S&P Capital IQ

CONTENTS

Arch Capital Group Ltd. NasdaqGS:ACGL

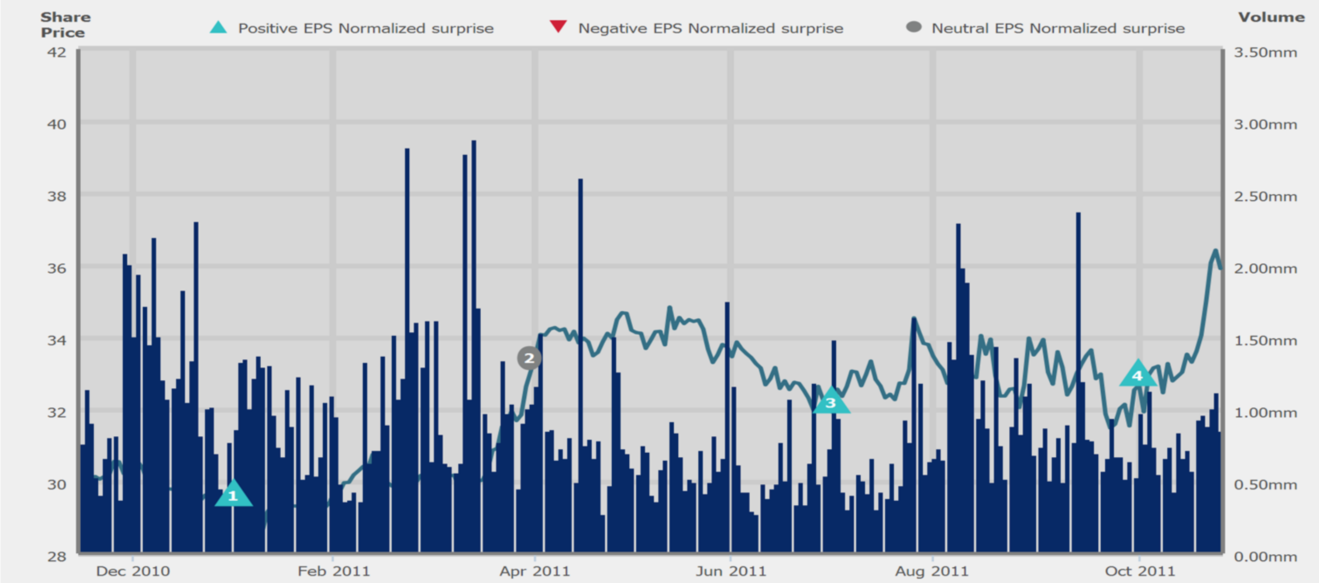
FQ4 2011 Earnings Call Transcripts

Wednesday, February 15, 2012 4:00 PM GMT

S&P Capital IQ Estimates

	-FQ4 2011-			-FQ1 2012-	-FY 2011-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.63	0.92	46.03	0.71	1.91	2.20
Revenue (mm)	535.56	511.12	(4.56 %)	773.86	2670.12	2673.33

Currency: USD
Consensus as of Feb-15-2012 1:28 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2010	0.79	0.86	8.86 %
FQ1 2011	(0.33)	0.06	NM
FQ2 2011	0.21	0.45	114.29 %
FQ3 2011	0.64	0.78	21.88 %

Call Participants

EXECUTIVES

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

ANALYSTS

Gregory Locraft
Morgan Stanley, Research Division

Ian Gutterman
Adage Capital Management, L.P.

Jay H. Gelb
Barclays PLC, Research Division

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

Michael Zaremski
Crédit Suisse AG, Research Division

Vinay Gerard Misquith
Evercore ISI, Research Division

Presentation

Operator

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

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

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

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

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

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you, Keisha. Good morning, ladies and gentlemen, and thank you for joining us today. We're finally closing the 2011 year, which was challenging from a natural cap point of view. It was our worst year ever, surpassing even the 2005 Katrina year for us.

Fortunately, we have started the 2012 year with a more positive outlook as market conditions are showing signs of improvement. Taking all that into consideration, our fourth quarter performance was acceptable. On an operating basis, we earned $126.8 million or $0.92 per share, which on an annualized basis, represents a 12% return on equity.

Our investment performance for the quarter, including the effects of foreign exchange was a total return of 82 basis points, and our underwriting performance was very good at the 90.1% combined ratio. This was aided by reserve releases from prior years, predominantly from short-tail lines. John will give you more of a breakdown in a few minutes.

Cash flow for the quarter was $110 million, which on an adjusted basis was slightly higher than the 2010 fourth quarter numbers.

