S&P Capital IQ

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W. R. Berkley Corporation NYSE:WRB

FQ3 2010 Earnings Call Transcripts

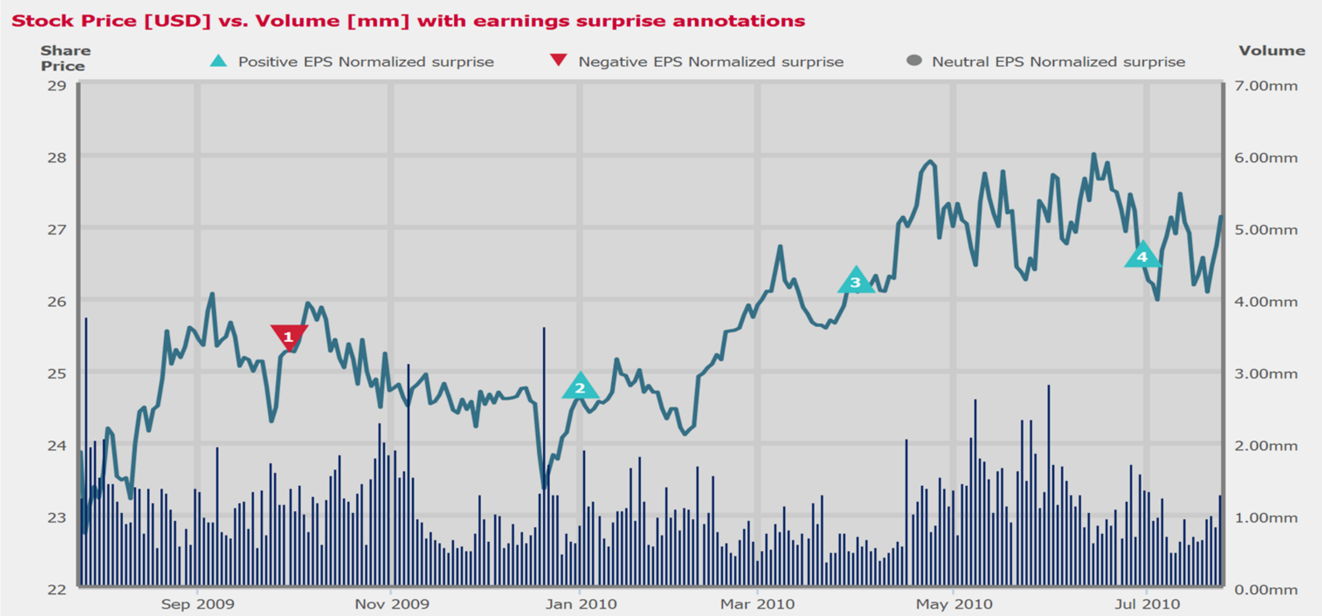
Tuesday, October 26, 2010 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2010-			-FQ4 2010-	-FY 2010-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.66	0.66	▲1.52	0.67	2.69	2.60
Revenue (mm)	1133.47	1176.11	▲3.76	1101.89	4534.13	4658.64

Currency: USD

Consensus as of Oct-26-2010 1:34 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2009	0.65	0.57	▼1 (12.31 %)
FQ4 2009	0.67	0.71	▲2 5.97 %
FQ1 2010	0.65	0.70	▲3 7.69 %
FQ2 2010	0.62	0.65	▲4 4.84 %

Call Participants

EXECUTIVES

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Executive Vice President of Finance

William Robert Berkley
Chief Executive Officer, President and Director

William Robert Berkley
Founder and Executive Chairman

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Meyer Shields
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Evercore ISI, Research Division

Presentation

Operator

Good day, and welcome to W. R. Berkley Corporation's Third Quarter 2010 Earnings Conference Call. Today's conference is being recorded. The speakers' remarks may contain forward-looking statements. Some of the forward-looking statements can be identified by the use of forward-looking words, including without limitation, beliefs, expects or estimate. We caution you that such forward-looking statements should not be regarded as a representation by us that the future plans, estimates or expectations contemplated by us will in fact be achieved. Please refer to our annual report on Form 10-K for the year ended December 31, 2009, and our other annual filings made with the SEC for a description of the business environment in which we operate and the important factors that may materially affect our results.

W. R. Berkley Corporation is not under any obligation and expressly disclaims any such obligations to update or alter its forward-looking statements, whether as a result of new information, future events or otherwise. I would now like to turn the call over too Mr. William R. Berkley. Please go ahead, sir.

William Robert Berkley
Founder and Executive Chairman

Good morning. We were satisfied with our quarterly results, and we're going to start the call with Rob Berkley going through our operating units, then we'll follow with Gene, and then I'll pick up and give you an overall overview and then questions. So first, Rob Berkley.

William Robert Berkley
Chief Executive Officer, President and Director

Bill, thank you. Good morning, everyone. While the commercial lines market remains competitive, there appears to be a growing recognition amongst industry participants that pricing action is required. By example, we are witnessing initial efforts by many carriers attempting to test the market in search of additional rates. The standard market is, generally speaking, no longer pushing deeper into the specialty lines, and we are seeing few yet growing numbers of standard carriers retreating back to their traditional appetite. Additionally, we're observing some examples of specialty carriers reexamining their strategy and on occasion withdrawing some lines of business altogether. Finally, a slowly improving U.S. economy is manifesting itself through fewer insurers going out of business, improved audit premium activity as well as increased freight loads over both road and rail in the quarter.

