S&P Global
Market Intelligence

Arch Capital Group Ltd. NasdaqGS:ACGL

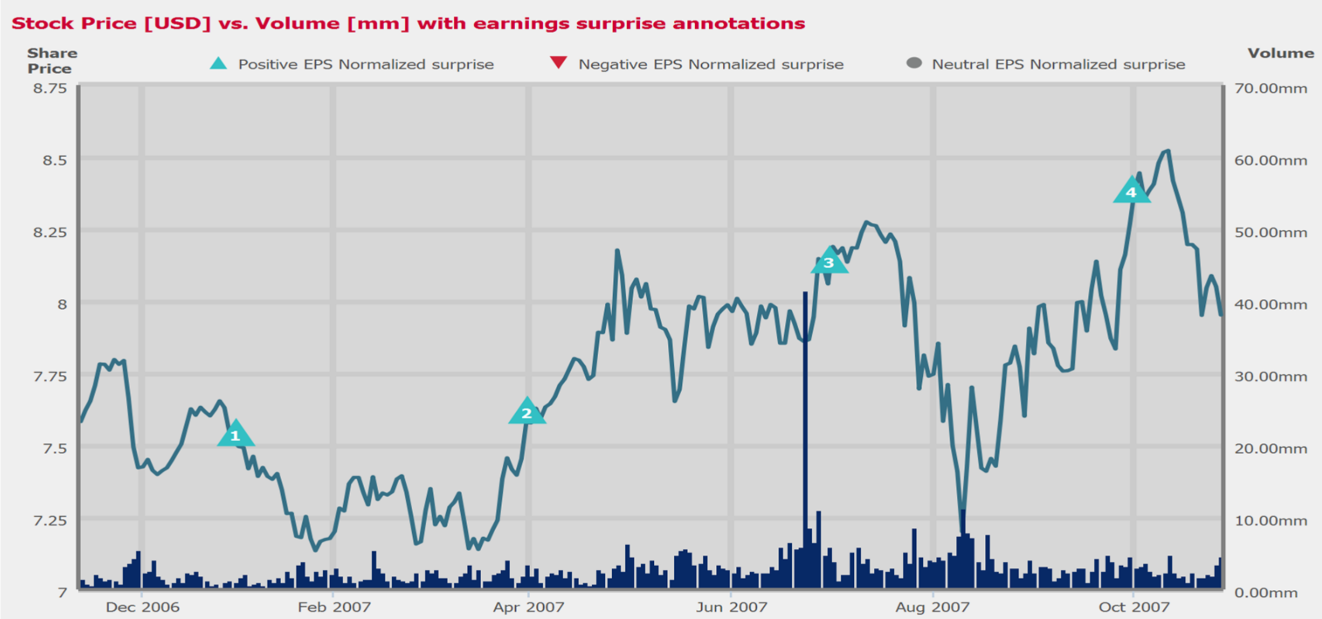
FQ4 2007 Earnings Call Transcripts

Tuesday, February 12, 2008 4:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2007-			-FQ1 2008-	-FY 2007-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.31	0.35	▲12.90	0.30	1.22	1.27
Revenue	-	-	▲0.00	-	-	-
Revenue (mm)	577.66	577.67	-	845.09	2901.84	2901.94

Currency: USD
Consensus as of Feb-12-2008 1:55 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ4 2006	0.27	0.32	▲1 18.52 %
FQ1 2007	0.26	0.29	▲2 11.54 %
FQ2 2007	0.28	0.31	▲3 10.71 %
FQ3 2007	0.26	0.32	▲4 33.33 %

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Call Participants

EXECUTIVES

Constantine Iordanou

John D. Vollaro

ANALYSTS

Brian Meredith
UBS

Matthew Heimermann
J.P. Morgan

Ron Bobman
Capital Returns

Susan Spivak
Wachovia

Vinay Misquith
Credit Suisse

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Fourth Quarter 2007 Arch Capital Group Earnings Call. My name is Tanya, and I will be your coordinator for today. At this time, all participants are in a listen-only mode. We will be conduct a question-and-answer session towards the end of the conference. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes.

Before we get started today, the company will like to 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 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 assumes 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 presentation over to your host for today's call, Mr. Dinos Iordanou and John Vollaro. Please proceed.

Constantine Iordanou

Thank you, Tanya, and good morning ladies and gentlemen, and welcome to our fourth quarter and year-end earnings call. We are very pleased with the results we have achieved and equally pleased with the underwriting discipline our operating units display during the year in a much more challenging market environment.

