of these borrowings is LIBOR, one, two, three or six months plus 28 basis points, and these borrowings mature in August 2011.

With respect to capital management, during the second quarter of 2008, we repurchased 2.9 million common shares for a consideration of approximately $200 million, which represents an average price per share of roughly $61.61 or 1.2 on IMS book value per share at quarter end.

Through the first 22 days of July, we repurchased an additional 1.7 million shares at an average cost of $65.94 per share. As of July 22nd, 2008, we had approximately $461 million remaining under our current share repurchase authorization.

On a weighted average basis, share repurchases were accretive to EPS by approximately $0.30 per share for the 2008 quarter. Moreover, the repurchases enhanced ROE for the 2008 quarter by approximately 290 basis points.

For the quarter, share repurchases net of accretion, reduced book value per share by approximately $0.54.

In summary, the combination of the operating results and capital management initiatives produced an ROE of about 21% in the quarter, and book value per share, despite the short-term effects of the share repurchases and a significant increase in interest rates, grew by approximately 1% during the quarter. That concludes our prepared remarks, and we will take questions now, Lacy.
Question And Answer

Question and Answer

Operator

[Operator Instructions]. And our first question will come from the line of Josh Shanker with Citi. Please proceed.

Joshua Shanker
Citigroup Smith Barney

Good morning.

Constantine Lordanou

Good morning, Josh.

John D. Vollaro

Good morning.

Joshua Shanker
Citigroup Smith Barney

First a numbers question. Can we find out the IBNR percentage of the reserves, and they'd be maybe the case additional case reserve amount.

Constantine Lordanou

Yes, IBNR is a little over 70%, and the case reserves are little under 3. Together they total about 73%.

Joshua Shanker
Citigroup Smith Barney

Okay, thank you. And I'm wondering the first thing, growth seems actually much more stable, or these premiums seem more stable ours than the competitors. Can we strip out, do we have the gross premium or the net premium numbers for Flatiron in 2007 so we can normalize our numbers of '08?

Constantine Lordanou

Yes, we'd get you those numbers. But, it was approximately, I think, Flatiron was about $300 million on annually session. So, I think, if my memory, John is looking at the specific number, my memory is good, I'm usually good with numbers, about $311 million for '07, but we'll give you the specific number in a minute.

Joshua Shanker
Citigroup Smith Barney

Okay. And giving... but you are planning, we listen to one of your competitor's conference calls last night. They felt that combined ratio for the industry was headed over a 100% this year. One of your other competitors out in Connecticut thought that by next year we would be at 110% combined. Given this business that you're writing in your parts of the market, do you agree with this sort of a market summary?

Constantine Lordanou

Well, let's refine combined ratio first. Is it on a calendar year, or accident year or policy year?

Joshua Shanker
Citigroup Smith Barney

I think they're talking about policy year probably.

Constantine Lordanou

Policy year. No even on a policy year basis, which truly reflects the current market environment for our book of business, we believe that based on our mix and where we're operating, we're in the low 90s and there would be some deterioration over '09. Assuming there is no... the market conditions continue to drift as we've seen them, but that deterioration will probably be in the range of 3, 4 points on the combined ratio, so that will get us for '09 to probably in the high 90s. And I am talking about, you know us in the industry. So I will disagree, I don't know whom you're referring to, but I will disagree that the industry is going to experience 210 on a policy year next year.

John D. Vollaro

Yes. Josh just quickly Dinos was...so far in '08 the ceded written to Flatiron is just about $25 million. In '07 we ceded just about $300 million.

Joshua Shanker
Citigroup Smith Barney

Okay.

John D. Vollaro

Is that --.

Joshua Shanker
Citigroup Smith Barney

No, I will book it through. I'm really just trying to get some run rate numbers on your premium volume and I will figure it out and I'll get back to you, appreciate it. And finally, given the pace at which you are buying back shares, does it cross your to get a partner, does it make sense for Arch to be a public company during the soft market here?