Our book value per common share was $32.03, a 2.7% increase from September 30, 2011, and it was due mostly of our operating results.

The broad market environment continues to show improvements across the board. From a rate standpoint, most lines of business moved into positive territory. The exceptions were in executive assurance and healthcare, where we're still seeing rate reductions, a bit less than in prior quarters, but they're in the range of 1% to 7% for healthcare and approximately 6% for executive assurance.

Even with these improvements in the rate environment, we believe that significant more rate is needed in many lines in order to achieve adequate returns.

In our view, based in part on the level of interest rates currently available for new money invested, the long-tail lines require quite a bit of improvement in premium rate to become attractive.

We view primary casualty, umbrella liability, excess liability as areas requiring the most significant rate improvement.

Workers' compensation on an industry-wide basis is achieving high single-digit rate improvements, but this is still not enough to bring this line of business to adequate returns.

In our insurance sector, rate improved significantly on a risk-adjusted basis in the property CAD area while all other lines remained basically unchanged.

From a premium production point of view on a consolidated basis, our gross written premiums were up 5.3% and our net written premiums were up 5.8%.

The Insurance Group was up approximately 2.5% on both a gross and net basis. The Reinsurance Group was up 16.5% on a gross basis and 14.7% on a net basis. The increase resulted from new opportunities in U.K. motor based on current operating conditions in that marketplace, an increase in accident and health business, as well as from property cat back-up progress due to the storms.

We always are looking for opportunities to expand our underwriting capabilities organically. In the past 6 quarters, we were successful in attracting management teams in life and accident and health, mortgage insurance and reinsurance, treaty reinsurance in Canada, global crop hail business, as well as title insurance in Canada.

All these are investments in talent and capabilities for the future. In some of these lines, we're already producing business and in some, we're in the process of building the needed infrastructure and obtaining the necessary licenses.

While the degree of success of these opportunities in the short term will be dependent on market conditions, we're confident that, over the long term, these will prove to be successful profit centers contributing to the value of our enterprise.

During the quarter, we essentially did not purchase any of our shares. This decision was influenced by several potential opportunities that were presented to us in the last quarter. This activity was unusual and if successful, these transactions would have had their potential to utilize a significant amount of capital. These opportunities emanated from the property and casualty sector, life and health reinsurance sector and mortgage sector.

Unfortunately, only one of these transactions has closed. The biggest obstacle to closing some of these deals has been the wide spread between the bid and ask. We continue to work on some of these opportunities and on new ones that we received in the first quarter of 2012.

In general, our philosophy on capital management has not changed. We prefer to deploy our capital in our business first, and absent the ability to do so, to return it to our shareholders.

Although the current operating environment is improving, we still do not have clear visibility on the degree of improvement in market conditions or on our ability to close on some of the unusual deals that we have been working on. As a result, we will take a wait-and-see attitude with respect to share repurchases until we have more clarity.

Before I turn it over to John for more commentary on our financial results, let me touch upon and update you on our cat PMLs. As of January 1, 2012, our 1 in 250-year PML for a single event was $881 million or 20% of common shareholders' equity in the Gulf and $842 million in the Northeast. Our Florida Tri-County PML now stands at only $638 million, which gives us ample capacity for the upcoming Florida renewal season.

With that, let me turn it over to John for more commentary on our financials. And after John, we'll come back and have you ask your questions. John?

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

Thank you, Dinos. Good morning. On a consolidated basis, the ratio of net premium to gross premium in the quarter was 73% the same as a year ago. Our overall operating results for the quarter reflected a combined ratio of 90.1% compared to 92.7% for the same period in 2010.

2011 fourth quarter included $70.8 million or 10.5 points of current accident year cat activity, net of reinsurance and reinstatement premiums compared to $31 million or 4.9 points in the 2010 fourth quarter.

The 2011 fourth quarter included $60.6 million for the Thailand flooding, where we're reserving toward the higher end of our preannounced range of $35 million to $65 million, corresponding to a total industry estimated loss of $10 billion to $20 billion.

In addition, the 2011 fourth quarter reflects an estimated $5.4 million for the Christmas Day Australian hailstorm. The 2011 fourth quarter combined ratio reflected 15 points or $101 million of estimated favorable prior year reserve development, net of related adjustments compared to 6.1 points or $38 million in the 2010 fourth quarter.

The net favorable prior year development in the 2011 fourth quarter is comprised 64% from property cat, property and other short-tail lines, 20% from medium-tail lines and 16% from longer-tail lines.

The 2011 fourth quarter net release, in general, reflects the better-than-expected claims emergence that we experienced throughout 2011 across most of our lines.

