S&P Global
Market Intelligence

Chubb Limited NYSE:CB

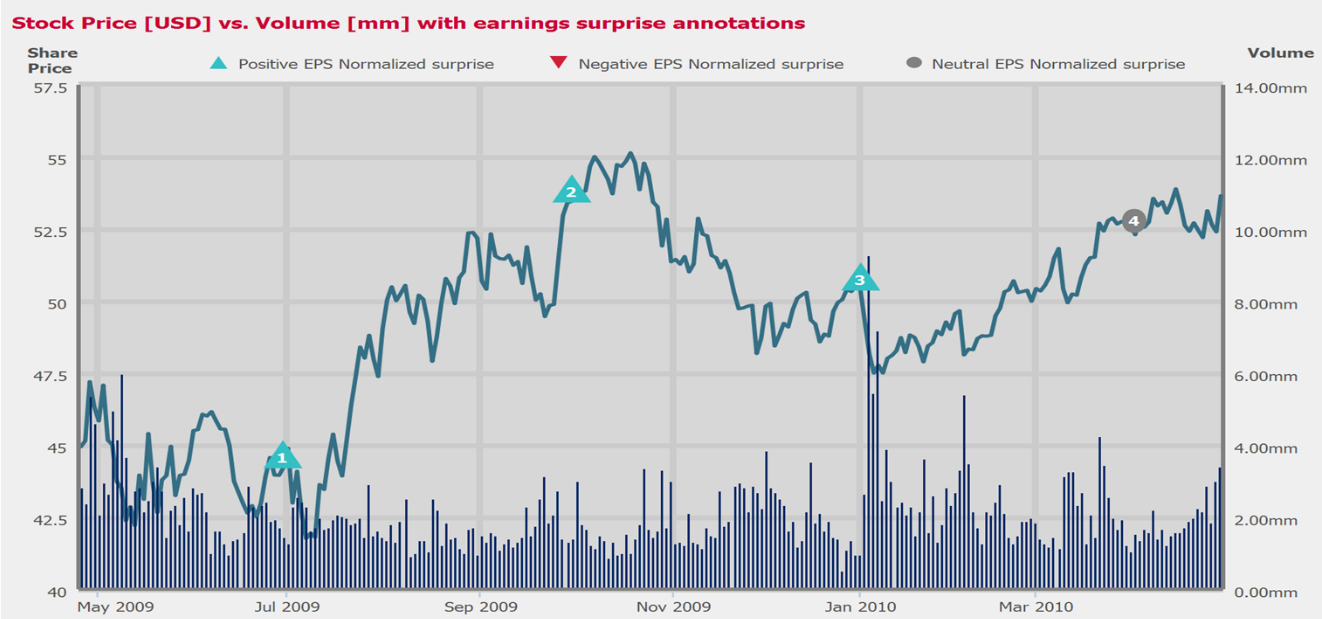
FQ2 2010 Earnings Call Transcripts

Wednesday, July 28, 2010 12:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2010-			-FQ3 2010-	-FY 2010-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	GUIDANCE
EPS Normalized	1.83	2.01	▲9.84	1.68	7.10	6.75
Revenue	-	-	▲0.99	-	-	-
Revenue (mm)	3386.47	3420.00	-	3210.14	13202.45	-

Currency: USD
Consensus as of Jul-28-2010 5:11 AM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ2 2009	1.94	2.09	▲7.73 %
FQ3 2009	1.96	2.07	▲5.61 %
FQ4 2009	1.94	2.01	▲3.61 %
FQ1 2010	1.70	1.70	●0.00 %

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EXECUTIVES

Brian Dowd

Evan Greenberg

Helen Wilson

John Keogh

Phil Bancroft

Sean Ringsted

ANALYSTS

Brian Meredith
UBS

Cliff Gallant
KBW

Greg Locraft
Morgan Stanley

Ian Gutterman
Adage Capital

Jay Cohen
Bank of America/Merrill Lynch

Jay Gelb
Barclays Capital

Keith Walsh
Citi

Matthew Heimermann
JPMorgan

Mike Grasher
Piper Jaffray

Paul Newsome
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Thomas Mitchell
Miller Tabak

Vinay Misquith
Credit Suisse

Presentation

Operator

Good day and welcome to the ACE Limited second quarter 2010 earnings conference call. Today's call is being recorded.