Constantine Lordanou

Yes, I think it's a capital intensive business, the insurance business so you... we believe unique to have the ability to have access to the capital markets, plus the rating agencies is so much that will allow you to put debt on the company and maintain your ratings, so you make sense from that.

On the other hand though I think when our share price as viewed by the public markets, is significantly below what we believe is the intrinsic value of the company. It's prudent for us as a management team to invest in ourselves and buyback shares aggressively, and we have done so.

Joshua Shanker
Citigroup Smith Barney

Well, congratulations on another great quarter.

Constantine Lordanou

Thank you, Josh.

Operator

And our next question will come from the line of Susan Spivak with Wachovia. Please proceed.

Susan Spivak-Bernstein
Wachovia Securities

Good morning, Dinos and John. I have a few questions. One, I'm not exactly sure how to phrase, so I'm just going to say it how I think. We all know there has been a recent downgrade of a major competitor on the island who has been similar line of business to you, been taken up security list, have seen brokers issue warnings. And so, I just want to know what you are doing to capitalize on that opportunity. That's my first question.

Second, I want to know... can you give us some idea what the premium volume from the Middle East joint venture will be.

John D. Vollaro

Let me take --

Susan Spivak-Bernstein
Wachovia Securities

And then, I am sorry, one more sir. Just remind me if you released any casualty reserve or what you mean by medium-tail lines on the reserve releases?

Constantine Lordanou

Let me start with the first one. Listen, the insurance business is highly competitive business. So usually you try to find opportunities in the marketplace, independent it is because our competitors sample [ph], or you have the opportunity to pick up a team or you have the opportunity to pick up a program that somebody else had. So we've seen some opportunities, but in a very, very competitive environment I wouldn't say those opportunities they're going to change the volume directions that we see. Yes, we look to find opportunities that are better rating and the confidence the distribution channel has in our people, and the stability and the response that we give to the brokers makes a difference, so from that perspective. And of course, if we find opportunities to hire good people, we'd take those opportunities.

Susan Spivak-Bernstein
Wachovia Securities

Have you hired any in the recent months?

Constantine Lordanou

Yes, we have added... don't forget, net-net, we have... we are down in personnel, because we are managing predominantly through attrition, and also with some job eliminations to try to match our revenue with the expense structure. In a soft market, you got to be cognizant of your expenses. But in certain situations where we could upgrade personnel, we took that opportunity to do it, even though net-net probably we're down 55 people for the quarter as a company.

Now, your second question, is way too early for the joint venture. They just opened their doors. They're writing some business. They're seeing opportunities. I'd be guessing as to what they're going be able to do. This is they're only been in operations for a few weeks. So, but early indications is that, they're seeing stuff and they're seeing the kind of business that we expected for them to see, and they're starting to bind some business. We'll know more about that as the year goes... progresses. And then --

Susan Spivak-Bernstein
Wachovia Securities

But, part of 2009 benefits then.

Constantine Lordanou

Right, and then, I'll turn it over to John to give you a little bit on more flavor on their releases of short, medium-tail and some long-tail.

John D. Vollaro

Right, yes.

Susan Spivak-Bernstein
Wachovia Securities

Okay.

John D. Vollaro

Your question specifically, what we would consider to be medium-tail lines would be relatively low limits professional liability i.e. claims made, types of business, so, for miscellaneous types of professional liability. For instance, we would not consider executive assurance to be medium-tail; we consider that to be long-tail even tough it's claims made because of the nature of the limits and the fact that a lot of it is written excess and it takes a long time to develop.

So, we have released periodically depending upon where the data takes us, both some of the medium and some of the longer terms. So, on this quarter, we said two- thirds of it came from short and medium-tail, and I would say that was predominantly short-tail with some medium-tail releases. The balance was from longer tail lines. Again, on the longer tail side, which would include executive assurance as well as certain types of professional liability in the health area, excess over hospitals and miscellaneous facilities, we didn't include some longer tail lines were released, but most of that came... again most of that came on claims made business.

Susan Spivak-Bernstein
Wachovia Securities

Okay, great. Thank you. And again, I commend you on your discipline of share repurchase and how you're navigating through this soft cycle.