The 2011 fourth quarter current accident year combined ratio, which excludes named cat events in prior year development was 101% in the Insurance segment, slightly better than the 102.9% in the 2010 period primarily due to lower expenses.

In the Reinsurance segment, the 2011 accident year combined ratio was 83.7%, higher than the 77.9% from the 2010 period, due in part to a change in the mix of earned premium towards medium-tail, other specialty lines, which generally have a higher booked combined ratio than property lines.

The 2011 fourth quarter expense ratio of 33.9% was lower than the 34.6% in the 2010 fourth quarter reflecting lower operating expenses and incentive compensation charges, which more than offset a higher level of commission expenses related to prior year favorable development.

On a per share basis, pretax net investment income was essentially flat at $0.59 in the 2011 fourth quarter compared to $0.60 for the same period a year ago and $0.60 in the third quarter of 2011. Our embedded pretax book yield before expenses was 2.98% in the 2011 fourth quarter, down from 3.09% in the 2011 third quarter and 3.52% a year ago, which primarily reflects lower reinvestment rates.

The portfolio duration was 2.99, down from 3.17 at the end of the third quarter. We continue to be cautious with the duration of our investment portfolio due to the risks in our global economy.

The total return of the investment portfolio was 82 basis points in the 2011 fourth quarter, compared to a minus 7 basis points in the corresponding 2010 period. Excluding foreign exchange, it was a positive 95 basis points in the quarter.

The total return in the fourth quarter benefited from a recovery in equity markets and stable returns on U.S. treasuries offset by a negative return on some alternative assets.

Our alternative assets include bank loans, global and emerging market bond and multi-asset funds and energy investments. These alternative assets drove the $14.7 million in net losses and equity method accounted investments.

We expected these funds to have more volatility quarter-to-quarter. But we also expect that over the longer term, we will gain an acceptable return. We continue to maintain the vast majority of investable assets in our very high quality, fixed income investment portfolio.

Starting this quarter, due to the ever-changing views of the rating agencies, we're reporting the average quality of our investment portfolio from both S&P at AA and Moody's Aa1, and we have split out our U.S. government and government-sponsored securities in a separate category in our disclosures. In the past, our average credit quality was calculated as an average for the 3 primary rating agencies.

In addition, we added an exhibit to our financial supplement on our Eurozone investments, including sovereign debt, corporate, covered bonds and other sectors. Our exposure to troubled Eurozone countries is minimal and we have no exposures in Greece.

We recorded net foreign exchange gains of $13.2 million during the 2011 fourth quarter, mainly due to the strengthening of the U.S. dollar against the euro. These gains resulted from revaluing our net insurance liabilities required to be settled in foreign currencies at each balance sheet date. However, this should be compared to the minus 13 basis points total return from foreign exchange on our investment portfolio, which essentially then offset this income statement gain in the equity section of our balance sheet.

For the 2011 year, our effective tax rate on pretax operating income was a benefit of 3.7% and 2.2% on pretax net income. The cat activity this year, low investment returns and the relative mix of income or loss by jurisdiction have resulted in a beneficial net tax position.

Our preliminary estimate of the implementation of the new DAC accounting standard required on January 1, 2012, that we communicated last quarter is still the same and the new standard should reduce our book value by less than 1% and should not have a material impact on operating earnings in 2012.

Our balance sheet continues to be conservatively positioned with total capital at $5.03 billion at December 31, 2011, up from $4.9 billion at September 30, 2011.

In the quarter, we had no material share repurchases. Our debt plus hybrids represent 14.4% of our total capital, well below any rating agency limit for our targeted rating.

As we announced last quarter in the calculation of our target capital position, we have now implemented our version of RMS 11. As of December 31, 2011, our actual capital is in excess of our target capital.

With regard to subsequent events to year-end based on current information, we expect to record a loss of $8 million to $10 million on our investment in Aeolus LP, which we report on a one quarter lag and is included in other income. We also expect a loss net of reinsurance and restatement premiums up between $18 million and $35 million for the January 2012 Costa Concordia marine event corresponding to a total industry loss of $850 million to $2 billion. Reflecting on the 2011 full year results, the after-tax operating profit was $304 million, which reflects the significant level of catastrophic activity during 2011.

The year combined ratio was 98.3%. The Insurance segment had an accident year combined ratio excluding cats and prior year development of 100.6%. And the Reinsurance segment produced an 80.6% ratio. For the year, the operating ROE was 7.2%. Our book value per share ended the quarter at $32.03, up 2.7% from the last quarter and 6.8% from a year ago.
With these comments, we are pleased to take your questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Mike Zaremski with Credit Suisse.