Now, for opening remarks and introductions, I would like to turn the call over to Helen Wilson, Investor Relations. Please go ahead, ma'am.

Helen Wilson

Thank you and welcome to the ACE Limited June 30, 2010 second quarter earnings conference call.

Our report today will contain forward-looking statements. These include statements relating to economic and insurance industry pricing and other trends, our financial outlook and guidance, competition and growth prospects, all of which are subject to risks and uncertainties. Actual results may differ materially.

Please refer to our most recent SEC filings as well as our earnings press release and financial supplement which are available on our Web site for more information on factors that could affect these matters.

This call is being webcast live and will be available for replay for one month. All remarks made during the call are current at the time of the call and will not be updated to reflect subsequent material developments.

Now, I'd like to introduce our speakers. First, we have Evan Greenberg, Chairman and Chief Executive Officer followed by Phil Bancroft, our Chief Financial Officer. And then, we'll take your questions. Also, with us to assist with your questions are several members of our management team.

Now, it's my pleasure to turn the call over to Evan.

Evan Greenberg

Good morning. As you saw from the numbers, ACE had an excellent second quarter which contributed to a strong first six months. After-tax operating income for the quarter was $688 million, just over $0.02 a share. Net income was $677 million and was up about 27% from the second quarter last year. All divisions of the company made a contribution to results, a strong contribution.

Per share book value grew almost 4% and now it stands at over $63 and book value per share is up 8% year-to-date and our ROE was 13.8% in the quarter, up from 12% in the first quarter. Our combined ratio for the quarter was 89.7%, which included net catastrophe losses mostly from U.S. events of $76 million and favorable prior period reserve development of about $150 million.

Cat losses were more than double the amount from last year, but largely in line with our expectations, while prior period development was a little less than prior. Our accident year combined for the quarter excluding cats and PPD was $92.1 million, a very good result and flat with prior year, with the loss ratio down and expense ratio up. Phil will provide more detail around the current accident year numbers.

I want to make a few comments about the macro and insurance market environment and its impact on our company. Economic growth was weak, particularly in Europe and the U.S. and it remains so, while conditions are considerably better in Asia and Latin America. Unemployment in the U.S. and Europe remains high and likely will for years to come.

In the U.S., there is generally a lack of confidence among consumers and business alike and with little meaningful impetus for sustained economic growth; we are likely in a period of prolonged slow growth. In addition, insurance market conditions remain competitive with prices generally soft and softening around the world. I expect these macro conditions will be with us for the foreseeable future though there is much uncertainty.

On a reported basis, our total company net premiums were flat in the quarter. Commercial P&C was down. A&H, personal lines and Life were up. We continue to practice what we believe is prudent cycle management in our commercial P&C businesses, shedding exposure where prices in terms are inadequate to generate an underwriting profit.

Our new business writings were down year-on-year and our renewal retention rates, particularly in our retail P&C businesses were up. Recession-related reduction and exposures are moderating and had less than a 2 point impact on revenue in the quarter, the lowest in a number of quarters.

Retail insurance again performed better than wholesale with retail up about 1.5% while wholesale was shrinking about 6%. Adjusting for a large loss portfolio transaction we wrote last year in North America, as well as less crop premium in our U.S. wholesale business, retail commercial P&C was actually up over 7% and wholesale was up 3%, though our growth benefited from a positive foreign exchange impact of about 2 points.