John D. Vollaro

Thank you.

Operator

And our next question will come from line of Dan Johnson with Citadel. Please proceed.

Daniel Johnson
Citadel Investment Group

Great, thank you very much. Two questions. John, could you remind us or say again what was the average book or average repurchase price in the second quarter?

John D. Vollaro

In the quarter? In the first or second quarter?

Daniel Johnson
Citadel Investment Group

Second quarter, please.

John D. Vollaro

Second quarter was 69.61, and then in the first 22 days of this month that's 65.94.

Daniel Johnson
Citadel Investment Group

Okay, 69.61.

John D. Vollaro

Yes, right.

Daniel Johnson
Citadel Investment Group

Got it. Okay. And then the question on the outlook for investment yields, can you talk a little bit about relative to the average yield that we're earning on the portfolio now, where are you putting new money to work and in terms of yields and then where are you putting new money to work in terms of types of assets?

John D. Vollaro

Okay. We're pretty much haven't changed the... what we've been doing. We did as we mentioned, put, we did in the quarter for a little bit more money into the bank loan funds. They performed very, very well for the quarter. Remember, they're predominantly floating rate instruments. So, those are a nice hedge against some of the interest rate volatility we're seeing.

We've put a very minor amount of money in addition into certain high yield opportunities on a case-by-case basis. We haven't committed any more money per se, to that area through a manager. And the rest of it is, we're in... we continue to look for areas where on a credit side, where you're getting paid today, it's a lot more attractive on high quality stocks. So, we're continuing to invest primarily in the higher end of the credit spectrum. We're still somewhat cautious about the overall outlook for the economy and for credit. We're not sure we've seen the end of what's going on in the credit cycle, so we remain cautious.

But given where spreads are, and given where treasury yields are, given the backup in the second quarter, which obviously impacted everybody, we're still investing new money around the yield that were reported this quarter. Obviously that can change either way depending upon what goes on in the market place, but we're not seeing any... and we do track sort of... we manage our portfolio actively so we are... we will continue to sell or buy things based on relative value. But for the most part of the stuff we track, new investments are yielding comparable amounts to things we're selling, so I don't think you're seeing anything dramatic...any dramatic fall off there.

Constantine Lordanou

And we're not...we're not going to be aggressive on the investment side. The people buy our stock because we are good underwriters, so.

Daniel Johnson
Citadel Investment Group

Right, but....

John D. Vollaro

Obviously if we thought, there are the areas that were attractive, we might... given the fact, despite the fact that we return a lot of capital, we still have excess capital and that will give us the room, if we see opportunities that are attractive enough. But again its always on a risk adjusted basis and it's always going to be within our tolerance for risks.

Constantine Lordanou

That's right.

Daniel Johnson
Citadel Investment Group

The after-tax yields came down, it looks like something like, I don't know, maybe eightish basis points.

John D. Vollaro

Yes, about eight basis point.

Daniel Johnson
Citadel Investment Group

Sequentially and call it roughly 10 year-over-year. I'm just trying to figure out, the marginal trends going forward is not for lower yield?

John D. Vollaro

Not dramatically lower. I think if you look at... because remember even though interest rates which were extraordinarily low in the first treasuries, and we talk about treasuries, we're very low in the first quarter, bounced back quite a bit in the second, and in spreads widened quite a bit. So, we're currently still able to find relatively high quality instruments in that neighborhood.

Daniel Johnson
Citadel Investment Group

And then last question to this piece is, when you look at the maturity schedule of your investments, how does the maturity... how does the maturity yield is compared to the reinvestment yield today?

John D. Vollaro

Well, that's I was just mentioning. We track more so than the maturities although we... because we do...again we actively manage so we're buying and selling all the time and we do track sort of what's leaving the portfolio against what's coming in and it's fairly consistent. It can move around on you a little bit, but it's reasonably consistent and it's not down dramatically at least in the last few weeks that we've been watching it here. Where it goes, I can't predict.

Constantine Lordanou

We don't know whether spreads are going to come.