Net written premiums for the quarter were $987 million, up 2% from 2009. The growth during the quarter came predominantly from our younger operations or startups, if you will. This was particularly visible in the Specialty and International segments where our startup operations are more concentrated. The macro philosophy behind these startups stems from our historic and ongoing efforts to strategically position ourselves for what we believe to be an inevitable turn in the market. Much of this activity is focused on parts of both the domestic and international economies that offer strong fundamentals. As we have noted in the past, growth in this type of environment is something that we are acutely sensitive too. The confidence we have in our management team, coupled with our technical data, as well as our internal controls, give us the needed checks and balances to have comfort in the quality of the business being written.

Our price monitoring indicated the group's rates were down a mere 0.1% for the quarter and were flat for the month of September. Our renewal retention remained at an acceptable level of 80% for the 9-month period, and the combined ratio of a 95.4% for the quarter was generally in line with our expectations. Our loss ratio of a 61.8 was somewhat impacted by storms and the expense ratio at a 33.6 was a continuation of the improving trend we have seen quarter-over-quarter this year. As discussed in the past, this expense ratio trend is simply a reflection of our startups beginning to mature and consequently, the earned premium is building momentum.

With regard to reserves, as in the past, we continue to take what we believe is a measured approach. The group takes our fiduciary responsibility very seriously, and consequently feels as though one can't simply assume past trends will continue in the future. The realities of available investment returns, combined with the distinct possibility of inflation at some point in the future, as well as early signs of frequencies picking up for the industry in 2009 and 2010, lead us to the conclusion that an appropriate level of caution is warranted in selecting loss picks. In light of this, it is our belief that the current accident year continues to run at approximately a 99 combined and, with storms, roughly a 101. It is true that we have historically outperformed our initial loss picks. However, we maintain the position of not counting our chickens before they hatch.

While the current market conditions remain challenging, we are increasingly encouraged that change is approaching and our organization is particularly well-positioned to maximize future opportunity.

William Robert Berkley
Founder and Executive Chairman

Thanks, Rob. Gene, do you want to pick up about the financials now, please?

Eugene G. Ballard
Executive Vice President of Finance

Yes, I will. Thanks, Bill. And Rob covered some of this in terms of the premiums, so I'll just go into a little bit more detail. Both the net and gross premiums were up 2% in the quarter compared with the prior year quarter. Premiums for the startup companies were up 36% to $165 million, while the premiums for our remaining businesses were down 3% to $822 million. As Rob mentioned, the Specialty and International segments account for a large portion of our startup premiums, actually 3/4 of the startup premiums are in those 2 segments and net premiums for those segments were up 10% and 34%, respectively.

The premiums for the other segments were down, Regional, by 2%; Alternative Markets by 10% and Reinsurance, by 20%. That decline in the Reinsurance segment was primarily due to our minority participation in a Lloyd's syndicate. The overall loss ratio decreased 0.3 from the prior quarter to 61.8. Weather-related losses were $22 million in this quarter compared with $23 million a year ago. Those weather-related losses were all in the Regional segment and added 8 points to the Regional loss ratio and 2.3 points to the overall loss ratio.

Payable reserve development was $51 million in this quarter, up slightly from $47 million a year ago, and the majority of that payroll reserve development in 2010 was related to the Specialty and Regional segments and to accident years 2005 through 2009. Expense ratio, 33.6, up 0.7, but again as Rob mentioned, our expense ratio actually peaked in the first quarter of this year due to those -- that drag from the startup companies and since then, it's come down by 1.5 points as the earned premiums for those companies have now caught up with their expense base. Some of that improvement has been offset by higher expense ratios for the more mature companies that are still seeing some premium declines. That gives us a combined ratio of 95.4, up 0.4 from last year.

Net investment income was $138 million, down 2% from a year ago. The arbitrage account had a good quarter with a $14 million profit and an annualized yield of 11%, and in spite of the year-over-year declines in interest rates, the average annualized yield on the remainder of the portfolio was down just 0.2 to 4.0. Unrealized investment gains were $695 million at September 30. That's up $190 million in the quarter and $357 million for the first 9 months.

We did report a loss of $19 million from investment funds. That's primarily due to a decline in the estimated fair value of energy-related investments following the oil spill in the Gulf and the ensuing offshore drilling moratorium. Those funds are reported on a one quarter lag, so that decline in value occurred -- incurred in the second quarter was reflected in our third quarter.

Profits from our Service Fee business were up $2 million to $4.7 million in the quarter. That's due largely to expense reductions in that part of our business. And interest expense is up $5 million as a result of debt that we issued in late 2009. In addition, we issued $300 million of 10-year senior notes and repaid $150 million of senior notes in the third quarter of this year. At quarter end, we're holding over $500 million of liquid assets at the parent company.

During the quarter, we again used most of our net income to repurchase stock. We bought 3.3 million shares in the quarter for an aggregate cost of $88 million. That brings us to 12.2 million shares repurchased so far in 2010 or 8% of our outstanding shares at the beginning of the year. Our operating cash flow was $204 million and our paid loss ratio was the lowest it's been in 5 quarters at 59.7%. The impact of foreign currency exchange fees was not significant to either our revenue or our earnings in the quarter. So that adds up to operating earnings of $103 million and an operating ROE of 11.4% and our book value per share increased 6% for the quarter and 15% for the first 9 months to $26.36 at September 30.

