Arch Capital Group Ltd. NasdaqGS:ACGL

FQ4 2009 Earnings Call Transcripts

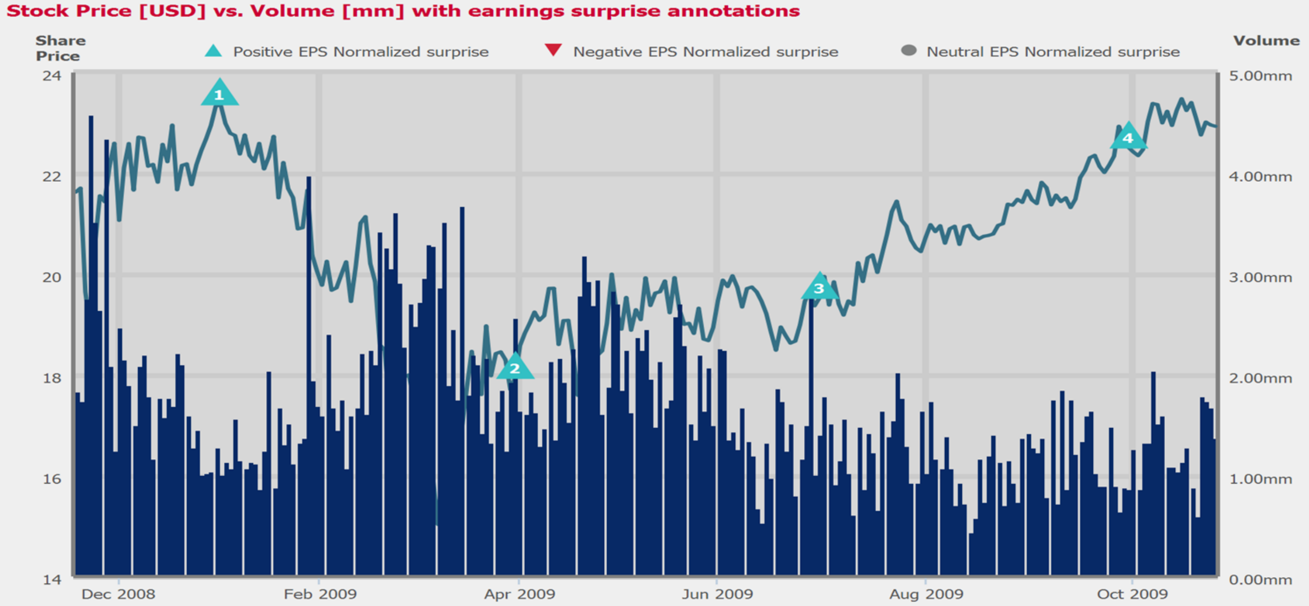
Wednesday, February 17, 2010 4:00 PM GMT

S&P Capital IQ Estimates

	-FQ4 2009-			-FQ1 2010-	-FY 2009-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.84	0.89	▲5.95	0.81	3.46	3.51
Revenue (mm)	632.42	519.09	▼(17.92 %)	829.34	2876.44	2763.11

Currency: USD
Consensus as of Feb-17-2010 1:48 PM GMT

Stock Price [USD] vs. Volume [mm] with earnings surprise annotations



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2008	0.36	0.48	▲1 33.33 %
FQ1 2009	0.86	0.90	▲2 4.65 %
FQ2 2009	0.82	0.87	▲3 6.10 %
FQ3 2009	0.79	0.85	▲4 7.59 %

Call Participants

EXECUTIVES

Constantine P. Iordanou
Chairman and Chief Executive Officer

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

ANALYSTS

Ian Gutterman
Adage Capital

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Jay H. Gelb
Barclays PLC, Research Division