John D. Vollaro

Where the spreads and rates are going. Our feeling is spreads have a way to go and get to where they are more attractive, but it depends on which sector you're looking at. And we don't... we try not to forecast interest rates. We'll leave that to other people.

Daniel Johnson
Citadel Investment Group

Fair enough. Thanks very much for the question.

Operator

And our next question will come from the line of Vinay Misquith with Credit Suisse. Please proceed

Vinay Misquith
Credit Suisse

Hi, good morning.

Constantine Lordanou

Hi, Vinay.

Vinay Misquith
Credit Suisse

Nice quarter. On your program business, I saw that that's one of the only lines where you actually had some growth. Could you let us know what's happening there? Did you have a new program in that business?

Constantine Lordanou

Yes, actually we have three new programs that some of them we introduced in the first quarter, some in the second and they're starting to get some traction. So, that's.....our program business is behaving well from a rate point of view, flattish overall and then by adding new opportunities, you see a little bit of growth.

John D. Vollaro

And Vinay, about half the growth you see... we talked about this last year, but about a year or so ago, we reduced the amount of quota share reinsurance repurchase, so about half the growth you see in program.

Constantine Lordanou

On a net basis.

John D. Vollaro

On a net basis, which is why he is looking at simply from the reduction in quota share ceded the balance is growth net.

Vinay Misquith
Credit Suisse

Fair enough. In this environment are you really seeing opportunities for new programs, given that everyone is having pressure on the top line? How hard is it for you to find new programs?

Constantine Lordanou

It very hard for us. Don't forget, we see a hundred a year and we do a couple maybe three, and they got to be specialized. I'll give you an example, I mean the new stuff that we're doing is highly specialized, it's heat ventilation, air condition contractors. We're doing some water and sewer contractors hat. They specialize to the point that you need that expertise to be able to do it, so it eliminates some of the competition, if they don't understand the sector for... the more difficult classes you need to better underwriters and you need knowledge to do it. So it is from that perspective, because we're not interested in writing undifferentiated program that they just write package policies for run of the mill competing with the standard markets, that's not what we're all about.

Vinay Misquith
Credit Suisse

Sure. On the surety side, I know you guys are a small player, but sort of top 10 player. Are you seeing any trends of higher claims in that business?

Constantine Lordanou

No, I mean that surely is a credit line business and it's kind of lumpy either you... but we haven't seen it front of additional clients. What we see is that, yes, from a production point of view, we have less volume because some contractors are not getting as many jobs as they used to. Also the companies including ours are looking to have... we're looking for more collateral, better credit analysis, more of a view that the credit crunch is not behind us. So for that reason, it eliminates some of the volume that you're doing. But we haven't seen uptick in defaults.

John D. Vollaro

Yes, we are however... we are cognizant of the environment we're in and so from an underwriting posture standpoint, we're definitely taking a cautious approach there.

Vinay Misquith
Credit Suisse

And the contractors are exposed to, are they on the residential side or are they on the public work side?

Constantine Lordanou

It's mostly on the public work side with the exception of our... and we talked about this in past calls. We write a lot of subdivision bonds, but that business is down significantly because nobody is subdividing new tracks now for... and the experience on our subdivision bond business has been extremely good because it's the first part even a residential contractor does and usually they complete that because they can't stop building unless all the utilities and roads and services are in.

Vinay Misquith
Credit Suisse

And will this business have been written on a claim made basis, so if you're not seeing the claims you're done?

Constantine Lordanou

Well, it's not... its contract-by-contract, it's not claims. It's a completion work, so in essence some of it they take a year or two, some of them they take two to three. Once you complete the project, you're off the bond.

Vinay Misquith
Credit Suisse

Okay. So it's more or like in a currency policy, alright. Finally, on the share buyback, you bought back over 10% of your stock last year, 8% first half. I mean how much do you see yourselves buying the stock? Do you see yourself buying about 10% of a company each year? Is that the run rate?