William Robert Berkley
Founder and Executive Chairman

Thanks, Gene. So overall, we had a fine quarter. I think that there are signs of this market change that I've spoken about for an extended period of time. It isn't here at this instance. Prices are definitely flattening out. You still have this every now and then strange behavior where we can lose a piece of business that we've renewed for 6 or 7 years at $500,000 a premium and someone comes in at a discount of as much as 30%. But we don't have many large accounts left anymore, so it doesn't happen very often. But by and large, as our pricing numbers show, we've gotten through most of the year with virtually flat pricing and in September, it was absolutely flat pricing. We're glad to see that.

We are seeing lots of movement in the market. A number of our large competitors are acting more seriously as when they look at their pricing and we're not having this vicious competition, which seemed to be a lack of knowledge. But there still is, on occasion, this strange price cutting that's taking place, and it's hard to understand why. It's almost like a random behavior. There are some companies that are still being quite aggressive, stretching for volume. I don't think that's going to change. I think that the big issue that people are focusing on is change in frequency and potential deflation. That's giving people hope that lower prices will be rewarded. Our own exposure numbers and experience have told us that frequency has stopped going down for the past 18 months, and while it's not dramatically increasing, it certainly stopped going down and is slightly increasing, but not significantly. But definitely the time where we could benefit from dramatic improvements in frequency seem to have come to an end.

As to deflation, we think people are making some bad assumptions about those issues. #1, clearly medical costs are not going to be deflating. We just think that, that represents a very large part of the costs of our claims in the aggregate, and I think people aren't considering that with enough weight. In addition to that, we're really not expecting significant deflation. We actually think you'll be at a slight reinflation by the time we get to the end of the year and things will be picking up. Not a worry about great inflation, but I wouldn't want to make a bet on deflation. So we think those optimistic assumptions probably don't warrant the kind of price cutting that's taking place, and we've clearly stated our position, where the industry is running at probably 110 combined ratio at the moment. And we've consistently run 8 to 10 points better than the industry, and that's where we're booking at, roughly 100 combined ratio. We think we're probably being cautious and conservative as Rob said, but we're more comfortable in that issue than otherwise because the risk of ultimate inflation when we have a long tail into the business is more significant and more concerning than otherwise.

Investment income, clearly we've had a decline in rate. The one benefit for us and most players in the property casualty business is, we don't need instant liquidity. So we can invest and play in areas of the market where short-term liquidity is not a critical issue, and there are opportunities to invest at, while lower rates only modestly lower rates. And there are small opportunities and there are lots of them around. It's not like we could invest billions of dollars in those small opportunities, but they are they and up to now, we've been able to invest our cash flow.

In addition, we've invested in a number of common stocks that have offered attractive yields and what we think for the first time in my investing life, we can get yield on common stocks that are higher than the comparable bond yields for these same high-quality companies. So we've begun to invest some amount of money in common stocks on a yield basis that we think are quite attractive.

Overall, business is getting a little better. We're getting substantial traction in our startups. People appreciate our candor, they appreciate the fact that as we say, we are always in the marketplace. We are always there at a price, and the fact is, the distribution channels that we deal with are beginning to recognize, when this market changes, they need partners who are consistent and there all the time, and that doesn't give us lots of business all of a sudden, but they are thinking about what they're going to do as this marketplace changes. And in spite of what we all may say from a company point of view about brokers and agents, brokers and agents understand how they make money, how they survive and how they serve their customer best and are always concerned about the future. And therefore, as this environment starts to change, they're going to be ahead of the environment looking to deal with people like us, who will be there consistently, who don't turn away business for lack of capital.

So with that, I'm happy to take any questions,, and we are all sitting here, and we'll be pleased to answer any of your questions.

Question and Answer

Operator

[Operator Instructions] And our first question comes from Kevin Walsh with Citi.

Keith F. Walsh
Citigroup Inc, Research Division

Just the first question I guess for Gene on net investment income that continues to hold up pretty well here. And I just want to know how much of the portfolio is being reinvested approximately in 2011 and 2012? And what's the gap between the new money and the portfolio yield?

Eugene G. Ballard
Executive Vice President of Finance

Yes, it's around $1.2 billion to $1.3 billion each year in 2011 and '12 that would be rolling off and maturing.

William Robert Berkley
Founder and Executive Chairman

But a lot of that is in our short-term portfolio. So a fair amount of that is -- we have a barbell approach to our portfolio, and therefore, a fair amount of that is the short-term side of our portfolio rolling over.

Keith F. Walsh
Citigroup Inc, Research Division

And roughly what's the gap between the portfolio yield and the new money rate today that you're seeing?

William Robert Berkley
Founder and Executive Chairman

I would guess that we are talking about probably 0.5%, maybe 0.75%.

Keith F. Walsh
Citigroup Inc, Research Division

Okay, and just maybe to follow-up on that, it seems you guys are doing a lot better on new money rates than your competition, which is probably 150 basis points, at least, of a gap. What specifically -- what's driving that differential?

William Robert Berkley
Founder and Executive Chairman

Well, I think first of all, understand that one of the problems when you search for small things and things without liquidity, the markets are small and it's not something we want to tell the world that we're doing this or that because candidly, the markets and the opportunities are small and they'd go away if we told the world about them. And it's easy -- it's not like there's this great generic place, but it's private placements, it's finding companies we know have liquidity issues, it's particular kinds of security. There's a bunch of people out there being -- beating the weeds, trying to find opportunities where you can invest $5 million, $10 million, $20 million, $25 million in high-quality securities where you might not have liquidity, and those are the kinds of things we're doing. There's no change in quality and, by and large, the stuff hasn't had liquidity. I think that if we were in a position where our cash flow was to dramatically increase, it would be a more difficult task. But as long as our cash flow is as it is, it's probably okay. We think we can continue to find opportunities.