Michael Zaremski
Crédit Suisse AG, Research Division

Regarding the "unusual deals that closed", the one deal that closed in 4Q, was that the U.K. motor deal?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, that's the one, yes.

Michael Zaremski
Crédit Suisse AG, Research Division

So what was the size of the U.K. motor deal? And then, I guess, can you -- just a number of questions around this, why are the deals unusual? What type of returns do you feel these opportunities offer? And are they of similar size with the U.K. motor deal?

Constantine P. Iordanou
Chairman and Chief Executive Officer

A lot of questions. Let me start with -- the U.K. was not unusual. It was an opportunity for us to partner with some people that they have an existing book of business and they're looking to expand the market conditions. They're attractive for the time-being and we can achieve double-digit ROEs. And the deal size, depends on how successful you are in growing their business, is going to be in excess of $120 million for the year. It's a 2012 event for us. Some of the other transactions that weren't as usual, meaning that you might put them in the category or either renewal rights deals with books of business offered to us to pick up underwriting teams and their renewal rights, we had a few of those. We're still working on some. We have seen opportunities in the mortgage space that is a reinsurance behind either bank portfolios and/or building societies portfolios. And the size of these deals can be anywhere from $100 million to $300 million, $400 million in range and in essence, depending on the line and the capital attraction or the capital utilization, can be anywhere from $50 million to $250 million. So looking at that, I wanted to be cautious in the way that we were deploying our capital because you can get in the batter's box and hit a few home runs or you can get in the batter's box and strike out, but you can always do share repurchase at a future date. So that was what was driving our decision making.

Michael Zaremski
Crédit Suisse AG, Research Division

Okay. That's very helpful. And lastly, the Aeolus loss, what drove that? And is $35 million the maximum loss potential in this investment?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, the investment has been a very, very successful investment for us. We invested $50 million. We received already $67 million in distributions and we have a carrying value, as of the end of the year, of $35 million. So when you add it all together, this investment almost double our money independent of the loss that we're going to take in the first quarter. The loss is emanating from the worst cat year in the history of insurance. It's fourth quarter cat losses and it's coming from mostly the floods in Thailand.

Operator

Your next question comes from the line of Greg Locraft with Morgan Stanley.

Gregory Locraft
Morgan Stanley, Research Division

I wanted to just understand on the buyback, just -- if you could just remind us of the philosophy and sort of your appetite going forward with the stock at 1.2 book.

Constantine P. Iordanou
Chairman and Chief Executive Officer

If you go in our website, I think we have a grid that tells you as to when we decide and at what level to do the buybacks. And basically, it's a combination of what we anticipate the current business ROE to be versus how long will it take for us to recover. And if it's 3 years or less because if you're paying above book, you got a recovery period. If the period is 3 years or less, then we choose buybacks. If it's going to be more than that and we have excess capital and we don't think there is potential in the future to utilize it, we'll probably use some other method, maybe an extraordinary dividend, et cetera. So this has been our philosophy consistent now for the last 5 years. So no change in that. John, anything you want to add or...

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

Well, I think the point is that, as Dinos said, we're going to wait and see and we'll make decisions when we get there in that quarter, at that time, what the trading is, what the outlook is for business so we will make those decisions when we get there.

Gregory Locraft
Morgan Stanley, Research Division

Okay, yes. I mean, again, you guys, few in the entire industry have been as aggressive as you in returning capital in the last 5 years and with the share count not moving down last several quarters. I guess what I'm wrestling with is do I take the organic earnings because you're right at the upper end of where -- of that threshold, the chart to which you're referencing. I'm wondering if you're going to do any in '12 or if it's sort of over for now.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Listen, I don't know. If -- I would like to do none. Because the market is so good, I'm deploying my capital in the marketplace. So -- but having said that, when I said the bid and ask was -- it had a wide spread to it, we were pricing a lot of our deals and I wouldn't say all of them at 15% ROE, some of them it was even at 12% ROE, expected ROE. And even with that, we couldn't get the buyers to agree with that. Some of the buyers that were looking for us to deploy capital at 5%, 6%, 7% ROE. We're not going to do that. So I'm not saying we're not going to work on the deals. We're going to work. We'll put a price out that we're comfortable with. It's going to be in the double-digit ROE. That's what we tell the market, that's when we tell the brokerage community, that's when we tell the buyers. But now do I have clarity if the market will respond to that or not? No. If I have that clarity, I can give you more of a precise answer. So not knowing that, that's why I said I'm going to have a wait-and-see attitude. We're going to -- we'll continue to work on these deals. Some of them may have a long leeway. Some of them, they may take 2 quarters, 3 quarters from beginning to end. And if we're successful, it's music to my ears. I'm deploying capital for what I'm getting paid for in our business. If not, then we're going to revisit excess capital and what do we do with it.