On the wholesale side of the business, we continue to shrink our book where necessary due to inadequate pricing. For example, premiums were down about 8% in our London wholesale business where competitive London market conditions continue to impact nearly all lines including marine, aviation, energy and property. In our U.S. wholesale business premiums were down about 7%. Adjusting for the crop, however, premiums were up 15%.

As I mentioned in the fourth quarter, we wrote a large program that moved to ACE because the insured was seeking a more secured carrier and we had the capability. This had a substantial benefit on our U.S. wholesale growth rate.

On the retail side, commercial P&C in the U.S. was down on a reported basis, but grew 7% after adjusting for that one large LPT transaction we wrote last year.

U.S. retail revenue and wholesale for that matter benefited from a very large new construction project we wrote, as well as higher renewal retention rates, which were up about 2%, though again we wrote substantially less new business than a year ago.

As we detailed during last month's Investor Day, for those areas of our business where a client is engaging us for our capability and not simply price, business is less cyclical, less commodity-like.

We experienced higher retentions, better pricing and firmer terms and conditions. These include areas such as the primary lead layers of excess casualty and D&O, our risk management business, construction and multinational global programs. Once you leave these kinds of areas, were specialties such as crop, etc., the business becomes more cyclical, more commodity-oriented.

On the international side, retail P&C was up about 8% on a reported basis and up 4% on a constant dollar basis, driven by double-digit growth in both Latin America and Asia Pacific. Concerning the rate environment, rates for the business we wrote in the U.S. were down about 2.7%, while rates for our international business were down about 1%.

Let me give you two new business examples for our commercial lines. The first illustrates our product capability, the second our on-the-ground local presence globally.

In our North American Insurance division, net premiums in our construction practice were up substantially in the quarter, driven by a large complex long-term public infrastructure project in the New York, New Jersey area where ACE was selected as the lead carrier for the primary, excess casualty and builders' risk covers.

ACE won the business as a result of our underwriting, claims and risk control expertise. Not to mention our A plus balance sheet, a critical requirement for this long-term project.

In our International Insurance business, I just came back from a visit to Latin America, including the stop in Sao Paulo. Our business in Brazil is doing very well, driven by a fast growing and liberalized economy, major infrastructure spending and newly modernized insurance regulation.

Net premiums are up serious double-digits year-to-date. We're experiencing robust growth in commercial P&C, A&H and Life insurance.

Another area where we continue to experience solid growth in the quarter is our young and growing personal lines business both domestically and internationally.

In the United States, net premiums in ACE Private Risk Services are up significantly year-to-date, while our specialty-oriented international personal lines business experienced reasonable growth as well, driven by Latin America and Europe.

Our global personal lines businesses, which are again by-design specialty and focus, are approaching 1 billion at annual premiums and we believe we'll continue to experience solid growth in these areas for the foreseeable future.

In reinsurance, we experienced a reduction in premium levels in our global re-business with both casualty and short-tail lines shrinking in the quarter. Our international life insurance business on the other hand, premiums were up double-digit in Asia, Latin America and the Middle East.

Turning to our access in health insurance business, A&H growth globally was up 5% on a reported basis. That's essentially flat in constant dollars, improving in line with our expectations and what we said in the previous quarters.

Latin America, in particular, exhibited strong double-digit growth in the quarter, while our business in Asia has stabilized and is on solid footing and should return to positive growth.

Meanwhile, earnings at combined insurance were up substantially in the quarter year-on-year, with improvement in both the loss and expense ratio. Combined customer retention ratios, new business writings and growth in agents are all moving in the right direction. In sum, we expect global A&H growth to steadily pick up in the second half of the year.

Before I turn things over to Phil, there are a couple of other noteworthy events. First, as all of you know, earlier this month, ACE returned to both the S&P 500 Index and the Russell 1000 Index. These moves were anticipated as a result of recent changes in their eligibility criteria.