Keith F. Walsh
Citigroup Inc, Research Division

And then Bill, just second question, just to follow up around your price monitoring strategy. I know you guys talk about that and just on the renewal. The renewals seem to be running at a good rate. But what's the average rate change that a nonincumbent has to come in and take business away from you? What's the differential there between what you put out and what they're putting out? And then in addition to that, when you take -- when you're growing business right now, what is the rate differential between what you're offering customers versus what the incumbent carrier is offering them?

William Robert Berkley
Chief Executive Officer, President and Director

It's Rob. As far as the first piece of the question, if I understood it correctly, while there are always outliers, when it's an apples-to-apples situation as far as coverage, it usually takes more than 5% and typically as you reach 10%, that is the breaking point of when business will move. Having said that, particularly most sophisticated buyers or long-term customers that have experienced the service that our company brings to bear tend to have a higher tolerance for price differentiation.

William Robert Berkley
Founder and Executive Chairman

When our actuaries tell us our renewal pricing versus our new business pricing, it's virtually identical. At this point, one of the things we learned in the last cycle is our renewal pricing was looking fine, but we weren't measuring our new business pricing. We now have our actuaries to measure our new business pricing and our new business pricing is at the same level as our renewal pricing.

Operator

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

Joshua David Shanker
Deutsche Bank AG, Research Division

I wanted to talk to you about business that's leaving you and where it's going and the difference in characteristics for admitted carriers versus EMS carriers and whatnot. And maybe you can expound that a bit and I'll follow up.

William Robert Berkley
Founder and Executive Chairman

I think that -- I'm trying to understand your question, Josh, but I'll make a stab and then probably you can sort of redirect me a little bit. I think most -- for the most part, our business that leads in the EMS segment of the market has, in the recent past, gone to standard markets. That's beginning to change at the moment. I think that the EMS market has remained disciplined, and I think that for the most part, that should start to see a return of business to the EMS market going forward beginning this quarter. There are still some large carriers who are being aggressive price-wise, who have their own strategies, who built in a pricing strategy that they feel is such that their long-term value to getting the customer is worthwhile. But from our point of view, I think we sort of have an equilibrium now. I think that, that 80% renewal in a harder market was closer to 90% 3 years ago and 10% is people who close, who move or who change agents. That's sort of the normal friction costs.

Joshua David Shanker
Deutsche Bank AG, Research Division

In terms of equilibrium, what would be causing admitted carriers to behave more responsibly if they haven't yet seen losses?

William Robert Berkley
Founder and Executive Chairman

I think that some of them have seen losses. Some of them have seen the signs of losses. Some of them have seen worrying signs of reported claims even though they haven't booked them. So I think your well-run insurance companies, and I think that includes lots of companies, as far as claims departments, the signs -- and they take a series of steps before they ultimately do what we think they need to do, which is raise prices, but they have a number of steps they take. The first step is withdrawing from the places that they're concerned about. The second step is getting out of businesses that they don't know anything about or seem to be troublesome. And then the third step is raising prices on everything they do. I think that we're seeing the first step now, which is, selectively, people are starting to get out of the businesses. You want to add to that, Rob?

William Robert Berkley
Chief Executive Officer, President and Director

No I think you've covered it unless Josh had a further questions.

Joshua David Shanker
Deutsche Bank AG, Research Division

The only thing, is there any rule of thumb we can use to think about pricing between business -- how it's priced in the admitted market versus how it would priced in the EMS market?

William Robert Berkley
Chief Executive Officer, President and Director

Well clearly, historically the nonadmitted market or the EMS market has had more robust rates and perhaps and if not more important, their terms and conditions are such that it translates into perhaps a better all-in effective rate.

Joshua David Shanker
Deutsche Bank AG, Research Division

It's difficult to quantify.

William Robert Berkley
Chief Executive Officer, President and Director

Yes, I think the short answer is it's difficult to quantify in general beyond the fact that, for the most part historically, the nonstandard market has charged higher rates for exposure than the standard market.

Joshua David Shanker
Deutsche Bank AG, Research Division

Yes, all right.

William Robert Berkley
Founder and Executive Chairman

Josh, I think if we were to put up a number on the value, you'll probably say terms and conditions are worth a significant amount, pricing is worth a significant amount. You can certainly say it was at least a 25% differential.

Operator

Our next question comes from the line of Vinay Misquith with Crédit Suisse.

Vinay Gerard Misquith
Evercore ISI, Research Division

Your pricing commentary seems to be more favorable than some competitors. I just want to get a sense from you as to which lines of business that you're writing or what segments of your business is allowing you to get flatter pricing versus some competitors.

William Robert Berkley
Chief Executive Officer, President and Director

This is Rob. I think one should not confuse our comments or observations about the general market versus what we are seeing in our own pricing. Obviously, they are related not -- but they are not necessarily one and the same. As far as specifics go as to where we are able to achieve rates or for that matter, where rates are holding pat, we -- that's typically not something that we get into a lot of detail about where we see opportunities. We just don't think that's in the best interest of our shareholders. So I'm not trying to be coy but...

William Robert Berkley
Founder and Executive Chairman

I think there's a couple of other things too, and that is, as we've said for a number of quarters, we've really lost almost all our large account business. So a large account for us today is probably a couple of hundred thousand dollars premium. We've lost all our big business. And in fact that makes -- you could probably, certainly count -- a typical company, the number of pieces of business that were very large on your fingers and toes. And we did lose one particular account that brought, that we brought our attention [ph] at a 30% price cut. So there's still some price cutting that's pretty crazy. But it's -- we look at the overall statistical mix of our business, and that's what the overall statistical mix is. And I think that's it's fairly much across the board. There is no one place that's particularly unique or special, that's way off that chart, one way or the other.