Our book value per share including the effects of share repurchases increased to $55.12, a 25% increase from December of 2006. Our after-tax operating income for the fourth quarter was $3.11 per share, which represents 24.3% annualized return on average common equity.

John as usual will give you a more detailed commentary on our financials in a few minutes. But, before I turn it over to him, let me share with you some comments on subprime exposures, our Gulf Re joint venture investment, and on general market conditions.

Our subprime exposures are relatively small. On pages 10 and 11 of our earnings release, we provided a more detailed listing of our investments. As you can see our subprime holdings are minimal and the quality of our other holdings is excellent. John will provide further color later on in his presentation.

On the liability side of the balance sheet, we also believe that in relative terms our exposures are not significant. Before I give you some of the specific data, I would like to remind you that we began to dramatically reduce our D&O exposures starting in the year 2005. This reduction was more acute on our reinsurance business than in our insurance business.

Our reinsurance units write no retro clash cover. In addition, our exposure to the top six D&O writers is limited to one company and only for a portion of their book-of-business. We estimate the market share of our reinsurance operations in the affected D&O and E&O lines to be in the range of four-tenths of 1% to eight-tenths of 1%, a very minimal exposure.

As for our insurance operations, our total financial institutions premium volume for 2006 was 89 million on a gross basis, and 46 million on a net basis with an average limit of 4.5 million net and an average attachment of $60 million.

In 2007, our gross written premium was 77 million, and our net written premium was 36 million with an average limit of 4 million net, and the same 60 million average attachment points. We estimate the U.S. financial institutions market to be between $3 billion to $4 billion. Therefore, our market share on a net basis is approximately 1%.

We believe that industry losses emanating from the subprime crisis will be from the 2006 and 2007 underwriting years, and will develop over the next several years. It is also our view that primary writers will incur a larger amount of the industry loss than excess carriers. Based on these assumptions, and although it is still early in the development of these losses, we believe that our potential loss should be contained within our loss estimates and our IBNR provisions.

Turning to strategic developments, on January 22nd, we enter into a joint venture agreement with the Gulf Investment Corporation to form a reinsurance company in Dubai International Financial Center. The Gulf Investment Corporation is owned equally by the six Gulf States, which are members of the Gulf Cooperative Council. The joint venture which is a 50-50 partnership will operate in the gulf territories and provide property and casualty reinsurance.

Our underwriting expertise combined with our partner's strong local relationships in a region that is growing very fast should afford us the opportunity to gain a meaningful amount of profitable business over the long term. Gail Norstrom, a seasoned veteran of the insurance business will be the CEO of Gulf Re. This venture is another step in our long-term strategy of gaining further territorial diversification.

The insurance market in general continues to drift downwards, and is following the recent trends we have experienced in the past year or two, with rate movement varying by line of business. Rate reductions range from the low to mid single-digits to up to the low mid double-digits for certain sectors.

Large premium accounts continue to be under more competitive pressures than smaller premium accounts. Overall, our gross return premium declined by 5%, and our net return premium declined by 4%. By unit, our reinsurance group reduced its premium writings by 10% on a gross basis, and 12% on a net basis, while our insurance group premium volume was down by 3.5% on a gross basis and relatively flat on a net basis.

We are pleased with the returns generated by both of our operating units and although our focus on maintaining margins resulted in a declining premium volume, we are confident that the underwriting discipline exhibited by our units will enhance our ability to grow our book value per share at very attractive rate overtime.

In reinsurance, primary companies are increasingly scrutinizing their reinsurance purchases by retaining more business net, and by attempting to shift from proportional placements to excess of loss. With the exception of more pressure on seeding commissions other reinsurance terms are generally holding.

On insurance, we continue to shift our emphasis to smaller accounts and loss sensitive business where pressure on rates is less. Large premium accounts as I mentioned before, continues to attract the most competition. We have grown in the following sectors; professional liability, construction surety, national accounts, and executive assurance. Our professional liability growth emanates from our travel accident business, which is included in the professional liability line because management responsibility lies there.

Our executive assurance, is experiencing actually negative growth in the U.S. and Bermuda, while is growing its non-U.S. exposures in small to medium size companies predominantly in Europe. The growth in construction surety and nation accounts is coming predominantly from our loss -sensitive business, national accounts business. All other segments have shown negative growth due to market conditions.