The second event I want to mention concerns the job we have been performing in the last three months, the BP in the Gulf of Mexico. In late April, at the request of BP, our third-party claims administrator, ESIS went into action and assumed the oversight and administration role for the tens of thousands of claims generated by the Deepwater Horizon oil leak catastrophe. ESIS put in place over 1,000 claims professionals, established call centers and opened dozens of claims offices in four states.

After processing more than 100,000 claims, we are now working with BP on transitioning claims handling over to Ken Feinberg, the federally appointed Administrator and his firm. As many of you saw during our Investor Day, our company has very broad capabilities and I think this assignment illustrates that fact as well as our nimbleness and ability to respond quickly.

With that, I'll turn the call over to Phil, and then we'll be back to take your questions.

Phil Bancroft

Thank you, Evan. Our balance sheet continued to grow stronger. Our tangible book value per share has increased about 5% for the quarter and almost 11% for the first half of the year. Our cash flow was $870 million and included positive underwriting cash flow of about $500 million. Our invested assets grew by about $750 million driven by our strong cash flow and the increase in the market value of the portfolio offset by a reduction due to foreign exchange.

Net realized and unrealized gains were about $400 million before tax. The investment portfolio gains including foreign exchange were about $560 million, which were offset by a $160 million increase in the fair value liability of our variable annuity business, driven principally by declines in interest rates and a decline in equity markets. Overall, our investment portfolio is in a $1.6 billion pre-tax unrealized gain position.

Investment income was $518 million. Income on new cash flow was offset by lower new money yields and our investment income was up only slightly from last year. Our net loss reserves were about flat with last quarter adjusted for foreign exchange. Our paid-to-incurred ratio of 103% is higher than a run rate over the past several quarters and was affected by the payment of a number of one-time large claims in ACE Bermuda.

Our reinsurance recoverable leverage continues to drop and now stands at 61%. As Evan said earlier, our accident year combined ratio before cat losses is about flat compared to the prior year.

Our P&C accident year loss ratio before cat losses decreased 1.4 percentage points over the last year. This is principally due to large LPT contract we wrote last year, and higher risk management, and crop premiums in 2009, which carry higher loss ratios.

Excluding these items the loss ratio was flat. In addition, we had changes in our mix of business in North America to lines with lower loss ratios, both long-tail and short-tail. This occurred as we restricted writings in lines where pricing is inadequate and emphasized writings were pricing remains reasonable. In certain causality lines loss ratios are not rising as rapidly as rate and trend might suggest because of the favorable impact from prior year experience.

Finally, loss ratios in all the other lines rose as appropriate. Our expense ratio is up 1.3 percentage points over last year's quarter. This increase is driven again by the large 2009 LPT transaction and less crop, both of which carry low expense ratios. Excluding these items, the expense ratio will be about flat with last year.

The tax rate for the quarter is lower than our normal run rate because of a reduction in tax reserves as a result of the most recent tax audit. Financial flexibility at the holding company level remains strong given our operating company's dividend capacity and low levels of debt refinancing needs over the next five years.

Finally, we now expect to be at the top end of the range of our original guidance which was $6.25 to $6.75.

With that, I'll turn the call back over to Helen.

Helen Wilson
Thank you, Phil. At this point, we'd like to take your questions.

Question and Answer

Operator

(Operator instructions). And we'll go first to Keith Walsh with Citi.

Keith Walsh
Citi

First question I guess for Phil around the guidance. I'm just a little confused with some of the numbers here. So you are at the high end of the range, but roughly $0.60 of reserve releases in the numbers, and then if I am including that in the numbers, aren't you effectively lowering your guidance than if I back that out?

Phil Bancroft

So, we have included the prior period developments that we had in the first half of the year and we've obviously added that to what we think is going to happen for the rest of the year. We've selected the top end of the range and we think it's reasonable and prudent and we think it's in the range of possible outcomes. We're comfortable with that estimate.

Keith Walsh
Citi

The cat loss assumptions are the same embedded in that number as you pointed out in January?