Vinay Gerard Misquith
Evercore ISI, Research Division

And on the new business you're getting, would it be fair to say some of it is coming from the old companies and that [ph] those teams within some of it is coming from the new companies?

William Robert Berkley
Chief Executive Officer, President and Director

I think the way we would characterize it is that the people that are leading some of these new businesses certainly have relationships in the marketplace and with distributions. Where that business was prior to us writing it, that's not something that we could begin to speculate about, but certainly, the teams of people that have joined us are accomplished insurance professionals with long-standing relationships and they have a following of people that would like to do business with them.

William Robert Berkley
Chief Executive Officer, President and Director

And more importantly in such uncertain times, both economic and within the insurance industry, I think you've got to recognize that the smart brokers and agents want to diversify who they do business with. So they're very interested in having new relationships all the time because they don't know what's going to be the outcome of their past relationships. This is a time in the economic world where things change.

Vinay Gerard Misquith
Evercore ISI, Research Division

Fair enough. And last question, if I may, is on the debt. You took on $300 million of debt to pay down $150 million. I'm just curious as to what you plan to do with the other $150 million since the capital is now roughly near the 28% level.

William Robert Berkley
Founder and Executive Chairman

Right, which is just below what we have said the high end is, and I think that, that's okay. We thought it was an attractive time to borrow and we're going to sit with the money. There's lots of opportunities, whether it's buying back our own stock or whatever. We think that there's lots of opportunities and the opportunities to raise debt at an attractive price drove us to do that.

Operator

Our next question comes from Ken Billingsley with BGB Securities.

Kenneth G. Billingsley
BGB Securities, Inc., Research Division

I just have a few follow-up questions. I just want to ask about were there any reserve releases during the quarter?

Eugene G. Ballard
Executive Vice President of Finance

Yes, $51 million.

Kenneth G. Billingsley
BGB Securities, Inc., Research Division

$51 million? And were those related mostly on the casualty side?

Eugene G. Ballard
Executive Vice President of Finance

Yes, it was primarily in the specialty and regional segments and 2005 through 2009 years in casualty. Yes, predominantly casualty business.

Kenneth G. Billingsley
BGB Securities, Inc., Research Division

And the International business tends to be, I look at it on an LTM basis, tends to be a considerable growing piece of your business. Can you just talk about maybe what's going on, maybe a little bit of pricing commentary, but just in general of opportunities there? It seems that domestically, you might have some more opportunities if the standard line continues to pull back based on your experiences, but how will that impact your plans internationally?

William Robert Berkley
Founder and Executive Chairman

Why don't I let Rob talk about some of the details and then I'll finish up. Go ahead, Rob.

William Robert Berkley
Chief Executive Officer, President and Director

As far as the International segment goes, certainly the growth rate has been meaningful, but you need to first recognize what the base is that we're starting from. It hasn't been a huge part of our business historically, but it's certainly becoming more meaningful. We have been investing in activities outside of the United States for many years now, and we've been searching for markets where we feel as though there are positive fundamentals, such as what we see in a place like Brazil or Australia or Canada. And then obviously, in addition to that, we seek out management teams that we feel as though have exceptional talent in writing the business in their specific market. So the growth that we've been experiencing this year has been driven one, by our new Lloyd's operation. Two, we've been getting a fair amount of growth out of South America, particularly Brazil. We've also been enjoying some growth coming out of Norway as we have pushed our European operations into the Scandinavian territories, if you will. And certainly, we have found that Australia has been an attractive place to do business as well. And finally our neighbors to the North, Canada, has historically been a very insurance-friendly environment. So we have a fair number of pots on the stove, and they are beginning to get traction. Do we think that the growth rate will maintain at this level over an extended period of time? Well, probably not quite at the rate that it has been, but we think that there's plenty of room to grow.

William Robert Berkley
Founder and Executive Chairman

So, I think overall, while it's a very competitive year and modest, it's less competitive in a lot of places outside the United States, and we're still going to be primarily a U.S. company, but it's an opportunity for us to use some of our newly-generated resources to expand in places that Rob went through. We're interested in economies that are natural-resource driven, that we think are governments that will allow us to make a profit and we're interested in finding good local management that can fit culturally into where we do business.

Kenneth G. Billingsley
BGB Securities, Inc., Research Division

Regarding the audit activity that you mentioned in your initial comments, are you actually seeing that audit premiums are above expectations? Or could you just put a little bit color in those comments?

William Robert Berkley
Chief Executive Officer, President and Director

I think what I was trying to articulate or suggest is that the trend has changed from where we were seeing huge erosion early in 2010 and certainly in 2009 and significant returned premiums based on where payrolls and receipts were, we are seeing that shift in direction, once again suggesting that the general economic conditions and by extension, the activity of our insurers, is improving.

William Robert Berkley
Founder and Executive Chairman

I think that the bottom line is our audit premiums were frequently negative in 2009. They were flat, but not positive at the beginning of 2010, slightly negatively frequently and at this point, they've become positive, and we see that as a trend as opposed to a one-off occasion. So we think that's consequential both for our business and also, frankly, for the economy.