Joshua David Shanker
Deutsche Bank AG, Research Division

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Fourth Quarter 2009 Arch Capital Group Earnings Conference Call. My name is Lacey, and I'll be your coordinator for today. [Operator Instructions] Before the company gets started with this update, management wants to first remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the Federal Securities laws. These statements are based upon management's current assessments and assumptions, and are subject to a number of risks and uncertainties. Consequently, actual results may differ materially from those expressed or implied. For more information on the risks or other factors that may affect the 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 this call to be subject to the Safe Harbor created thereby. Management also will take reference to some non-GAAP measures of financial performance. The reconciliation to GAAP and the definition of operating income can be found in the company's current report on Form 8-K furnished by 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 presentation over to your host for today's call, Miss (sic) [Mr.] Dinos Iordanou and Mr. John Hele. Please proceed.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you, Lacey. Good morning, everyone and thank you for joining us today. We finished the 2009 year with a very good calendar year underwriting and investment results. The results were aided by a light cat [catastrophe] activity and favorable reserve development as well as significant improvement during the year in the bond market.

We strongly believe that the most important measure in creating value for our shareholders is our ability to increase book value per share. At $73.1, our book value per share increased an impressive 42.2% from year-end '08, 5.1% from the prior quarter and 32% from year-end '07 to the '09 period.

Our annualized return on equity for the year was 18.3% and for the quarter 15.7%. And our underwriting performance as measured by the combined ratio was excellent, an 88% for the year and 89% for the quarter.

Cash flow from operations remained strong at $184 million for the quarter and $993 million for the year, despite the continuing shift in our mix of business to short-tail lines and the maturation of our Casualty business written from 2003 to 2006.

At first glance, these calendar year numbers look impressive. However, in our view, they mask the headwinds that we are facing in this phase of the cycle. Headwinds, by the way, that in our view got a bit stronger at year end. At Arch, we have always run our business on an underwriting or policy basis. We look at the economics of the business we underwrite on that basis. We allocate capital and underwriting resources on that basis. And most importantly, we compensate our underwriters on that basis.

I'm not going to make a habit of this to do part of your homework, but if you put 2009 results on an underwriting year basis, the expected return on equity would be closer to 10%, not 18%, as the calendar year numbers indicate. Approximately, five points of our reported returns on equity came from prior-year reserve releases, and three points from a level of cat activity that was lower than long-term expectancy.

Even though current market conditions do not allow us to achieve a 15% return on equity for the business we underwrite, our stated goal of achieving that 15% return on average over this cycle has not changed.

And we believe that by focusing on underwriting margins, maintaining discipline during the soft phase of the cycle, we will be able to deliver on that goal.

From a production point of view, for the year, our gross written premiums were down 2% and our net written premiums declined by 1.5%. For the year, the Insurance Group was up 1% on gross written premium and 2.8% on net written premium, while the Reinsurance Group was down 9% on gross and 7.8% on net.

For the quarter, insurance was basically flat, both on gross and net written premiums, while Reinsurance was down 40% on gross and 40% on net, for the quarter.

About 50% of the significant reduction in our Reinsurance volume was driven by actions we have taken as we non-renew [ph] or reduce shares on treaties that we did not meet our return goals. The other half was due to actions taken by our clients, where they either decided to retain more net on quota share contracts or where they restructure their purchases to excess of loss contracts.

Reinsurance terms and conditions have remained fairly stable, with the only exception as we reported in prior quarter is being continue pressure and request for improved ceding commissions.

Property cat rates, while down in the mid-single digits are still attractive on an absolute basis. In the fourth quarter on January 1 renewals, we intentionally utilized a bit less PML than a year ago. Assuming market conditions remain stable, we expect to redirect this unused PML capacity during the balance of the year.

For our Insurance Group, rates for the fourth quarter as measured on our book of business for both new and renewal business were essentially flat ranging from a negative 5% to a positive 6%. When you factor in trend or claims inflation, which in our estimation ranges from a plus 2% to plus 8%, depending on the line of business, we are losing some ground from a margin point of view.

We continue to focus our underwriting activities and efforts on small- to medium-sized accounts in all of our units, as we believe that competition is somewhat less aggressive for these type of accounts.