Phil Bancroft

We haven't changed our cat assumptions for the second half of the year. Obviously, the whole year will go up because we had higher cats than we would have expected in the second quarter.

Keith Walsh
Citi

And then the second question just around crop insurance, how large is this business on a gross and a net basis?

Evan Greenberg

On a net basis, it's a few hundred million, about $300 million or so.

Operator

Jay Gelb, Barclays Capital.

Jay Gelb
Barclays Capital

I believe, Evan, you mentioned that the impact from the slow economy on growth was about 2 points and that was the lowest in several quarters. Can you give us a sense if you feel that could stabilize at that level for a while or are we towards an uptick there?

Evan Greenberg

Jay, the industry lags in the recognition of the impact of recession-related exposure reductions and its recognition in premium. Because you generally book an estimate for many large clients and then they report their actual exposures at the end of the period and that will have to do with sales. It will have to do with employment levels, and so we saw a precipitous drop in those as you know over the last couple of years and so you didn't immediately feel that and then you did through '09 and the early part of '10.

My sense is because the economic environment, the growth really has bottomed. We're kind of moving along the bottom. It's very tepid growth that I think you'll just watch that flatten out unless there is a double-dip and then from there, if anything, it will begin to tick up.

Jay Gelb
Barclays Capital

And then just two quick numbers question. The first, what should we be assuming for an effective tax rate going forward on operating income given the benefit in the second quarter and was there any impact of Deepwater Horizon claims in second quarter results?

Evan Greenberg

I'll take the Deepwater Horizon and turn over to Phil, the tax rate. In our second quarter, you would not see an impact of Deepwater Horizon. Any losses we had were contained within the lines of businesses that are exposed to Deepwater Horizon.

Phil Bancroft

On the tax, I would say, our tax rate, this quarter, as I mentioned was lower because of the reserve release in connection with the IRS audit. So I would think historical run rate, we've been running from 18% to 22%, and it depends on where losses occur, where income emerges, so somewhere in that range is what I would do, what I would be thinking about.

Jay Gelb
Barclays Capital

Even though it was 17 for all of 2009?

Phil Bancroft

Yes, as I say. If you go back and look at the last two years, it bounces around, just because of where income emerges or where losses occur.

Operator

Thomas Mitchell, Miller Tabak.

Thomas Mitchell
Miller Tabak

I was wondering if there is an outlook for investment income that would be a little bit more robust. What is your thinking about reaching for a little bit of yield now as oppose to say three months or six months ago and what should we be looking for?

Phil Bancroft

What I would expect is that you won't see a significant change in the make-up of our portfolio, maybe on the edges, tactical changes, but nothing significant, and what we see is that cash flow is offsetting the decline in rates. So as we redeploy the new money, we have enough cash flow to support our investment income and we would expect it to stay relatively constant for the…

Evan Greenberg

Our cash has been quite robust.

Operator

Vinay Misquith, Credit Suisse.

Vinay Misquith
Credit Suisse

First question is on the guidance, just a question on whether you're assuming your second half of your margins similar to last year's second half. Because I am trying to get your number, it seems to me that the margins in the second half of this year would have to be better than the second half of last year?

Evan Greenberg

Vinay, look, as you know, we don't get into too much dialogue about the guidance. We don't get into worksheets and the parts and pieces. We selected the top end of our range as the point estimate in a range of possible outcomes. It could turn out that our ultimate number is better, and your ultimate number could always be worse. There is plenty of risk and unknowns in the environment economically, financially, including foreign exchange and the insurance market is soft. You cannot project with accuracy short-tail line exposures and loss experience at any given time.

So we think it is reasonable, it is prudent and I understand how others could rationally come to a higher number, because I understand some may come to a lower number. That's why we selected and I think by signaling the top end of our range, I think we're signaling actually that we feel pretty good.

Vinay Misquith
Credit Suisse

Were there any one-time items like the LPT you had in the second quarter of last year that negatively impacted the second half of last year's margins?