Gregory Locraft
Morgan Stanley, Research Division

Okay, perfect. And then one last one, totally different area, but just the reserve releases was definitely much, much better than peers. Obviously, your balance sheet continues to be in excellent shape. Can you give us -- I mean, you did provide some color in the commentary as to where it came from and stuff. Can you may be a bit more granular? And obviously, what we're all trying to figure out is the sustainability of that going forward. So again, any comments or thoughts.

Constantine P. Iordanou
Chairman and Chief Executive Officer

I thought John was pretty granular. It's 64% of property cat, which means that -- I think we have a better record in reserving cat than most. At the end of the day, they don't materialize. Would it be conservative? You've seen what we've done with the Thai losses, too, because the contingent business interruption is so difficult to estimate. Even though we never wrote excess of loss cat business in the country of Thailand. We have no direct traditional excess of loss cat business in that territory. We're anticipating losses coming from both our Insurance Group and Reinsurance on large industrial risk that's done on a global basis. But because the contingent business interruption is such a difficult measure, we became very conservative. And at the end of the day, I'd rather be on the high end of the reserving range than the low end. You might say we've done the same in prior years, in '05, in '04, et cetera. And if you look at our history, we had consistent reserve releases from short-tail lines. This is not the first year. It just happened to be unusually high. But on short-tail lines, you know what you got. It's either you got a loss or you don't and you don't have to wait for many years to figure it out. Now the 16% on long-tail lines, which is about $16 million out of the total, came from the very good years in the Casualty business, '04, '05, '06. This is no reserves from any of the later years. And the medium term, it might be a few years after that but it's mostly medium term...

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

It's in the Professional Liability or...

Constantine P. Iordanou
Chairman and Chief Executive Officer

Liability. Claims make Professional Liability business with low limits that usually within 3, 4, 5 years you know where you are.

Gregory Locraft
Morgan Stanley, Research Division

So any more color on...

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

And Greg, we've seen, and I think some others have seen in the industry through 2011, trend has been less than we have built in for this year. So that allows some of these releases across many of our lines to flow out. Whether or not that trend continues or not, we keep assuming trend is on a long-term basis. It will come back someday to that. We can't tell you when and we have to look at that quarter by quarter.

Gregory Locraft
Morgan Stanley, Research Division

Okay, that's really good. And then just one follow-up on the short-tail lines and perhaps you actually said this already, but which events did this come from?

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

Many. And it's also property as well as property cat.

Constantine P. Iordanou
Chairman and Chief Executive Officer

For more events starting with '08, don't forget '08, it was a very heavy year with earthquakes, floods, et cetera. It's all events. This is not just one event.

Operator

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

Jay H. Gelb
Barclays PLC, Research Division

I just want to catch up on a couple of points. Dinos, at year end, how would you peg the level of excess capital for Arch?

Constantine P. Iordanou
Chairman and Chief Executive Officer

A little stronger than what we've told you last quarter because we didn't do share repurchases and our premium growth hasn't been that dramatic yet.

Jay H. Gelb
Barclays PLC, Research Division

Regarding the premium growth in reinsurance, I think you mentioned the potential for a couple of onetime deals. Were they in the Reinsurance segment? Because that..

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, the one that we did, it was in the Reinsurance sector and we set the size of it. It's about a figure of $25 million a quarter. It's about $120 million and it's a 13-month deal.

Jay H. Gelb
Barclays PLC, Research Division

Okay. So that's going to still flow through on the written side in 2012, not just earned?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It will flow through 2012, yes.

Jay H. Gelb
Barclays PLC, Research Division

In written?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Written, yes.

Jay H. Gelb
Barclays PLC, Research Division

Got it, okay. And then on the pace of investment income, which on the recurring investment income, which has been slowing about -- slowing each quarter, I mean, is that $80.5 million? Is that the right run rate and then we should take into account lower reinvestment yields going forward so it might continue to drop?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, the reinvestment yield is less. I mean, we look to always find opportunities, but also what I wanted point out to you, the number that you mentioned is before expenses, right? You said, what, the embedded yield, you said it was, what, 2.98?

Jay H. Gelb
Barclays PLC, Research Division

I suppose, yes.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, that's before expenses. So you got to take -- if you're putting it on your model, you better take out investment expense out of that too.