As indicated in our release, given market conditions, we did not renew the Flatiron facility. As a result of this action, our net property and property cat volume will increase, but we intend to remain within our risk management guidelines in our aggregate PML exposures. As we have reminded you in the past in determining our 1 in 250 event PML, we include all exposures that we believe could accumulate in a given event not just the property exposures.

As of February 1st 2007, our 1in 250 PML from a single event expresses a percentage of common equity, was approximately 20% with Northeast windstorm and in Tri-County, Florida being the largest loss.

With that, I am going to turn it over to John to get you through our financial performance. John?

John D. Vollaro

Thank you, Dinos. Good morning, everyone.

From a financial standpoint, our fourth quarter results capped another terrific year, with a return on equity of over 24% driving growth in book value per share in excess of 7% for the quarter, and 25% for the year. As usual, I'm going to briefly walk through the key components of our financial results, starting with the top line, and focusing primarily on the quarterly results included in the release.

Dinos, has commented on some detail on premium volume, but there are few additional items of note. For the year, premium is written by the insurance segment represented 64% of our gross volume, and 59% of our net, while property, and other short-tail lines of business now represent approximately 36% of our consolidated net premium volume. On a consolidated basis, the ratio of net to gross written premium in 2007 remained at approximately 7%.

On a reported basis, we ceded $35 million of written premium to Flatiron in the fourth quarter's of 2007 and 2006. On an earned basis premium ceded on to this treaty amounted to $76 million for the fourth quarter of 2007 in comparison with $62 million ceded during the 2006 fourth quarter. The overwrite and estimated profit commission recorded on the treaty with Flatiron are reflected as a reduction of the acquisition expenses of the reinsurance segment, and improved the expense ratio of that segment by 410 basis points in 2007.

While the impact on their expense ratio in the comparable 06, period was 250 basis points. As Dinos indicated, we did not renew the treaty with Flatiron. The unearned premium on business ceded to Flatiron was approximately $145 million at December, 31 2007. We also expect that an additional $25 million of written premium on existing contracts will be ceded to Flatiron in 2008 primarily. Most of the ceded premium yet to be earned and their related fees including profit sharing if any will be reflected in earnings in 2008, and 2009, but predominantly in the first and second quarter's of 2008. In addition, since we own the rights of the business previously ceded, any newer renewal business return will afford us the opportunity for additional profit.

Underwriting income for the fourth quarter of 2007 was $1.59 per share in comparison with $1.71 per share recorded in the fourth quarter of last year. On a consolidated basis, the combined ratio was 84.4% in 2007 quarterly period, which was slightly higher than the comparable 2006 level. These outstanding underwriting results would do in part to the continuation of the excellent results of the property, and marine business of the reinsurance segment, as well as to the favorable development of prior year reserves. The difference in the combined ratio, quarter-over-quarter resulted from an increase in the loss ratio attributable in part to a lower effect on the loss ratio from favorable development.

On a consolidated basis, favorable reserve development net of related adjustment acquisition expenses, totaled $32 million in the 2007 fourth quarter compared to $33 million recorded in the fourth quarter of 2006. The components when you look at the acquisition versus loss, however were different accounting for the difference in the loss ratio.

A significant portion of the net favorable development in 2007 quarter was attributable to short and medium-tail lines. In general, reported and paid claim activity across most of lines of business, remained at favorable levels, and IBNRs and ACRs remained at approximately three-fourths of our total loss reserve.

Pretax net investment income in the fourth quarter on a reported basis increase by approximately 11% to $120 million or $1.69 per share. Investment income in the 2000 fourth quarter was adversely impacted by $1.6 million or $0.02 per share from mark-to- market adjustments on certain fixed income investments that are accounted for in this manner, because of the legal form of the investments.

There are no such investments in the comparable 2006 period. The growth in investment income on our quarter-over-quarter basis was primarily due to a higher level of average investable assets. This growth was generated by cash flow from operations, which amounted to $333 million for the 2007 quarter, and $1.44 billion for the full year. After reflecting share repurchases, which I will comment on a detail in a movement investable assets rose by 11% to approximately $10.1 billion at year end, and the portfolio remains very healthy, and well positioned.

The total pretax return of the portfolio was approximately 8.3% for the fourth quarter of 2007 and 6.5% for the full year. The average pretax yield of the fixed income portfolio before the effects of the mark-to-market adjustments I just mentioned was 4.95% in the 2007 quarter. This represented an increase of six basis points over the comparable 2006 yield plus sequentially on an adjusted basis the yield was flat.