Kenneth G. Billingsley
BGB Securities, Inc., Research Division

Great. Last question is regarding the Neal bill and prospects of taxation on insurers. What are your expectations if Republicans take control of Congress or more?

William Robert Berkley
Founder and Executive Chairman

Well, you should understand it's neither an issue of Republican nor Democrat. It's an issue of when our Congress decides they are going to generate taxes to reduce the deficit. And when they take that seriously, we believe the Neal bill will get quick attention. Up to now, Republicans have not been enthusiastic about new taxes, the Democrats have not been enthusiastic about new taxes and no one put the issue of solving the deficit as our primary focus. We think whoever controls the Congress going forward, the focus on the deficit will become more important, and we think the probability of the Neal bill or some variation of it is much enhanced.

Operator

Our next question comes from Doug Mewhirter with RBC Capital Markets.

Douglas Robert Mewhirter
RBC Capital Markets, LLC, Research Division

Most of my questions have been answered. I guess my first question, I guess maybe Rob, how would you characterize the organic growth in the International business? I know there's still a lot of new businesses, but I think some of them may have maybe crossed the 12-month anniversary. So is it in double digits or single digits?

William Robert Berkley
Chief Executive Officer, President and Director

It really depends on the operation, but generally speaking, it's certainly double digits, and once again that's because they're operating off a relatively modest base. Our view is that these companies are operating in economies that have a fair bit of momentum and so just as the domestic markets here in the United States has suffered as a result of the U.S. economy when you're operating in a place like Canada or Australia or Brazil, where there are economies that have significant momentum, they, by extension, benefit from it. Having said that, our view is that there is significant opportunity, but the growth, the primary goal needs to be that the growth comes about in a controlled and measured way.

Douglas Robert Mewhirter
RBC Capital Markets, LLC, Research Division

And also in the prepared remarks, you mentioned that the earned premiums are catching up to expenses. Is there still a drag on the expense ratio in the International segment? Is that sort of running where you kind of want it to be or is there still a little bit of subscale issues in International?

William Robert Berkley
Chief Executive Officer, President and Director

I think that the answer is that there's still a modest drag, but the fact is that the earned premium is -- what I was suggesting, or trying to suggest, is that the earned premium is building, and we are getting the critical mass, where we're able to leverage our fixed expenses. So do we have a little ways to go? Yes. Do I think over time we'll be able to leverage them even further, particularly in improved market conditions? Yes. Having said that, I think we are well on our way.

William Robert Berkley
Founder and Executive Chairman

I think one of the things you have to keep in mind is, because of the environment, the growth in startups is not going to be and has not been and nor do we expect it to have been, a quick start out of the box. It's going to be a slow process. It's going to be a 3 or 4-year process. And I think we're just beginning to see that growth take hold now. I'd be surprised if it didn't continue for a number of additional years.

Douglas Robert Mewhirter
RBC Capital Markets, LLC, Research Division

Okay, and my last question, I just want to change gears to the reserve side. We looked at the -- the end of 2009, we looked at how companies have looked at their -- treated their reserves over the year, and it looked like a lot of your competitors had actually had some adverse development in the 2008 accident year, and you still had favorable development, but it was obviously not nearly to the extent of 2006 and '07. From the early returns of -- as the people reported so far, including yourself, it looked like -- it seems as if the 2008 accident year and 2009 for that matter didn't seem to be quite a concern. In fact there were some reserve takedowns. Do you think that, that was -- that I guess that less favorable treatment of 2008, do you think maybe there's a little bit of backtracking from that because of inflation or...

William Robert Berkley
Founder and Executive Chairman

I think you have to understand how we establish our reserves. We establish our reserves by choosing a year and each year based on how we see pricing and inflation changing, we establish a loss pick. We establish that loss pick before taking into consideration any subsequent takedowns. So as each year, from the older years results in takedowns of redundancies, that almost automatically means subsequent years will, in all likelihood, have some level of redundancies. We try and take that into consideration to some degree as we have those redundancies more visible in each subsequent period of time. So we might consider that in establishing our loss pick. What that really means is 2008 is likely to have been a conservative loss pick in its initial stages, 2009 a little less conservative because we saw more positive developments from 2006, 2007. So we're a little less conservative in 2009. And again, we think we were conservative, but probably closer to right on for 2010. So it's an evolving process as we learn more about the first year, if you will, of the waterfall, we can better hold our loss picks for subsequent years. But bottom line is we think probably we still have some redundancies in later, in more recent years.

Operator

Our next question comes from Greg Locraft with Morgan Stanley.

Gregory Locraft
Morgan Stanley, Research Division

I wanted to just follow up on 2 items. First is on the release you mentioned improving returns from this point forward. I wanted to get a sense as to whether or not that was a comment regarding 2011, 2012 or how -- what the timing was. And also what the source of that improving return was from a high-level perspective. If it was from the underwriting operations or from the investment operations.

William Robert Berkley
Founder and Executive Chairman

I think it's overall from improving results. First of all, it talks to -- the improving returns meant for our overall business. It reflects improvements in a number of areas. #1, improvements from our startups where we think they're going to continue to improve their returns as we get more traction writing more business. #2, we think, as we've said to everybody, we're going to have modest kinds of price increases, but it's not going to be very much for this year, and certainly, it won't be much in earned premium. So we think it will be very modest for this year, but it will have more impact next year. So we think that overall it will be higher returns, and we're pretty comfortable with just what's committed to and what we've been able to find that there are a number of opportunities, where we'll be able to continue to reinvest our money at attractive returns. Not -- when I say attractive, attractive is a relative thing. It's not quite as good as what's coming off, but it's relatively attractive compared to what's generally available in the marketplace.