Constantine Lordanou

Well, here we have an authorization that has $461 million remaining and basically there is different events that determine what we will do with share repurchases. First foremost is our earnings. If we continue to generate excess capital and we cannot deploy that capital in the business because of market conditions, we're not going to hold capital within the company; we're going to return it to its rightful owners the shareholders. And we chose share repurchase as the proper vehicle based where our share price is, which we believe a biased opinion by us. It does not reflect intrinsic value of the company as to where the stock is trading.

Now if situations change, either because there is significant cat activity and earnings get impacted or for whatever reason, and we're not anticipating this that, there is event that changed the market, and we can deploy capital on the underwriting side. Of course, we're going to change our posture. But, the way we see things today, we believe we're going to continue with share purchases periodically on that basis, trying to distribute the excess capital back to shareholders.

If our share price continues to be attractive to buy, we'll do a share repurchases. If the market rewards our efforts with a different share price, there might be other vehicles to return excess capital to shareholders, hedges, extra on our dividends, or special dividends.

Vinay Misquith
Credit Suisse

So, that's good. Thank you.

Operator

And our next question will come from the line Matthew Heimermann with JP Morgan. Please proceed.

Matthew Heimermann
JP Morgan

Yes, good morning. I almost fall asleep there. No offense to you. Couple of questions; just securities lendings, your commitments there. Is there anything happening, anything in the credit environment that makes you more or less excited about that?

Constantine Lordanou

No. Well, actually there is two things that is going to drive that. One, it's a function of what you have, what type of security you own. Predominantly, it's treasuries that get loaned. And then the second thing you got to be very careful about there is, what kind of the risk you take when you invest in collateral. And, we've always taken a very conservative approach there. We do everything and i.e. we're not going to effectively borrow short length loan, which can get you in trouble. And it's gotten some people in trouble, and we're not looking to take a lot credit risk, when we do that. And they're interrelated, because, obviously, if you take, you go out longer, you take interest rate risk and you take more credit risk.

So, our volume of what we've lent has declined. That's a function of the makeup of the portfolio. The actual earnings declined somewhat in the second quarter versus the first, but that's because in the first quarter, the premium you were being paid for lender securities was extraordinarily high, you know 10x what you might otherwise ordinarily expect. So, again, we think it's an area, it's like everything. Everything you do has risk in it. You have to be aware of the risks. And then it comes down to your risk appetite.

Our view there is we're not looking to take a lot of risk at all, if we can edge some marginal earnings with minimal risks, we'll do it. But, we're not going to take a lot of risk on the lending side.

Matthew Heimermann
JP Morgan

Okay. That's fair. And then, I can't recall whether or not, you have any preferred stocks?

Constantine Lordanou

We do not own any preferred stocks.

Matthew Heimermann
JP Morgan

Okay. I wanted to make sure I wasn't missing any non-redeemable. And then, I guess, did you quantify the risk classes in the quarter at all, was that something you can do?

Constantine Lordanou

No, we did not quantify that. You're always going to get some. I think, we quantified them in one of the units. I don't have that of hand. But, they were... you're probably looking at $20 million to $30 million of what were unusual.

Matthew Heimermann
JP Morgan

Okay.

Constantine Lordanou

Right. There is always some level of average risk classes you expect in the quarter.

Matthew Heimermann
JP Morgan

Okay. That's fair. Nothing else. Have a great weekend guys.

Constantine Lordanou

Thank you,

Operator

And our next question will come from the line of Brian Meredith with UBS. Please proceed.

Brian Meredith
UBS

Yes, good morning. A couple of quick question here. First, on the other insurance line, can you just tell us what areas you're actually growing there? I know there is a couple of things that makes up that other insurance area. It's the excess comp business right in the access?

John D. Vollaro

It is not growing.

Constantine Lordanou

It's not growing. This quarter it's growing. And it's some miscellaneous stuff. So, there is not... it's just a small line.

John D. Vollaro

Yes, we have that small lending program in there... there is nothing big in there.

Constantine Lordanou

there is nothing big in there. We do some--

John D. Vollaro

But, with respect to comp, well, that book is not growing, the excess workers comp.