The increase in investment yield on quarter-over-quarter basis resulted primarily from higher interest rates embedded in the portfolio, as the portfolios average credit quality remain near the AAA level. During the quarter, the duration of the portfolio basically remain unchanged at approximately 3.3 years.

Realized and unrealized gains on the portfolio increased book value per share by $1.1 for the 2007 quarter, and were primarily attributable to interest rate, and currency movements partially offset by the effects of wider credits spreads. Portfolio continues to be comprised primarily of high quality fixed income securities with essentially no investment in hedged or private equity funds.

As Dinos indicated in his remarks, we have included additional data on mortgage-backed securities in our portfolio on page 11, of the release which I encourage you to review. As the data indicates our exposure to subprime securities is minor, and the quality of the mortgage-backed securities is very high as reflected by numerous metrics including their vintage, loan-to-values, subordination, market value relative to costs and current ratings.

In addition, the portfolio contains no CDOs or CLOs. We remain very comfortable with the quality and liquidity of the portfolio, and a result we are position to look for attracted opportunity that may arise as a result of the turmoil, currently affecting the financial markets.

Running through the tax expense we recorded an income tax benefit applicable to operating income of $1.9 million in the 2007 quarter. As you may know, the company's tax provision is adjusted each quarter to reflect changes in our estimated annual effective tax rate.

Moreover, a significant part of the companies catastrophe exports written, business is written by Bermuda subsidiary, as a result the company's effective tax rate is favorably affected in period with a low level of cap losses and adversely impacted and periods with significant catastrophe claims activity.

Primarily due to the below average level of cat losses incurred fourth quarter results included credit of approximately $6.2 million or $0.09 a share due to a downward adjustment to our annual effective tax rate. We currently expect that our annual effective rate on taxes on operating income for 2008 will fall within a range of 2% to 4%.

Our balance sheet is in terrific shape, and our financial flexibility remains strong with total capital amounting to approximately $4.3 billion at year-end, and with debt and hybrids representing less than 15% of the total.

With respect to capital management during the fourth quarter of 07, we repurchased approximately 2 million common shares for a consideration of $136 million. That brought the total number of shares repurchased in 2007 to approximately 7.8 million shares at a cost of $537 million, which represent an average price per share of $69.13 or 1.25 times our year-end book value per share. At year-end, we had approximately $463 million remaining available under the current share repurchase authorization.

On a weighted average basis, the share repurchases were accretive to earnings per share by approximately $0.19 for the 2007 quarter. The effect would have been $0.22 per share if full weight were given to the repurchases in the quarter.

The repurchases also enhanced return on equity for the quarter by approximately 220 basis points, and 150 basis points for the year, for the quarter share repurchases net of accretion reduced book value per share by approximately $0.08 while for the full year share repurchases reduced book value per share by roughly $1.45 on a net basis.

In summary, our 2007 operating results and capital management initiatives produced a return on equity of more than 24% in book value despite the effect of the share repurchases grew over 7% during the quarter, and 25% for the full year.

That concludes our prepared remarks. We will take questions now Tanya.
Question And Answer

Question and Answer

Operator

[Operator Instructions]. Our first question comes from the line of Vinay Misquith with Credit Suisse. Please proceed.

Vinay Misquith
Credit Suisse

Hi, good morning.

Constantine Iordanou

Good morning, Vinay.

Vinay Misquith
Credit Suisse

Thanks for the clarity on the D&O on the E&O exposures. Do you have sense for what the total industry losses will be for such exposures?

Constantine Iordanou

We believe as most believe that the losses would be around $3 billion, but its too early in the game. That number is very, very soft. I don't want you to pay tremendous amount of attention to it, it could be. There is scenarios that they can make it larger, and there is scenario that can make it a bit smaller than that. The thing, I want you to focus on is that, the D&O-E&O, premium for the industries is in excess of $10 billion, and these will effect two years, the 06, and 07 year. So, you got $20 billion worth of revenue the industry is getting from writing these lines. So, even if the loss is double what I mentioned, as a percent, as a loss ratio percent is not going to be dramatic because all other activity within the lines has been benign. So, it is a loss. It will develop overtime. But, at the end of the day, I don't think is changing the market significantly.

Vinay Misquith
Credit Suisse

Thanks, Dinos. When you said your reserves for your losses for 06 and 07, was it based on an industry loss estimate of about $3 billion or was it more based on contract specifications?