Gregory Locraft
Morgan Stanley, Research Division

Okay. So is this a comment -- so do you think the ROE into next year is going up, or because if the returns are rolling off, investment income doesn't sound like it will increase, and so therefore, it's got to come out of underwriting, and so therefore, we see higher underwriting profits from the startups?

William Robert Berkley
Founder and Executive Chairman

Well, since you've already decided what it is, you've answered your question for yourself. There's no sense in me responding.

Gregory Locraft
Morgan Stanley, Research Division

Okay. Second is alternatives. Can you be more specific with regards to how the $14 million was generated? Because this looks like a record high from this book. Is it a record high and how sustainable is that going forward?

William Robert Berkley
Founder and Executive Chairman

It was a change in merger arbitrage. Merger arbitrage had a particularly poor quarter last quarter, and it was a slightly better than average quarter this quarter.

William Robert Berkley
Chief Executive Officer, President and Director

Yes, 11% is not anywhere near a high for that business.

Gregory Locraft
Morgan Stanley, Research Division

That isn't? Okay. So how do we think about the sustainability of those returns going forward? Is this a realistic level or should we -- because last quarter was one and this quarter was 14. Should we -- I mean how should we be thinking about that in our models going forward?

William Robert Berkley
Founder and Executive Chairman

I think that the business is a variable quarter to quarter and it's given us a, let's just say an 8% to 12% return over 26 years. It's varied as high as 20 plus percent returns. It's always been a positive return. We don't try to predict that on a quarter-to-quarter basis, so I can't tell how you should.

Gregory Locraft
Morgan Stanley, Research Division

Okay, great. So 8% to 12%.

Operator

Our next question comes from Jay Cohen from Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Two questions. I guess that reserve methodology that you just talked about a couple of questions ago. I guess that, then, should explain why, if I look at your accident year loss ratio excluding weather, it's been for the past 3 years fairly flat. But that would be explained by the process you just talked about where that favorable development from prior years causes you to adjust your current year accident picks?

William Robert Berkley
Founder and Executive Chairman

Yes. And it also says that probably one would think that any takedowns probably are somewhat offset by caution in the current years.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

I guess you also have the other issue of prices have been going down, so that would obviously put some upward pressure on that pick, too.

William Robert Berkley
Founder and Executive Chairman

Yes, but -- yes.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And then the second question is the weather. You had over $20 million of weather-related losses. Where did those occur?

William Robert Berkley
Founder and Executive Chairman

One of the things people don't understand is our weather-related activity is not the same as many other companies' weather-related activity because we still have substantial Midwest business, which has hail and tornadoes, and it's not necessarily named storms. We could have a hail storm in Wichita, Kansas that nobody ever heard about, and it can cost us multimillions of dollars. So it's those kinds of things, Jay. It's not a bunch of named storms. It's really mainly Midwest storms.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Any exposure to the New Zealand earthquake?

William Robert Berkley
Founder and Executive Chairman

Nothing of consequence.

Operator

Our next question comes from Meyer Shields with Stifel, Nicolaus.

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

One big picture question and one numbers. First Bill, if you were to adjust the comments you gave on the marketplace to talk specifically about worker's compensation, would things be any different?

William Robert Berkley
Founder and Executive Chairman

I think that in California, the market is better, although there's lots of political turmoil there. California has more political turmoil than any state always. But in general, there's a weaker economic climate, but a better pricing environment at the moment. I'd say overall, worker's compensation is competitive, and I -- it seems to have bottomed out, but I think that we're cautiously optimistic at the moment. I think that at the moment, we're concerned, but we're particularly concerned because a number of new players have entered the excess worker's comp market who are using forecasted interest rates that are substantially above current returns. And at the very long tail on the business. So excess comp is particularly competitive at the moment. Standard markets, we think, have sort of bottomed out beginning to turn around and prices are barely adequate. And California, whose prices are better, political environment and economic environment is crummy.

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

Okay. That's very helpful. And should we incorporate the lowered tax rate on investment, I'm sorry, on underwriting income as a reflection of the growth on the international front?

William Robert Berkley
Founder and Executive Chairman

I think that, that's part of it. It's also some of the things that we're investing in have particularly favorable tax consequences, which is impacting our tax rate. There's a lot of different things going on. Some of the investment opportunities we're seeing are going to have an impact on our tax rate, that we're making trade-offs from investment income to get tax benefits instead. There's a lot of stuff going on in that tax rate, and I'm sure that if you'd like, we can talk off-line about some of those things. But I think that the tax rate is an issue that's being generated by lots of different pieces.

Operator

Our next question comes from Bob Farnam with Keefe, Bruyette & Woods.

Robert Edward Farnam
Keefe, Bruyette, & Woods, Inc., Research Division

A couple of questions. You've previously said that if the Bermuda tax advantage is not addressed, the domestic carriers will not be able to compete and will be priced out of the market over time. First off, is that an accurate depiction of your opinion?

William Robert Berkley
Founder and Executive Chairman

Yes, sir.

Robert Edward Farnam
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. The question is if the offshore tax legislation again fizzles out, what if anything will change at Berkley to compete with the tax advantaged competitors?