Matthew Heimermann
JP Morgan

Okay, good. Next question, your PMLs went up modestly. Is that because of business that you're taking in from Flatiron, or keeping on your books? Or did you just have some pretty good successes, several renewals in the reinsurance area?

John D. Vollaro

No, actually, most of it... the PMS... the dollar, the expected loss didn't move very much, the PML didn't move. Equity capital actually went down a little and that's as much responsible for that slight change in that ratio.

Matthew Heimermann
JP Morgan

So, how were 71 renewals?

Constantine Lordanou

They were as expected, pretty good. Their rates went down a bit, single-digits. But we pick and choose our spots. With Flatiron, we had a bigger portfolio to look, and we're pick and choose the opportunities that we felt gave us the better returns. And that's what we've bound.

John D. Vollaro

Yes, actually, was an interesting phenomenon, because 71s were better on... we're talking of property cat now.

Matthew Heimermann
JP Morgan

Yes.

John D. Vollaro

U.S property cat and we know it's mostly Florida at that point. The 71s were actually better than the 61s. And from what we could determine, what we saw was some people --

Constantine Lordanou

Run out of capacities.

John D. Vollaro

Ran out of capacities. So, we were able to do some things at 71, that were much, more attractive than what some of what we saw at 61.

Matthew Heimermann
JP Morgan

Okay. And then last question, could you comment about loss cost inflation, I mean, you put your lost sticks up in the casualty and long tail lines. Is that largely due to loss cost inflation of pricing or it was going on--

Constantine Lordanou

No, it's mostly because of pricing. I mean, it's pricing and you do have some loss cost inflation. But, nothing is moving dramatically. Still, to a great extent, I think, frequency is leveling off, it was coming down, severity is up taking a bit, and you got to go on the buy line. But, we're giving upgrades. So, that's the effect on the loss and loss adjustment expense.

And, we think the industry year-over-year if you take '07 to '08, it would be probably on average up 3 to 4 loss ratio points, as an industry. And we're not going to be immune from that. As much as we try to focus people to good underwriting, and not walk away from accounts, but really the stupid deal is out there. You're still part of the industry. And you, your loss ratio is going to get effected.

Matthew Heimermann
JP Morgan

Great. Thank you.

Constantine Lordanou

You're welcome.

Operator

And our next question will come from the line of Jay Cohen with Merrill Lynch. Please proceed.

Jay Cohen
Merrill Lynch

I guess lot of my questions were answered, and giving good answers, thank you. Just a couple of things, just as more of a clarification. The... where you are releasing some of the longer tail reserves? My assumption is, those are the older accident years, '03, let's say '04 maybe.

Constantine Lordanou

Yes, Jay. We predominantly --

John D. Vollaro

It is the '05

Constantine Lordanou

'05 and prior, with most of it coming out of '04 and prior.

John D. Vollaro

And as claims made in this, some of it is high excess to, right.

Jay Cohen
Merrill Lynch

Which is consistent, with what you've been saying for the last five years. So, and maybe, just a follow up to the last question on claims inflation. You pick up the paper, you read a lot of inflation throughout the economy, and you know some of that's going to seep into insurance claims. It sounds as if, you haven't seen it yet. But, when you guys are doing the underwriting, and your actuaries are looking at pricing assumptions. Are you building in a kind of escalation in claims inflation?

Constantine Lordanou

Yes. Yes, we do. And, we try to take also a forward look, and... for example, we're very much concerned about the high-end of the property business, because we're not immune to when steel prices, they're going up 40%, 50% and other commodities. Yes, labor, might be coming down a bit, et cetera. But we try to factor that in, it's not that easy to have that forward look. But, our actuaries when they decide, to get with the underwriters on how they're going to project future pricing, and create the benchmark pricing that we measure everything, renew our business, or new business, they take that into consideration. And sometimes we're right, and sometimes we're wrong in our projections.