Constantine Iordanou

Well, we do two things. One is you said case reserves on specific cases. So, we had a few reported in our insurance group, you make the evaluation and you set up a case reserve for those, and if we had any reports in the reinsurance side, we do exactly the same. The rest of it, we put in our IBNR account and it's a combination of looking at industry estimated aggregate loss and what our market share is. And in the reinsurance division, we look contract by contract and what we believe our maximum exposure will be on a particular contract. The fact that we have not participated on the reinsurance side in the top six writers, we don't have that many contracts for us that give us a concern.

Vinay Misquith
Credit Suisse

Okay, that's fair. And, the second question is the growth in your surety and contractors, if you could just explain that. And also, in a declining economy, how do you see the losses on that business stacking up? Thanks.

Constantine Iordanou

Well, on the D&O lines and this is predominately commentary on the insurance group. We saw reductions because of price pressures in the U.S., and also what we do in Bermuda, which is predominately U.S. exposed type of business. In Bermuda we write the very high excess; a lot of it is Side A and is touching in excess of 100 million in most cases. What we have grown in the D&O area is our initiatives in Europe. We write a small to medium size enterprises that have no U.S. exposure, no ADRs, and no listening in the U.S. exchanges. So, that's the mix in our D&O, E&O book. That was your question or you had something further to that?

Vinay Misquith
Credit Suisse

It wason the surety and contractors, actually. Sorry.

Constantine Iordanou

Okay. I'll get into that in a bit. We classified construction surety and national accounts into one bucket because of the way we manage that grew. On the construction side, we kind of flattish and most of what we write is that medium to larger contractors not the jumbos and a lot of what we do is loss-sensitive. These are our accounts that they will retain the first 100,000 to 250,000 of each and every loss for GL, auto and workers' comp. That's our portfolio.

On the surety side, we have seen a significant reduction in volume for our subdivision bonds, which were a big facility, we write a lot of subdivision bonds. It's not a lot of premium, but we have seen quite bit over restrain by developers in developing a new tracks of land for development. It's the obvious thing. I mean, if they have high inventory of unsold homes and not going to be developing new track that business is performing extremely well for us. The unfortunate thing is that the volume is not as great as we had in prior years, and probably won't be for another year or two. The rest of the surety is predominantly, on commercial contracts and a lot of it is for either federal state work etcetera, and we haven't seen a slowdown, either in activity or request or we haven't seen significant degradation of the financials of some of these contractors. With the exception of some that they on both sides, of they do residential and commercial construction and they go back and forth. So, it's too early, but traditionally surety has not suffered because we go through a softer cycle of course sub-prime. It's going to create some credit crunch and it will affect that sector also, but we monitoring it that and along with our credit committees we make sure that we have enough collateral when we extend credit to these contractors.

John D. Vollaro

Vinay, the thing I would add is when you look at that grouping, the growth is coming out of the national accounts business, the loss-sensitive business. We are not growing the surety book at the movement.

Vinay Misquith
Credit Suisse

All right. Okay. Thank you.

Operator

Our next question comes from the line of Matthew Heimermann with J.P. Morgan. Please proceed

Matthew Heimermann
J.P. Morgan

Hey, good morning everyone.

Constantine Iordanou

Hi, Matt. Good morning.

Matthew Heimermann
J.P. Morgan

I guess I had a couple of quick numbers questions. The first one was John, could you just remind us how much Flatiron -- how much premium you ceded to Flatiron in 07?

John D. Vollaro

Yes. We ceded roughly -- on an earned basis?

Matthew Heimermann
J.P. Morgan

On a written basis, actually.

John D. Vollaro

On a written basis, roughly $280 million we ceded to them in 07.

Matthew Heimermann
J.P. Morgan

Okay. And then, going forward when we think about the premium left to earn, we should be summing the one the unwritten premium, which I think you said was 147 plus the 25 that's going to be written?

Constantine Iordanou

Well this is going to be a little bit of written to.

Matthew Heimermann
J.P. Morgan

Yes.

John D. Vollaro

Well,that's 145 written and 125 near, plus about 25 is our current estimate because it's on a pro rata contracts.

Matthew Heimermann
J.P. Morgan

Okay, perfect. I just wanted to make sure that I didn't screw that up. The other thing was Dinos -- actually, one more numbers question for John was just. Can you give us a sense or Dinos, can you give us sense in the commercial contactors business how much of your book is state federal, and how does -- how does that compare to the industry because a lot of people have been talking about a lot of this is federal or state business, but I don't really have any metric to put that in the contract?