Now let me turn a bit on capital management. Our capital management philosophy, which we believe is an integral part of managing through the cycles has not changed. We intend to continue to return excess capital to our shareholders as long as we do not see attractive opportunities to deploy it in our business.

In the fourth quarter, we repurchased 5.1 million shares at an average price of $69.67. And since the inception of our program and through February 12, 2010, we have repurchased approximately 24 million shares or 31% of our outstanding common stock, and have returned approximately $1.6 billion through the share repurchases to our shareholders. As of February 12, 2010, we had 870 million remaining authorized for future share repurchases.

Before I turn it over to John, he'll -- for more commentary on our financials and more color on our financials, let me update you on our PML aggregates. As of January 1, 2010, our one in 250 PML from a single event was $750 million, or 19% of common equity, down from $826 million at October 1, 2009. $46 million of the reduction was attributable to less exposure, and $30 million was attributed to us utilizing and adopting RMS 9.0. Tri-County, Florida remains our largest zone with northeast U.S. wind coming in at slightly less. With that, let me turn it over to John for his comments before we take your questions. John?

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

Thank you, Dinos. I would like to add some commentary to expand upon the information that is already been released. For 2009, premiums written by the Insurance segment represented about 70% of our gross volume, and 62% of our net volume slightly higher than in 2008 with the balance written by the Reinsurance segment. Property and other short-tail lines represented approximately 47% of our net premium volume in 2009 consistent with 2008.

For the 2009 fourth quarter, premiums written by the Insurance segment included an $18 million assumed premium block of contractual liability excess wear and tear business shown in the other line of business.

The amount of premium from this business going forward should be about $4 million to $5 million per quarter.

The quarter-to-quarter comparability of premiums written by the Reinsurance segment in the 2009 fourth quarter reflected portfolios in and out on a large property oriented quota share that we discussed last year. The total impact on comparability was $53 million.

On a consolidated basis, the ratio of net to gross written premiums in the 2009 fourth quarter decreased to roughly 72% from 75% in the 2008 fourth quarter, primarily driven by the mix between Insurance and Reinsurance, while the yearly comparisons were relatively flat.

Turning to our operating results, the consolidated combined ratio was 88.8% in the 2009 fourth quarter compared to 101.2% in the 2008 period. The 2009 fourth quarter loss ratio of 57.9% reflected the benefit of a light cat quarter. While the 2008 fourth quarter loss ratio at 70.3% included 22 points mainly from Hurricane Ike.

The 2009 fourth quarter consolidated accident year loss ratio, primarily benefited from a lower level of large specific risk loss activity and a reduction in property IBNR, related to current year events due to the lack of activity. In looking at the quarter-over-quarter, as well as sequential accident year loss ratios, please keep in mind that as the book shifts more to shorter tail business, there will be more fluctuations quarter-to-quarter. Therefore, we believe that the full year accident year loss ratios are more indicative than quarterly numbers.

2009 fourth quarter loss ratio had a lower level of favorable reserved development, net of related adjustments, which totaled $16 million, or 2.3 points compared to the 2008 fourth of $116 million, or 16.6 points. Prior-year development in the 2009 fourth quarter, primarily resulted from reductions in property reserves, partially offset by an increase in the Insurance segment for European professional liability and executive assurance reserves on a small number of large specific risk losses.

The consolidated expense ratio was flat quarter-over-quarter, with a 60 basis points decrease in the acquisition expense ratio, primarily due from a lower level of costs related to prior-year reserve development. The other operating expense ratio was 60 basis points higher and reflected cost related to the expansion of the Insurance segments presence and executive assurance and professional liability lines as well as Canada and as noted in prior calls. While the Reinsurance segments growth was primarily due to the lower level of net premiums earned.

With regard to the investment portfolio of $11.4 billion at the end of the year, it is down slightly from $11.5 billion at the third quarter mainly due to the impact of the share repurchases of $359 million in the quarter. On a per share basis, the net investment income was $1.56 in the fourth quarter of 2009 versus $1.60 in the third quarter of 2009. The investment portfolio book yield was 3.64% at December 31, 2009, down from 3.93% at September 30, which reflects the impact of lower interest rates for new money as well as the maturing of older, higher yielding assets.