Evan Greenberg

Negatively impacted. From memory, we wrote some LPT in the second half last year and those always come with a higher loss ratio. Remember, those are lumpy, so you can't predict. We could write more or less of that this year. There are individual transactions where they are highly scrutinized in here and we're very selective as we go along writing them, and there you go, but we always have a pipeline that we're looking at.

Vinay Misquith
Credit Suisse

On the frequency and severity trends could you give us a sense for where they are trending and seems that you're keeping your accident to your loss ratio ex-cats flat this year versus last year, because you are starting point was arguably lower than you thought it was. So, if you could just give us a sense for what you're seeing in the market right now for frequency and severity?

Evan Greenberg

Yes, but be careful of that. You just selected one piece which was okay. You are adding rate and trend, but then you are getting the ameliorating benefit of watching prior year experience emerge more favorably and that's what you said.

On the other side of the coin what Phil did say that we are very careful to put out there. There is a change of mix for us as well which is affecting it, and that is as lines of business, particularly in the casualty-related areas, reach pricing levels that produce a combined ratio that is unacceptable to us, we have been shutting and/or shedding that business and emphasizing areas where we still see some reasonable margin and that mix change has had an ameliorating impact on current accident year result as well.

With that loss trends that we are actually seeing have remained fairly benign. They've remained pretty steady. We're not seeing much change to it. But you know what, we're big writers of casualty business and we're not optimists. I don't think a good writer of casualty is an optimist.

Operator

Mike Grasher, Piper Jaffray.

Mike Grasher
Piper Jaffray

I guess following up on this actually the change of mix and how it's impacting. But can you talk a little bit about your outlook on inflation as it relates to loss cost and how maybe you are thinking about that in terms of reserving, particularly given your comments around the global economic landscape?

Evan Greenberg

Our outlook on inflation; two kinds of inflation here. When you look at the macro environment, so let's say, it is characterized by the CPI et cetera, our outlook is somewhere between flat and deflation in the developed economies, such as the U.S. and Europe. On the other side of the coin, when I think about insurance inflation, there are other factors; tort costs, which have been fairly stable, but you are talking about a political environment where we see a lot of nibbling around the edges and pressure building that could result in higher tort costs in the future; medical inflation, which plays a role.

So, while the inflation environment has been reasonably tamed for insurance, when we look out into the future, we do see reason to believe it might tick up. When I look longer-term in the macro, that is out past the next two years or three years and no one has a crystal ball. You could imagine given all the liquidity that has been pumped in fiscal deficits that you could imagine that overall inflation rises as interest rates rise. We're taking bets today on things we're going to payout many, many years from now.

Mike Grasher
Piper Jaffray

Just in terms of the current environment, how much of that do you think has played a role in terms of your frequency of claim activity being stable?

Evan Greenberg

I think it's played a role. There is slack demand. So, there hasn't been a lot of pricing pressure in raw materials and labor costs and all of that so sure. You get to miles driven, which are now coming backup, but which were low and travel, which was low. So, you've got a lot reasons to say that exposure benefited to you.

Operator

Matthew Heimermann, JPMorgan.

Matthew Heimermann
JPMorgan

Two questions if I may, first it looks like the GMDB paid losses are actually starting to decline little bit. I was curious if you could just give some color on whether that's driven by just improved market value adjustments or is mortality actually running a little bit better?

Phil Bancroft

It's not mortality. Mortality has been pretty flat and within our expectation. It is because the account balances are growing and there is less loss on a particular claim. As you see it's marginal. But when you go back to '09, when you look at '09, you can see the claim levels were much higher just because the account balances where at a lower level at that point.

Matthew Heimermann
JPMorgan

Can you gave us a sense of relative to maybe at the beginning of 2008 just the number of whether or not there has been a significant decrease just what the total annuity population has done since the beginning of the '08?