Constantine Iordanou

I don't have that number right in front of me, but we can get it to you. But, usually a lot of what gets bonded is state federal work because it's bonded by law. And in essence, the bigger portion of what we do emanates from those sectors. But, we will get to number. We don't have it right at our fingertips and I don't want to speculate. Speculation usually is not a good thing.

Matthew Heimermann
J.P. Morgan

Okay. Dinos, that's fair enough. I appreciate that. And then a last thing Dinos is just, I guess I would appreciate your views on how the D&O situation is going to play out. Do you -- is your sense that... it's going to take a while for people to figure out losses, but do you think we are going to see the industry establishing case reserves increasingly over the course of the next year or let's say, or do you think what we are going to see is purely companies are going to hold higher levels of IBNR than they have in the past and maybe some -- maybe you actually see a slow down in the release of IBNR from some of this D&O and E&O lines?

Constantine Iordanou

Well, it's kind of early on the games. Each case goes on its own facts and its own merit. And here, you had situations that they are going to be D&O cases, but also their going to be E&O cases. A lot of the E&O cases potentially would be for the large investment banks, which they were selling these kinds of products. It only takes a lawyer with a law degree to draft a complaint. I mean they sue -- and it's going to go basically on the merits. For the insurance business, not a lot of investment banks E&O has been purchased because it's a cover that was not really readily available for them. So in essence, the big investment banks are going to be on their own, when it comes to the E&O side.

On the D&O, of course, they are going to be their allegations too. The Side A is probably much more protected on the basis that we don't see any investment banks going bankrupt. So, Side A will give you derivative actions and bankruptcy. The rest of it, I think is got to go case -- case by case. Companies, they are setting reserves when they have the facts, but seems this is got so much notoriety also, companies they are trying to add to their IBNR because -- believe me, if I had a clearer picture, I'll be able to elaborate further. So, at least what we do is we try to get a global view what our market share is, insurance and reinsurance etcetera. Look at our specific cases, reserve those and then throw IBNR, which is now judgment should cover the rest of it. That's the approach that we take. I believe it is not that I have inside information that most companies have a similar process to that.

Matthew Heimermann
J.P. Morgan

Okay. Thank you.

Operator

Our next question comes from the line of Brian Meredith with UBS. Please proceed.

Brian Meredith
UBS

Thanks. Good morning, Dinos, and good morning, John. A couple of quick questions here for you. First, just quickly on the D&O situation, how much of your business is primary versus excess?

Constantine Iordanou

We have almost zero primary, we are predominantly an excess writer.

Brian Meredith
UBS

Okay, great. And then, on Flatiron, can you give me a sense of how much of that Flatiron business actually renews it one-one in the business you ceded and then, on top of that, how much business the Flatiron do you think you can keep here going forward without going above what your target threshold PML is?

Constantine Iordanou

Well, it vary by the two years. So, I am going to give you blended -- because it depends when we make decisions. But, January 1, I would say somewhere between 35% and 40%, you know, not January 1, the first quarter of each year [ph]. Our determination is to you know how much we are going to retain, is going to be depend on what the pricing is, and what aggregate PMLs, you know we want to retain on a net basis. As I said in my prepared remarks, we were not going to exceed our maximum risk management limit with just 25% of common equity you know at the maximum.

I will guess and this is depending, if the markets stays where it is today, probably you're going to see you know our PML go to maybe 22% to 23%, right before the season, but I can't tell you exactly which contracts, we are going to renew, and which contracts we are going to cut back on. It will depend on the available pricing in the marketplace and that's the way we allocate PML, aggregates, we go deal-by-deal, we see where we think the potential for maximizing our profit is, and that's where we allocate the PML capacity. But, we are going to have that overarching limit of PML capacity, and our intention is to use it. We still like the pricing even though the pricing was about down 15%, the year-over-year on the cat business, we still believe is it gives us adequate returns for the risk that we are taking, so we continue to be in that sector.

Brian Meredith
UBS

Great. And then John, could you give us some help here with how you expect the reinsurance expense ratio to kind of play out throughout 2008. I mean it looks like you've been getting a benefit of about three points a quarter on your expense ratio from the Flatiron commission income. So that kind of just gradually wind down every single quarter to the end of the year?