Given our conservative investment outlook and low yields, we see new money three-year duration investments at approximately 3%. Although, we were able to participate in TALF in the third quarter, there were no opportunities to do so in the fourth quarter. The investment income was also impacted by a drop in the demand for securities lending, which reduced investment income by $3 million in the quarter compared to the same quarter last year, as well as share buybacks that reduced investment income by approximately $1.5 million.

Our duration shortened to 2.87 from 3.09 at September 30, primarily due to aging and limited new money purchases due to share buybacks. Given the risks to insurance company, a potentially increase in interest rates. We prefer a shorter duration at this time versus a longer one.

The investment funds accounted for using the equity method of $392 million at December 31, which includes the bank loan fund investments of $277 million had a return of $32 million for the quarter and a full year return of $168 million. That has now recovered most of the loss in 2008.

The total return of the investment portfolio was 1.15% in the fourth quarter and 11.28% for the year. This has been accomplished with the portfolio with an average credit quality of AA+. Credit-related impairments were $4.8 million in the quarter.

The non-agency CMBS portfolio of $713 million at December 31 has a market-to-book price of $102, an average loan to value of 65%, delinquencies of 4.6% and current credit support of 27%. Our cash flow from operations was $184 million for the quarter and $993 million for the year.

Our balance sheet remains in excellent shape and our financial flexibility remains strong with total capital amounting to approximately $4.7 billion at December 31. Debt represented approximately 8% and hybrids represented less than 7% of our total capital. Our $100 million revolving credit borrowings mature in August of 2011, and our $300 million of senior notes mature in 2034. The hybrids are all perpetual preferred shares.

As of December 31, 2009, we continued to hold approximately $600 million to $700 million over our targeted capital level based on current rating agency models with an appropriate buffer. Our liquid, cash, short-term investments and treasury securities represent about 22% of our invested assets.

As mentioned earlier, we bought back $359 million of shares in the fourth quarter at 98% of the average book value for the period. This added $0.29 to book value in the quarter. With the December 31 book value per share of $73.01, this was an easy investment decision to make. Through year-end 2009, since inception, we have repurchased 22 million shares, which had an estimated positive impact on our book value of $1.24 and added 3.7 points to the 2009 full year ROE.
Given the current Insurance and Reinsurance market outlook, we continue to view buying back our shares when they trade at this current range as the best way to use excess capital. Reflecting the additional $119 million of shares repurchased through Friday, February 12, our main authorization through December 2011 is approximately $872 million. With these introductory comments, we are pleased to take your questions.

Question and Answer

Operator

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

Jay H. Gelb
Barclays PLC, Research Division

I was hoping you could give us a little insight in terms of how fast we might anticipate Arch could complete the remaining $870 million share buyback program?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Jay, it's Dinos. Well, it will depend on the share price that -- as how we trade in the marketplace and also, it will depend as to what part of the year we are. Traditionally, we don't do a lot during the hurricane season, which is in the third quarter. In the second quarter, we'll probably go steady. And our attitude is to continue to pretty much repurchase approximately what we are to earnings on a quarterly basis, even though we still have significant excess capital. But we don't want to do it all in one quarter. Having said that, if markets, for whatever reason, the Greek tragedy or cause the share price to become a lot more attractive, of course, we're going to respond to that. So John, you want to say anything?

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

No, I think the world outlook is still not easily certain, so we remain cautious and like to maintain a buffer in our capital. At the same time, we're looking for good opportunity until the share price comes down, we'll continue to buyback.

Jay H. Gelb
Barclays PLC, Research Division

And could you give us a sense of how your January 1 Reinsurance renewals went?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. January 1 -- and don't forget, it's only January. Year-over-year was approximately flattish, both for our Insurance and Reinsurance point of view. And basically, you're asking predominantly on volume, right?