Phil Bancroft

First of all, very little of our book is eligible for annuitization, because there is generally a 10-year waiting list and we haven't reached that point. But as we look at the industry, annuitization rates for companies that have mature books are trending about what we expect and we constantly monitor that.

Matthew Heimermann
JPMorgan

And then for Evan, you don't seem all that constructive on the outlook for the economy, I guess can you just give some sense, now that we've got healthcare put to bed, financial regulatory form, has been passed, I guess what impact is it easier to give a sense of whether there is a significant impact from either of those two events on the insurance industry broadly?

Evan Greenberg

Healthcare, I don't see a big impact on the P&C industry from what we can tell at the moment. It will remain to be seen how it impacts workers' comp. On Reg, in particular, on Reg reform, the industry, as you know, was impacted on the margin from what we can see in the big picture of 2,300 page bill. You look at the systemic risk regulator and insurance for the most part is carved out of that on an individual company basis, they can survey you and deem something.

On the fund and for future impairments or bankruptcies, I think the industry fared well. I was disappointed I can say in the role of the federal regulator, O&I, and the preemption authority that it was or was not given particularly to negotiate international agreements. I think that that does us a disservice both as an industry and as a country, but then from there, Matt, you got to remain a little bit cautious. There's over 200 enabling bills to be written, law on regulation and the devil is going to be in the detail of all of that and so you got to remain vigilant about it, and I don't have enough visibility around that right now.

Matthew Heimermann
JPMorgan

With respect to the systemic case, to the extent that this bill had been in place, let's say, 10 years ago, do you think that is something that may have stymied the development of some of the benefits on the annuity side?

Evan Greenberg

Well, I don't know. I'm not prescient. What I do know is it is one thing to write a set of regulations and to have a regulator put in place to administer. It's another thing to see regulation administered in a vigorous, thoughtful and insightful way. This would have required great insight and when I look back on the crises and I look at the role that current regulators played or didn't play in recognizing accumulations of risk and bad underwriting in the credit business, it doesn't give me a whole lot of encouragement about how regulators will behave in the future.

Operator

Brian Meredith, UBS.

Brian Meredith
UBS

First question, now that we've got an SRA agreement for the Federal Crop Insurance, can you give us a sense of what the financial impact would be in 2011 and can you still earn an acceptable return on capital relative to kind of what your return benchmarks are in the crop business?

Evan Greenberg

We can still achieve a reasonable return on capital for ACE. I'm just going to give you that punch line and ask Brian to now elaborate with some detail around the crop for you.

Brian Dowd

All the SRA holders, we've all signed the agreement for the 2011 year and you think about the impacts from the cuts, they hit both the delivery system and a bit to the underwriting results. One of the feature of the SRA, it redistributed some of the risk reward from the Midwest states to the non-Midwest states, because you think about the underwriting impact is actually going to vary by company, right, and what their individual makes a businesses.

So, regional underwriters focus on just Midwest business while it will clearly have a greater impact than the national underwriters, right? We underwrite the business through Rain and Hail, our MGA and we are one of two national underwriter. So we've remodeled our book over the last years and put the new SRA effect and we think it is a two point impact to our underwriting returns.

The other thing that I'd note about the SRA, it also reduces the downside exposures by reducing the maximum possible loss on SRA and again, that benefit the national underwriters more than the regional underwriters, because there is redistribution of the risk reward. So overall, we think as a national underwriter's business, we come out of the new SRA with some impact to our margin, but it's still a pretty good business for us.

Brian Meredith
UBS

When you say a one point impact, that's a one point impact to your crop business or to your overall kind of North American results?

Brian Dowd

I wasn't particularly clear. I said a few point impact and it's to the crop business only so only (inaudible) crop business.

Brian Meredith
UBS

And then one other quick question, Evan, contingent commissions, Aon, Marsh out there, now starting to collect them. What's ACE's view toward contingent commissions? Should we expect any lift in the expense ratio or asset ratio as a result of this?