John D. Vollaro

And I think I will be weighted more towards the, you'll get more benefit in the first and second quarters from the write-off of the Flatiron business, because they earn premium comes in, they'll still be getting benefit, and then the increase in the acquisition ratio purely itself. Now to the extent obviously we write additional business, and retain it for ourselves, that's going to be a kind of balancing factor, and how that plays out is just going to be a function of how much business we do take on, and then whether, or not its pro rata versus excess.

Constantine Iordanou

Catbusiness is usually success, and even though pro rata contract will give you a cat component, but on, if we will increase our excess business that comes at a much lower expense ratio it's the nature of how these contracts say operate, so it's very hard to predict the expenses ratio, because I've got to have the deals deal-by-deal and determine if the quota share, which they have the high ceding commission also high expense or excess of laws, which they give you a very low expenses ratio.

John D. Vollaro

And we are basically agnostic as to whether it's one or the other it's just where we think we can get the best risk adjusted return.

Constantine Iordanou

Right, the economics will drive a determination as to where we play.

Brian Meredith
UBS

Okay. And then last question on remind us as to kind of dividend for us. Any thoughts is implementing a dividend here any time soon?

John D. Vollaro

Well we are at the movement, we are still obviously have a lot left under our authorization and of course the board can always increase that again if they desire, and where we are currently is we still especially based on where the stock is today, and when you look at what we, the intrinsic value is of the company, we think it's a better use of the money to buy stock back at these levels, at some point, something we continue to think about all the time, and at some point in the future, that the scales may tilt in the other direction, but I say for now it's still rather, we rather used the capital or buyback stock.

Brian Meredith
UBS

Okay.Thank you.

Operator

Our next question comes from the line of Susan Spivak with Wachovia. Please proceed.

Susan Spivak
Wachovia

Good morning. Dinos and John, I was hoping you could go into a just a little bit more detail on the insurance side about the level of competition. We've just been hearing so much about how intense it is gone, and especially in the excess and surplus lines markets from a lot of the new players coming in and so, just wondering if you can talk a little bit about what your strategy is going forward, and what you are seeing in those markets?

Constantine Iordanou

Yes, let me, the, we see two things on the E&S side, yes we see more competition, it comes from two sources. The class of 01, if you refer to us, has been in this business now for five, six years, along with the domestic players. The new entrants is the class of 05, with some of them starting to set up E&S operations, and go after their business, but more importantly also the standard markets is trying to call back some of the business that shouldn't have gone through the E&S market, but it did and now they will write in on at immediate basis. So that was going, so the price is shrinking a bit, so we are writing less of it etcetera. From a pricing point of view, I can only give you on numbers, in the third quarter of 07, this segment for us, which includes both umbrella excess, and primary surplus lines. It was down 6% in rate. In the fourth quarter, it was down 7.9% in rate, that's on the business that we have renewed, and kept. The business that we have lost of course had a high percentage reduction in that. That's what happening in that particular segment, you know of the business.

Susan Spivak
Wachovia

So the new business pricing is down more than double than of the renewals?

Constantine Iordanou

No, no what I said is our, the business we have renewed and kept on our books, we lost 7.9% average rate.

Susan Spivak
Wachovia

Okay.

Constantine Iordanou

On business that we didn't renew, we lost to competition, the rate reduction was greater than 7.9%.

Susan Spivak
Wachovia

Okay, great. Thanks, Dino.

Constantine Iordanou

You're welcome.

Operator

Our next question comes as a follow-up from the line of Matthew Heimermann with J.P. Morgan. Please proceed.

Matthew Heimermann
J.P. Morgan

Hi, just two quick follow-ups on Flatiron, and one was John I guess maybe I wouldn't like the ceded earned premium from Flatiron last year, and the other thing was would you be willing to give us the PML, as of year-end, if you excluded the benefit of Flatiron. I mean the reinsurance protection you get from Flatiron as if that was all gross equal to that there?

John D. Vollaro

Probably it's a little tricky to do that only, because of the Florida business, if I gave it to you in the Northeast it might be more appropriate. I don't think it would be that dramatically different from where we are right now.

Matthew Heimermann
J.P. Morgan

Okay.

Constantine Iordanou

You see are agreeing don't forget the Flatiron cover our business return out of Arch Re Limited in Bermuda and we have other portions of businesses that they contribute to our PML like our U.S. operations, which is for the Northeast, they can be a factor, they don't the reinsurance operation in the U.S, they don't write a lot of Southeast win, but they do write Midwestern hail and tornado and some Northeast business, and of course, we have the insurance group, and the insurance group contributes to that. But, the business that we do in Bermuda, and we were at 55 to 45 split the PML usual is split on that same basis for that portion of the exposure.