Jay H. Gelb
Barclays PLC, Research Division

Right.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Wasn't your question on rates. Because I can give you a flavor on rates, too.

Jay H. Gelb
Barclays PLC, Research Division

That'd be great.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, rates, they were a bit down on the Reinsurance, as I mentioned in my prepared remarks. And don't forget, what we do in the Reinsurance sector is approximately 70% short-tail, and I think we've seen the rates come down mid-single digits. It was a little better on the Insurance Group with some exceptions. I think, casualty lines and this is not Professional Liability or D&O kind of stabilized and slightly positive. We were disappointed with the D&O world. I think D&O world in January 1 lost a ground a bit. It was in the minus 5% range. Professional Liability was stable and property, even though we like the absolute rates, it was a little bit under pressure and they were down as about the same rate as cat rates at about 5% or so. So that gives you a little flavor from what we saw in January 1. But volume-wise, I think we were pleased with what we achieved. One month doesn't make a year but it was a good beginning.

Jay H. Gelb
Barclays PLC, Research Division

And then for the year, should we be thinking about the volume trends at roughly the same pace at this early stage, flat for the year?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I don't know. I mean, we don't give guidance so I don't spend a lot of time worrying about the future. I try to respond to the market. You tell me where the market will go, I'll tell you how much I'm going to write. If conditions don't deteriorate further, probably you're looking at a flattish maybe slightly down year. If conditions improve, we're going to reverse that, but if conditions become extremely more competitive, we won't mind giving up volume, and we're going to react to whatever the market does. As my old boss says, Mr. Market had his own mind and you can't control it.

Operator

And your next question will come from the line of Josh Shanker with Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

I realized that the fourth quarter is not a big reinsurance quarter but you talked about reasons why rates were down dramatically. And I'm just sort of trying to think about how you think about the Insurance business versus the Reinsurance business where volumes were flat, combined ratio seemed to be edging to about breakeven. I'm trying to understand, thinking about the profitability of those two business at this point in the cycle, maybe you can do a compare and contrast?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I'll do that but before that, I didn't say rates was significantly down. I said our volume in Reinsurance was significantly down. So let's get that...

Joshua David Shanker
Deutsche Bank AG, Research Division

Maybe you can talk about why that is, I suppose.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Reinsurance is a lumpy business. Basically 75% of that reduction came from out of three contracts. One contract, it was declined and decided that they wanted to keep more of that business. We agree with them. I think if it was our choice, we'll probably would've stayed on the same level as a year ago. We thought the business was still attractive, but we had half a load instead of a full load. The other two situations that were contracts that we could have stayed on and we decided not to because we believe, I can utilize that PML capacity in the forthcoming quarters at better terms. So I wouldn't read a 40% reduction in Reinsurance as the norm quarter after quarter. It was the outcome of our underwriting activities for what we saw coming up for renewal in that quarter. As I said, January was a much better picture from both rating and volume point of view. And what's your second question?

Joshua David Shanker
Deutsche Bank AG, Research Division

And then, comparing with the Insurance business, it seems your running near -- in the high 90s, maybe near 100% combined. You talked about the 10% ROEs where your sort of return on equity would be, so to speak. Is that business, I'm trying to figure out, how long. . .