John D. Vollaro

Jay, I mean, some lines like executive assurance, we're using more longer term averages, because if you look backwards, claim inflation is very benign. And, you've to be careful that looking backwards, you don't lose sight of what can happen going forward. So, they periodically are reviewing every line of business, and updating the expected claims inflation for each line and that, that's not only factored into our pricing, but it's factored into our reserving as well.

Jay Cohen
Merrill Lynch

As you talk with other executives in the business, Dinos and John, I'm sure you have a kind of consistent dialogue with folks. Do you get a sense that everyone's getting a little concerned about this, or are people a little bit too comfortable with the recent past, which has been more than--

Constantine Lordanou

No, I think they're concerned. Don't forget... I don't... and there is lines of business that the uptick has nothing to do with inflation. The uptick has to do with economic conditions. For example, the workers comp line; it's going to get affected with soft tissue injuries, people that they get laid off, all of a sudden they are backwards and they are own [ph] et cetera and they're going to put claims in and a lot of those claims, I wouldn't call them fraudulent claims, but I'm going g to call them claims that you wouldn't have in the past because, if somebody's working, he takes an advil and he goes to work and its okay, and when he's not working, he goes to that doctor and he puts in a claim.

So, and companies and senior executives, they're aware of that, and they are starting to look at it. Same thing will all our liability especially on the trucking fleets and all that is maintenance going down. That has an effect on frequency, and in essence the severity of losses. So, we try to factor that in especially for those of us who have a grey hair, and been around cycles that in a bound... independent of the insurance cycle, in a downturn economic cycle, you will get an uptick on claims and you're going to get an uptick on course.

Jay Cohen
Merrill Lynch

That's great and I did know John had grey hair actually.

Constantine Lordanou

Well I didn't say no hair, but what little I have is grey.

Jay Cohen
Merrill Lynch

Great. Thanks for the answers.

Operator

And your next question is a follow up question from the line of Dan Johnson with Citadel. Please proceed.

Daniel Johnson

Citadel Investment Group

Great, thanks. Just sort of carrying on the steam, from a market point of view if the belief is, call it four points of... three or four point of loss ratio deterioration in '08. And if there is not a whole lot of sign of a change in the pricing trend and we're concerned about the potential implications of inflation, which haven't shown themselves in current loss ratios. Why isn't the... I don't know first starting point for '09, something north of 4 points from an industry point of view?

Constantine Lordanou

Dan, I'm not saying with certainty that is going to be three points, four points or five points. I mean in this business and that's the reason you see usually more conservative on the insurance side. I wouldn't say less conservative, but more comfortable on the insurance because we have the ability to price on a quarter-to-quarter basis, on a month-to-month basis and you navigate the shifts so to speak based on what you see in the marketplace and what's coming through and we will continue to do that. If I was that good progressed a predictor of what's going to happen, we will have more precision. You might be right by putting in your models a 5% or even a 6%, I don't know, we haven't seen it.

One thing I will tell you, when we look at own numbers, between the first quarter rate reductions and the second quarter, the second quarter rate reductions is slightly less than the first quarter. The data shows it, and it's not because D&O financial institutions went up, or commercial D&O is. It's kind of across the board, if it was 10, now it's 8, if it was 11, it's now 9, or something of that sort.

But I can't tell you what the third quarter is going to do, and I can't tell you what the fourth quarter is going to do, because I have seen competition heat up for the wrong reason. Somebody is trying to make their budgets in the fourth quarter for the year, and all of a sudden you get an anticipated competition. You got to factor that into what you do. And that's why, basically, I spend most my time and John, talking to our units, and trying to have our fingers on the pauses to what's happening quarter-to-quarter. So, if you want to project 5 or 6, I'm not going to be the guy who is going to dispute that. You might be right.

Daniel Johnson
Citadel Investment Group

No, I'd appreciate your thought. Thank you.

Constantine Lordanou

Quite welcome.

Operator

And at this time, we've no questions in queue.

Constantine Lordanou

Well, thank you everybody for giving us time, and listening to us. And we're looking forward to the next quarter. Have a good afternoon.

Operator
Thank you for your participation in today's conference. This concludes your presentation. You may now disconnect. Good day.