Matthew Heimermann
J.P. Morgan

Okay, and John.

Constantine Iordanou

John is working on some numbers.

Matthew Heimermann
J.P. Morgan

I was going to say your point on Florida basically reflects the fact that there is probabilistically you don't put a lot of risk in your PML at year-end for that business even if there is premium earned, correct? So, in other words if I ask you the PML differential at 7:1 [ph], there would be a bigger differential that you are talking about today?

Constantine Iordanou

Yes what I said is that given the market conditions where they are today, our PML now is at 20% of common equity probably at the beginning of the season. This is just a projection. It might or might not happen, because you don't know what kind of contracts you're going to get. That will probably increase to 22% to 23% that's our estimate right now.

Matthew Heimermann
J.P. Morgan

Okay. All right, that's helpful.

John D. Vollaro

That numbers I gave you was the earned as opposed to the written.

Matthew Heimermann
J.P. Morgan

Okay, do you have the written then.

John D. Vollaro

Yeah,let me get you that. You are working on your model I guess?

Matthew Heimermann
J.P. Morgan

The multi-tasking.

John D. Vollaro

The return was about 310.

Matthew Heimermann
J.P. Morgan

310. Okay, perfect. Thank you so much. Was it that obvious I was working on my model?

Constantine Iordanou

Your model is pretty good though, we will compliment you on that.

Matthew Heimermann
J.P. Morgan

Thanks.

Operator

[Operator Instructions]. Our next question comes from the line of Ron Bobman with Capital Returns. Please proceed.

Ron Bobman
Capital Returns

Hi, good morning, congrats and fine job.

John D. Vollaro

Hi, Ron.

Ron Bobman
Capital Returns

I had a question about your insurance business and your approach to buying reinsurance, whether you are buying more, buying less and if you talk about it on sort of the sub-segment lines of business in sight of the insurance book? Thanks a lot.

Constantine Iordanou

Let me -- we were net underwriters when we write exposures for what we call small accounts with small limits. So, usually in a lot of it in our professional liability, when we issue $0.5 million, $1 million dollar policies etcetera, we like to underwrite on our net account and we keep that know 100% net. When it comes to capacity products, D&O is one, or property is another one or large professional liability exposures or medical malpractice for hospitals. Our approach there is to buy reinsurance. And usually, we want to retain of 25 million capacity somewhere between $10 million to $12.5 million of net of that, so somewhere between 40% to 50% of the line net. The exception of that will be property that even when we put 100 million capacity, we only retain maximum of 15% -- $15 million net line or 50% of the $100 million.

Our philosophy with reinsurance is as follows; you want to protect your book of business both on a horizontal basis and on a vertical basis, we make those judgments. And then depending on what the market will give us, we determine if we're going to by more or less. Right now, our tendency is to buy more reinsurance rather than less in the sectors that require capacity because we believe, the pricing is not that detrimental to us. So, in essence we might have a positive arbitrage in the marketplace. The other thing we do is, we might switch some covers from a pro rata to an excess of loss, especially like the excess of loss in our course. And this is not unusual for companies to do in a softening market. They might switch some of the play. So, the bottom line is I think we are buying a little more and also I think in some of our programs, we are switching to an excess of loss if we can.

Ron Bobman
Capital Returns

And no change on what you sort of described just the small capacity business?

Constantine Iordanou

No, we -- as a matter of fact, those are the lines that basically, none of us more business is experiencing rate reduction that exceed 5%. A lot of then, we have segments that's are flat, we have segments that, their only 1% or 2%. It's not a good picture because you still have trend going against you, maybe the frequency is still good, but the severity trend is increasing. But, in a market that everything is going down when you're getting flat or 1% or 2% or 3% reductions, it's a much better business to keep. And also, is not as volatile because you don't have significant limits exposed.

John D. Vollaro

And Ron, that's obviously where we sit today and something we look about and think about all the time. We always try to be in a position so that we can adjust to what's going on in the market in a variety of ways, and reinsurance purchasing is one of them.

Ron Bobman
Capital Returns

Understood.Thanks again, and best of luck.

John D. Vollaro

Thank you.

Operator

[Operator Instructions]. And there are no other questions at this time.

Constantine Iordanou

Well, thank you, ladies and gentlemen. We are looking forward to seeing you next quarter. Have a good day.

Operator
That concludes the presentation. You may now disconnect. And have a great day.