Constantine P. Iordanou
Chairman and Chief Executive Officer

Let me give you a flavor of that. When you dissect it into different sectors. Let's say short tail, medium tail, longtail. A lot of the longtail business, when you factor the risk-free rate of return on new money invested and close to 100 combines, it's not going to give you very attractive ROEs. As a matter of fact, those ROEs they might be well below 10%. And as you can see, we're trying to minimize our writings. You can't totally exit the business. This is not a light switch, you turn it off and on. At the end of the day, you've got to maintain your book of business with -- you have long-standing clients, they're being good clients and not every client is looking for the big reduction. So you underwrite your way through, you're giving up some volume and you remain positive. Because when things turn, you can double and triple your volume and make a lot of money in the business. So in essence, you keep the factory going. Our short tail business, we still view attractive but it's not very easy to obtain. Everybody else looks at it with the same prism, with the same set of eyes. So you're starting to see a little more competition, but it's not unreasonable competition. There is cat exposures, there is model that everybody prices off to, et cetera. It's the blend of all that, that gives us the ability to achieve high single digits, low double digits ROE on a policy year basis, as we see it today. But I'm not telling you that every segment of the business is behaving equally. There is some that they're in the midteens, there is some that's in the very low single digits and if you have a good blend, you might get to 8%, 9%, 10%, 12% and it depends company to company, they are blended sort [ph] of. What I can tell you though is that we find better opportunities for better margins on smaller accounts than we do on larger accounts and that our effort to switch the book, it's not something we started yesterday. It's something we started actually going back to '06, '07, '08, '09. We were drifting towards that and losing some of the multimillion dollar account because that's where the competition was the stiffest.

Joshua David Shanker
Deutsche Bank AG, Research Division

Are you seeing any talented people looking for work these days?

Constantine P. Iordanou
Chairman and Chief Executive Officer

There are talented people who look for works and usually, we're a good employer for those. So if they called you and their talented, give them my number, I'd like to talk to them.

Joshua David Shanker
Deutsche Bank AG, Research Division

Are resumes floating around right now? Are you seeing or it slowed down to some extent?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, there's no slowdown. We're still getting a good flow of resumes, et cetera. But there's so much you can do. This is not the greatest environment to really expand your book. When you find extraordinary opportunities, you act on it. And I think history has shown that we were the beneficiaries of those extraordinary opportunities.

Operator

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

Vinay Gerard Misquith

Crédit Suisse AG, Research Division

Could you give me a sense for how much of a reduction in property IBNR you took this quarter?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, let me explain to you the process of how we reserve our property. Short-tail lines don't have significant amount of IBNR. Some segments, it might be 10 or 12 weeks of earned premium, some other segments maybe six months of their premium et cetera. Now we look at and this is short tail, so we look quarter after quarter to see how the activity from a large loss activity, what the expectancy is. And when we look at it in the fourth quarter, we were a bit conservative in the first, second and third, so we make the adjustment. But we have not changed our reserving patterns for short tail. The loss ratio went down, and I think it went down by four or five points. It was predominantly because the activity was pretty light, and you've got to factor that in. And for the fourth quarter, you get an amplified effect in essence because you look at the entire year and then you're making the adjustment in your fourth quarter. As John said in his prepared remarks, if you're looking for long-term trends, I think look at the entire year, the calendar year, that will be a better indicator.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

What is the normalized cat loss that we should assume for 2010?

Constantine P. Iordanou
Chairman and Chief Executive Officer

If you tell me how much business I'm going to write, I can tell you. If we write the same amount of business we wrote a year ago, it's close to $200 million.

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

It's about $50 million a quarter.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Do you have a duration gap between your assets and your liabilities?

Constantine P. Iordanou
Chairman and Chief Executive Officer

In that number, we include both the CATs [Catastrophe Bonds] and you know how we measure CATs. We measure CATs for anything that is over $5 million industry loss, there's a caddy [ph] then and it goes into the bucket. But also, we do factor in attritional CAT numbers because there might be tornadoes, hail, et cetera and all that. Now let me get back to your question. What was the question again?

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

It was about the duration gap between your assets and your liabilities? Because I find that the duration of your assets is very low this quarter. So I'm just curious as to whether you're keeping a shorter duration on your assets. . .