Jay H. Gelb
Barclays PLC, Research Division

Right. So I mean, directionally, will there be sort of continued...

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, I don't think it's going to move more further down because we're finding enough products with still high credit quality and enough spread from treasuries to continue maintaining approximately in the 2.5% to 3% yield and we're going to try to stay there. So I don't expect that to move dramatically.

Jay H. Gelb
Barclays PLC, Research Division

The yield, Dinos, or the investment income results?

Constantine P. Iordanou
Chairman and Chief Executive Officer

The investment income.

Jay H. Gelb
Barclays PLC, Research Division

Got you, okay. And then I just want to understand a little better structurally on the share buybacks. I mean, the reason to hold back a bit on share buybacks, is that more because you're -- there's potential to become -- to deploy more capital in the business as the market continues to firm and as well as kind of these one-off deals? I mean, there still seems to be so much excess capital...

Constantine P. Iordanou
Chairman and Chief Executive Officer

It was both. The -- I have -- we have the ability to grow the business quickly. If you go back in our origin, '02, '03, '04. We went from 0 premium to $3.5 billion gross in 3 years. So our ability to deploy quite a bit of capital -- as a matter of fact, our first year on a policy year basis, on an underwriting year basis, the Reinsurance Group grew at $1.2 billion in '02. So you can -- given a market turn that we can sense giving us good opportunities and good pricing, we can deploy capital very quickly. Now you put on top of it some unusual opportunities, somebody presenting us with $100 million renewal book of business that we will like to take over, we take over any one of these deals. You're starting to use big chunks of capital and why not be cautious in the way you're having your -- but if some of these deals don't materialize, that means we'll continue to have excess capital. And I'm even surprised that you guys keep asking questions on how we manage capital because I think our track record has been phenomenal. We're not trying to hold on to it. We're only trying to deploy into the market as best as we can. And if we have excess, we're not shy of giving it back to shareholders.

Jay H. Gelb

Barclays PLC, Research Division

We understand. And then on the transaction, so you're looking at potential, not just traditional large insurance or reinsurance deals, there's also in the market the potential for renewal rights transactions.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Absolutely.

Operator

Your next question comes from the line of Vinay Misquith with Evercore Partners.

Vinay Gerard Misquith
Evercore ISI, Research Division

The first question is, I just -- on the opportunities you're seeing, are you're seeing them in the normal P&C insurance market or...

Constantine P. Iordanou
Chairman and Chief Executive Officer

We saw them in 3 sectors, Vinay. We saw them on the P&C sectors. We saw them on our new initiative which is the mortgage space and then we see them also on a new initiative which is our life and A&H reinsurance sector. So we've seen them. And don't forget, you bring powerful teams, good underwriting people with market connections even though we believe, at least we believe, that with conservative underwriters, the market is responding and sending us these opportunities. Now it's up to us to find the right ones with the right profitability and bring them home and close. But I'm an optimist. I'm a patient optimist. Market is moving in our direction. We probably can utilize a little more capital over time. We're seeing these kinds of opportunities. If we hit on some, fine. If not, we'll go back to our old ways.

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

Vinay, this is John. I just want to add that the mortgage is -- the main focus is international, where there's good opportunities there, say, in the U.K. and some other places, Australia. So there's some proven opportunities there.

Vinay Gerard Misquith
Evercore ISI, Research Division

And how are you getting these opportunities now? I mean, why are you getting these now? Do you see more stress in the market or have you hired new teams that have helped you to get these opportunities now?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes and yes. It's more stress in the market because the traditional players lack capacity and/or ability to do them. And of course, you got to have the right team in order to get the opportunities. So the combination of both is what's presenting us with these opportunities.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, that's helpful. Now I believe on the auto deal, you said it'll be a double-digit ROE. I mean, is that what you're talking to?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, we believe we're going to produce double-digit ROE. We have good partners there. We like the people we have partnered together and we like the sector for what's happening in the U.K. motor market.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay. One other competitor actually pulled out of the excess of loss business for the U.K. market. I'm just curious as to how you got some of that.