William Robert Berkley
Founder and Executive Chairman

Mr. Farnum, I really want to answer this question, and I'm not sure I should. I have a lawyer sitting here staring at me. The answer is ultimately, we can't survive in this marketplace if the law doesn't change. We will have to find a way to leave domicile outside the United States or create a vehicle for our shareholders to have an enterprise that doesn't pay taxes. The economics are overwhelming, and I just -- it's hard for me to believe that Congress is not going to understand. Virtually all the U.S. reinsurers have already left, and that's ultimately what's going to happen. And it's the problem you face that if you generate revenue within this country and don't have to pay tax, you can't be domiciled here. So ultimately, the question is how long is ultimate and how long are we willing to sit and wait and battle the battle? And for now, we've been battling it for 4 years, and we haven't gotten much traction. On the other hand, we've all paid for big deficits because they haven't done much about solving tax issues.

Robert Edward Farnam
Keefe, Bruyette, & Woods, Inc., Research Division

Right. Okay, so basically you could be a very different company if it doesn't go through?

William Robert Berkley
Founder and Executive Chairman

I won't say we'll be a very different company, but it's certainly an issue that I take seriously. And we will have to give consideration to that because yes, I believe ultimately the cost of capital is a long-term driver of companies' abilities to survive.

Robert Edward Farnam
Keefe, Bruyette, & Woods, Inc., Research Division

Right, okay. And the second question I have is a little different topic. The International business, the growth there. You've talked about the different countries that -- you think you can go through what lines of business or types of business you're generating in these new countries?

William Robert Berkley
Founder and Executive Chairman

I think it's different everyplace. I think in Australia, it's mainly casualty business. In Canada it's mainly casualty business, but Australia, I might add, it's reinsurance or it's direct business and Canada. In the U.K., we have direct casualty business, we have property business through Lloyd's. In Scandinavia, we have marine business.

Robert Edward Farnam
Keefe, Bruyette, & Woods, Inc., Research Division

So not much different from your current year, your domestic book?

William Robert Berkley
Founder and Executive Chairman

No. Maybe slightly more property business, but that's about it.

Operator

Our next question comes from Larry Greenberg with Langen McAlenney.

Lawrence David Greenberg

Langen McAlenney

You guys have described some characteristics of the market that are kind of typical in affirming market environment, standard companies pulling away from nonstandard and distribution getting a little bit more discriminating. I mean if this does play out as you see it, do you see kind of a typical hard market? I mean I don't know if there is a typical hard market, but -- or do you see something perhaps more nuanced going forward?

William Robert Berkley
Founder and Executive Chairman

Part of the problem, Larry, that we don't know is we really don't know how, what condition everyone's reserves are in. We all talk about it. Clearly, there are a lot of people -- what we -- what I try to point out to people, and this is an issue that I've seen before, We, historically, have had, let's just say, 8 to 10 points better loss ratio than everybody else and confidentially a better combined ratio. And right now, we're booking 6 points worse than lots of other people. That's a 14-point spread, so either we've gotten 14 points stupider or some of the people we compete with are undersaving their loss picks by some significant amount. If that's the case, and I say if, because it may well not be the case, there's going to be a big price to pay when you start to put that kind of number against premium volumes. Those are going to be very large reserve deficiencies, and it's going to require companies to contract. And what's a little different about this, everyone who looks at the insurance business looks at the insurance business in terms of the underwriting cycle. But they need to look at it in terms of the capital raising cycle also. And I think that there's not a lot of people who want to put lots of capital in this business in a standard way. So I think that if all those people end up being short, their capacity to raise new capital will not be so easy, and we could find a very hard market pretty quickly as people try to internally reinvigorate their capital accounts.

Operator

Our next question comes from Connie Deboever from The Boston Company.

Connie DeBoever
The Boston Company Asset Management, LLC

Just have one question. Bill, in the past you've talked about your predictions for a market turn and specifically given the timing for it. I think the last update was for end of this year and I know in the prepared remarks, you've talked about signs of a change and pricing flattening out. But do you have an update as for when you think the market might turn?

William Robert Berkley
Founder and Executive Chairman

Well I think first of all, I've always said to people that my expectation is prices will start to move up in the fourth quarter, and I've also said that we don't -- we wouldn't run our business any differently if prices changed in the fourth quarter of this year or the second or third quarter of next year. I think that there are lots of signs prices are going to change. The question we face is, when will people's state of mind and reality become aligned? There's no question about what reality is, there is a question about when people's state of mind will get to the point that they say, interest rates are down, investment income is down, the industry combined ratio is, give or take, 110. When will people recognize the industry as a whole is losing money? Everyone's not losing money, but lots of people are not getting adequate returns. And when that realization happens, people are going to start to raise prices. I think there'll be modest price increases in the beginning of the fourth quarter, but if it doesn't happen until the first or second quarter, our managerial behavior would be no different. We're going to do exactly the same thing, and all we'll do is delay when that earned premium will come through, but we're starting to see some real positive signs. And I would expect for us that while in the third quarter, we had -- in September, our prices were flat, I would be surprised if we didn't have at least a small amount of price increases in the fourth quarter. But we'll have to see. I think that all the signs are there. But when are people's state of mind going to change? I don't know the answer to that. We're going to behave in the same way whether it's going to change in the fourth quarter or the second quarter or third quarter of next year. It can't go on for very long with the current economic climate for the industry.

Operator

And sir, I'm showing no further questions in the queue.

William Robert Berkley
Founder and Executive Chairman

Okay. Well thank you all very much. We continue to believe that we'll be able to continue having adequate underwriting results, and we do continue to see investment returns that should allow us to maintain that investment income level. And with that, I thank you very much, have a great day. And remember, Halloween is around the quarter. Have a wonderful Halloween.

Operator
Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may all disconnect. Everyone, have a great day.