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

What we do, Vinay, is that we analyze our liability duration which is about three and half and then we match asset flow against that. So we're matched on the assets backing the liabilities. It's the capital where we can change our duration longer or shorter depending upon our view. And that's now under a year, the assets backing our capital. That's about a year or so or less than that from an effective duration point of view. Whereas, we're three and half roughly on the assets backing the liabilities.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

When do you think you'll be willing to put that more to work in longer duration assets?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Listen, we'll be more conservative on that view. We discuss that with our investment committee every quarter. We're more worried about when the stimulus is removed and the easing and the flooding of the market, we're going to have pressure on interest rates and we'd rather be cautious in that approach. You're going to see us being cautious on duration and you're going to see us continue to be cautious on credit. Our shareholders are going to make money with us because we're great underwriters, not because we're brilliant investors. They can go to Buffet, he's a brilliant investor for that. With us, we'd try to be better than average underwriters.

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

Yes. So we do that what we give up by being a little shorter. If rates stay lower, go down more, that's a strategy and that's what you have. But if rates spike up, especially if the yield curve flattens or there's a rapid spike or parallel shift up. That's a big hit to your reported capital and you lose the opportunity to reinvest in higher rates. We think being shorter at this moment in time, given it's uncertain, really, we'd rather be in this position than reinvest in that money long at this time.

Operator

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

Jay Adam Cohen
BofA Merrill Lynch, Research Division

You suggested that you wanted to -- I guess essentially redirect some of your PML to later quarters. Should we read into that and maybe some of the U.S. business, Southeast U.S. business you find more attractive, those renewal center come up?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No. What you'll read [ph] into that, Jay, to be totally honest with you. A couple of contracts we had they were retro type of contracts. So in essence, you still further remove from looking at the underlying data set. And we prefer to use our PML when we have more knowledge about the underlying exposure and that was my comment. We felt that losing another five points on the Cat business, even though I think the rates are still adequate. Being a retrocession year, somebody might not be the most attractive way to deploy PML. We took that off the table and then we have it available. I have a lot of confidence in our cat team. Their performance over the last eight years has been fabulous. So I spent a lot of time with them. They even have some Greek blood in them.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Next question is on the favorable development, which dropped quite a bit and you talked about on the Insurance side some issues in Europe. Could you get into that in a bit more detail? And then in addition, the bigger picture question on the reserve development is, are you seeing any escalation in claims from a frequency or severity standpoint that might cut across your book?

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

We had some specific risk loss activity on a few number of claims. They were from the '07 underwriting year and we decided to add to those versus using IBNR for that just to really be conservative from a point of view from the '07, '08 time period. We remain cautious on that and want to be conservative on those points of view.

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's a call you make. We allow them to flow through and we chose not to make an IBNR adjustment, even though you can justify making an IBNR adjustment. So that is the essence of that.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Is this Professional Liability in Europe?

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

Yes.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And there's nothing systemic there, it's just. . .

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, it's just normal book of business, a couple of name [ph] activity.

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

But again, wanted to be cautious from the '07-'08 time period.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And from a claim standpoint in general, forgetting the European issue, what are you seeing?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We see both frequency to be benign, as a matter of fact, very good trends on frequency. A slight little uptick on severity but nothing -- still a lot better than historical averages. Like I said, we always reserve on very long historical averages. We don't try to measure the uptick in one year or in one quarter and change it prior [ph] because that can change. You'll see that in the D&O lines for example, frequency of reported claims is way down for the '09 year. But of course, everybody's recognizing. That's why you're getting more competition on the business and you see rates starting to come down.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Given the capital level you have, one option would be to reinsure less of your Insurance business and I'm wondering how you think about that?

Constantine P. Iordanou
Chairman and Chief Executive Officer

If you're willing to change your risk profile, of course, you can do that. The reason we buy reinsurance is twofold. One, is to have a reasonable belt [ph] on verticality. So basically, we don't want in the Insurance group to take more than $50 million net any one risk. So sometimes you need to issue policies that $50 million or $100 million depending -- especially on short tail business in the energy sector, et cetera. So for that reason, you're going to buy reinsurance. And also, you want to protect yourself from horizontal accumulations, and horizontal accumulations require you to buy reinsurance on that basis. And we do it on the Insurance group by limiting our cat exposure. We're doing it by -- so even though we like the business, otherwise we wouldn't write it for our own account. There is reinsurance protection that has to come in, in order to take out the volatility that is associated with either vertical penetrations or horizontal accumulations.