Constantine P. Iordanou
Chairman and Chief Executive Officer

This is not excess of loss, this is a partnership. This is a primary -- it's a primary deal with side by side.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, that's great. Just one more, if I may. What's your accident year sort of ROE in the business that you're writing right now for your normal P&C business?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Right now, on a policy basis, we think we're still in there -- around 9% range. That's how we're calculating it. It's a -- a lot of that influence comes, depending if you're going to do your own calculation. I can run you through pretty quickly. We had -- on an accident year, this is not policy, on an accident year basis, this way you can follow the numbers, we produced 7.2% for the year. The cat losses, they were a couple of hundred million more than normal. And then we had about $275 million of prior year reserve releases. So that will bring your ROEs slightly below 7% on an accident year basis. Now why is my policy better? First, there is some rate increases that is going to improve the book. And second, I think our mix is changing to higher ROE so that percentage of business with a higher ROE for the 2012 year is a little higher than what we had in the prior year. So when you push that, we're getting somewhere in the high 8% and change 9%. And we do those calculations, that's why I could speak to them because -- are we happy with it? No. You don't see my comments to be too enthusiastic that, "Hey, we're going to go and write a lot of business." Our growth is still predominantly emanating from one-off opportunities rather than across-the-board improvement. But I'm more optimistic than I was last quarter because I think the market environment is moving in a good direction.

Operator

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

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

A couple of questions. Just -- I was hoping you could help me understand, if you execute on some of these new opportunities, how would it all affect your ability to write other business if market conditions improve? So I guess I can appreciate that it would take up absolute capital. I'm just wondering in terms of how much kind of diverse -- dry powder you have left to -- from diversifying pipelines, let's say casualty or other things.

Constantine P. Iordanou
Chairman and Chief Executive Officer

I'm having difficulty deploying my excess capital. I'm not worrying about capability because when you look at the balance sheet, it has very low leverage, 14.4%. I have approximately $0.75 billion to $1 billion of hybrid capacity that I can go out without having to dilute my common and raise the debt or perpetual prefers or whatever form we decide to do. So at the end of the day, the instructions that I have given to all of our operating units is operate in the marketplace as if you have unlimited capacity. I'm not talking from a risk point of view, but from a capital point of view. And once you utilize whatever I'm allocating to you and we need more, I'll go out and find it. So we're not worried about -- we're operating with the ability that we have a lot of capacity and a lot of dry powder for us to -- given the right opportunity in the marketplace to capitalize.

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

That's fair. Just to make sure I'm getting -- fully understanding what you're saying effectively, if you execute on these things, it's more about using your existing capital you have but -- and then any incremental growth and appetite or business would then be funded by some of these -- by that hybrid return?

Constantine P. Iordanou
Chairman and Chief Executive Officer

As a first choice, yes, absolutely. I didn't buy all those shares back so to go back and dilute my common.

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

And Matt, it's John. We also have the earnings that flow through, throughout the year, that also creates capital as well.

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

Yes, absolutely. I think I snuck in retained earnings on my list at a further degree. The other question I had -- and one of the other question was around the development. One of the things that's kind of muted the net reserve development you've been showing in the last couple of years has just been a little bit of adverse push on some credit crisis exposed lines. I'm just wondering whether or not you're seeing some of those pressures dissipate as well?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I mean, listen, we do a granular analysis by profits sent by IBNR. And you -- depending what you wrote in our insurance and reinsurance, some things will pop up a little bit on one and go down on others, et cetera. All I can tell you is I spend as much time with the actuaries to the point that they -- I think they don't like me a lot because I ask too many questions and I spend too much time with them. I feel that our reserve position today is as good as it was a year ago or 2 years ago. And that's basically also the opinion of outside people that they advise us and they do independent reviews on what we have. We have a very good methodology in how we reserve the company and I think I'll let the track record speak for itself.

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

That's fair. And then just one last numbers question. Just on the retention change you mentioned in the surety line. Is kind of the magnitude delta we saw this quarter the right way to think about it? I know it's not a huge premium line, but I just want to make sure I...

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's not. I wouldn't read too much into it because -- let's face it, it's a line we like to grow cautiously because, let's face it, it's a credit line. And in the economic conditions we are, it is something that you need to be cautious. But also we -- it depends how you buy your reinsurance protections on the surety. And we're switching more from a quarter share to excess of loss which, in essence, it allows us to retain more of the net premium to us.

Operator

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

Ian Gutterman
Adage Capital Management, L.P.

I guess, first on this U.K. motor, can you talk a little bit more about what it is? I guess that line, from what I understand, has been a pretty miserable performer for some of the U.K. companies in the past few years. I think there's been some adverse court rulings or regulatory rulings that have caused a lot of trouble. So why is that attractive? I thought that was a pretty poorly lit [indiscernible] line these days?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Listen, motor insurance, I don't care if it's auto in the U.S. or motor in -- it's a predictable line. When you underprice it, you're going to find a lot of excuses why you're not making money. And when you price it appropriately, you're going to make money. We -- rates have improved in the last couple of years. Part -- some of the pricing challenges have been resolved. And if you have good partners and we think we do, don't forget, you also got to look at the partners that you partner with. We like the people. We felt it was a very good deal for us to do.

Ian Gutterman
Adage Capital Management, L.P.

Fair enough. And just in general, these opportunities you're looking at, they sound more like -- are they more opportunistic, things that you're in for a year or 2 and then you get out? Or are these sort of businesses that you might still be in 5 or 10 years from now?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Listen, we'd like to be in for as long as we can. I don't like to be doing all this work and going in and out at the end of the day. But on the other hand, we're not going to stay there and take losses. I mean, that's not what we get paid for. We get paid to make money for shareholders. So it's that combination.

Ian Gutterman
Adage Capital Management, L.P.

I guess I was wondering if it's something you hope to be in for a while. And then if you're optimistic on the cycle turning soon, that maybe you'd want to push things off and wait and go look and maybe build more longer term franchises like some of your competitors are doing, hiring new teams to get in front of the cycle, things like that. Is that something on the radar or is that something that makes sense?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Listen, our attitude on talent has not changed. I spend a little time in my prepared remarks just to tell you what we've done. And usually, we don't go out and put press releases if we hire some people, et cetera. But we've done enough that I thought for a lot of the analysts, it would have been important for them to know because some of them, they ask us, they hear about this, they hear about that and they ask us the questions. We will hire talent independent of cycle. We don't care -- if you get a Michael Jordan come knocking at your door, you hire him, right? Now is the market allowing them to deploy their talent and show a lot of revenue and profit immediately? In some cases, yes. In a lot of cases, no. But we're very patient. I'll give you 2 examples. We brought a very strong property fac team. They're doing fabulous, Steve Franklin and his team, et cetera. Their market allowed them to operate and do well for us and we let them do. We brought David McElroy and his team. They're fabulous people, probably one of the best underwriting teams. The market did not allow it. We're patient. We told them, "Listen, we hire you for your brains. We hire you for your capability. And one day, the market will allow you to display what you can do. So we'll be patient along with you." So our attitude is we find the right people, independent of cycle, we hire them. We warehouse them. I never saw a company go bust because maybe their expense ratio, it's a point or 2 above where it should be. But I've seen every single case that you do that when the right opportunities come, these teams more than pay for themselves and we're very, very patient about that.

Ian Gutterman
Adage Capital Management, L.P.

Very good. And then just my last one. In some of the lines you mentioned that were disappointing, casualty, executive assurance, things like that, it looks like you showed modest growth in those lines. I mean, it's not anything scary but I'm just kind of wondering if those lines aren't where your targets are, why aren't they shrinking as opposed to growing a little bit.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, a little bit of growth was in Europe. And it was mostly on small to medium-sized enterprises in that sector, both in the U.S. and in Europe, we like. So even within a line, even though we don't write the large financial institutions, the large FI business or commercial D&O, it's not in the best of shapes for us to be enthusiastic about significant growth. Things are improving, but not fast enough for us. There are other sectors that we do like and there, if we can grow, we're going to grow.

Operator

Your next question is a follow-up from the line of Mike Zaremski with Credit Suisse.

Michael Zaremski
Crédit Suisse AG, Research Division

With regard to the cruise line accidents, is $35 million -- is that based on a $2 billion loss? And do you think your loss can reach $2 billion?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, and we don't think it's going to reach there, but I don't have to make a judgment yet as to what I'm going to reserve it for next quarter. The industry experts, I'm not one of them, but they think that the loss is going to be somewhere between $850 million to $900 million. There is good logic around how they estimate that. You got about $0.5 billion, which is the whole, then you have the 32 deaths and then you have the evacuation and then you're going to have the removal of debris and wreckage, which all of that is going to go on the liability side. We estimated that $350 million to $400 million, that's not an unreasonable number. Now what things can change that is if we have a spill and then you have an environmental disaster. There is about $1 billion of cover on the liability side for pollution. If they run into some very difficult problems in removing, that might escalate. They don't anticipate that. But I have to give you a range and in that way of thinking, both with Thailand floods or this one, we give you a pretty broad range and we tell you what is going to cost us if it happens at $850 million versus $2 billion. Now do we believe $2 billion? No. I'm not sitting here and telling you that, that loss is going to be a $2 billion loss. It's probably -- it's a very high probability that is going to be in the $850 million to $1 billion and then we'll be on the low end of what -- by the end of the first quarter I've got to make that judgment and put a reserve up. And as we get more information, we're going to refine that number, but right now that's our range, $18 million to $35 million.

Operator

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

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you all for attending and we'll talk to you next quarter. Have a wonderful day.

Operator

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