Operator

[Operator Instructions] And our next question will come from the line of Ian Gutterman with Adage Capital.

Ian Gutterman
Adage Capital

First one, do you have what the fully diluted book value would be for the quarter?

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

Yes, we have it. Depending on the -- this is the treasury stock method, $70.05.

Ian Gutterman
Adage Capital

I guess, first on the underwriting year ROE. I guess a couple of thoughts, and I guess one is that I assume that's using your portfolio yield you earned last year. On a new money basis where it actually be lower than 10, since your. . .

Constantine P. Iordanou
Chairman and Chief Executive Officer

You're absolutely correct. They might be a couple of points down.

Ian Gutterman
Adage Capital

Given that property returns are so strong still, maybe mid or even high teens. Does that imply casualties maybe mid-single digits? Maybe low single digits?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, depends on the line, yes. You're correct. So you do and you're a geek, so you do the calculations.

Ian Gutterman
Adage Capital

And then on buyback capacity, I guess I understand I how you could buy back your earnings based on a -- topline isn't growing up. That means your exposure isn't growing, so pretty [ph] much the surplus doesn't change, the PML is not changing. I guess the one I look at that maybe does become a constrained as reserves and surplus. It looks like -- once your pace are really kind of spike up here that the reserve balance continues to grow, and if you keep capital flat that, that growth maybe tenth of a point a year on that ratio, is that correct?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Your reserves, they might even start coming down depending on your mix of business. Don't forget for the last few years, we have been replacing the mix with more short tail. Short tail business doesn't have a big reserve component because the losses come in, you pay them and you're out. And so when the longtail lines, which they're becoming a lot less as part of our book of business, they're maturing in claims. You will see a shift in your reserves. But if your reserve position continues to grow, yes, you're going to require more capital. You allocate capital to reserves, as you're allocating capital to the premium exposure you have depending where you are.

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

Ian, our reserves at the end of '08 were $7.6 billion and they're $7.7 billion at the end of this year. So you can see...

Constantine P. Iordanou
Chairman and Chief Executive Officer

They're growing a bit and we're going to maintain very strong reserves. But if volume continues to be flattish or coming down, and that the book is shifting at some point in time, as you mature you're going to have less reserves.

Ian Gutterman
Adage Capital

I guess doesn't that imply that the paid and incurred [ph] get close to $100 million then?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, yes, at some point in time, you can get to that, absolutely.

Ian Gutterman
Adage Capital

I guess, I was assuming that we will not necessarily see a large pay cut [ph] and made some investment in the model. . .

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, if you get a company who matures, meaning that their volume is not growing, they're flattish and they're mature, meaning they're seven, eight years into it, it's not unusual to have paid [ph] and incurred [ph] to be the same.

Ian Gutterman
Adage Capital

Do you have -- I mean, traditionally you've been about 1.5 times reserve to surplus. Is there sort of an upper boundary I should think about on that?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No. Listen, we don't spend a lot of time thinking about that. The way we reserve the company is we have what we call the IBNR families is books of business and we look at it from that perspective and we set the proper reserves in our judgment based on what the data shows us.

Ian Gutterman
Adage Capital

I don't mean from an adequate [ph] reserves, I just mean from a leverage standpoint as far as capital.

Constantine P. Iordanou
Chairman and Chief Executive Officer

They're on -- from a capital requirement point of view, predominantly, A.M. Best and S&P models, we run those. We run them like the AA+ level. We add a cushion as John said, on top of it. And beyond that cushion, we think of excess capital.

Ian Gutterman
Adage Capital

Do you have any words of wisdom on the Greek debt crisis?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Buy Greek bonds.

Operator

At this time, we have no further questions in queue. I would like to turn the call back over to Mr. Iordanou for any closing remarks.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you, Lacey and thanks everybody for giving us your time. We're looking forward to talking to you next quarter. Have a good afternoon.

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