Evan Greenberg

No, to that last part. Look, my view on contingent commissions, it's fairly well known, if you like I'll elaborate for you a little bit. First, what I ought to say because brokers are our partners, ACE's is a brokerage company and brokerage is our chosen means of distribution, and we have a high regard to the management of all the major brokerages. I consider the leaders of these firms thoughtful, earnest executives. In fact, I believe we have a constructive relationship with each of them, and that's to the benefit of clients and each of our respective firms, and every firm is different, and each is going to independently determine strategy in the interest of their company.

As a company, ACE has had a long-standing position on the subject of contingent commissions that is in agreement with many customers and certain large brokerages. Mainly, unlike agents, who represent insurance companies, brokers represents their client and as such, we believe contingent commissions for brokers by their nature create a conflict of interest. In fact, if I had my way, clients and not insurers would compensate brokers, but that's just not reality.

Regulators in the U.S. have recently opined on the subject of contingents once again, and they have deemed them acceptable and acceptable practice. Therefore, how prevalent they become will be determined by the marketplace. I have no doubt that if customers tolerate the practice of contingents their use over time will likely become more prevalent, and frankly, I hope that does not occur.

Operator

Paul Newsome, Sandler O'Neill.

Paul Newsome

Sandler O'Neill

You are fairly quickly deleveraging the firm; I know the debt ratios are going down. Is there an optimal debt level or capital structure that you would like over time from a debt or preferred structure and do you think there will be any changes in the near term?

Evan Greenberg

Paul, near-term we don't have a plan of levering, but it could be transaction-related. There you could incur debt in an acquisition or something like that. Our target ratio with the rating agencies is around 20% and our target optimal would be around that 20% to 22% range.

Paul Newsome
Sandler O'Neill

Separately, completely different topic. There have been some notable asbestos environmental events, firemen's going with a charge and this D&A Bercher [ph] transaction, both if you could sort of interpret what's happening differently depending upon which transaction you're looking at. But I was wondering if you had any thoughts on what's happening in the asbestos world clearly given your exposure?

Evan Greenberg

Look, globally, we don't see much change to the environment. New reported levels remain way down, that's been the trend for a while because of fewer unimpaired and less kind of gain by the trial bar of the legal system. The average cost per claim for the seriously impaired such as mesos is higher and these have been and remained the trends as we see it. Individual company reserve adequacy is really portfolio specific and it depends on the individual case experience for each company.

Paul Newsome
Sandler O'Neill

I guess there are series of reviews but can you remind us where we are in this process?

Evan Greenberg

Yes. We conduct a review every year, we do a more through ground up every two years and that is coincident with the state of PA's external auctorial review. I mean we look at it pretty thoroughly every year. This is the deeper dive year in the every two-year cycle and we're in the middle of the studies, and it's too early to speculate about results. It ripens by the fourth quarter for us and I can tell you I sit here and I know my colleagues do. We just have studies that are in the middle, going on and we have no reason to speculate one way or another.

Paul Newsome
Sandler O'Neill

We'll keep our fingers crossed that claims stay low.

Evan Greenberg

You'll light a candle for us.

Paul Newsome
Sandler O'Neill

I will. I will.

Operator

Cliff Gallant, KBW.

Cliff Gallant
KBW

I had two questions. The first, relating to ESIS was working with BP I was wondering if you expect there will be any change in buying behavior by the primaries to get some of the large self-insured. And then secondly, there was a workers' comp company in California that has reported some reserving issues and they're talking about unemployment hurting or changing claims experience that people are having hard time coming back to work. So their workers' comps claims are increasing. I was wondering if you have any comment on loss trends in that part of the industry.

Evan Greenberg

I'm going to first turn over to John Keogh on your question related to BP. I'm going to ask Sean and Brian if they want to expand on the workers' comp, but to say that malingering claims in a difficult economy and that you're seeing more malingering is not an unusual. I mean that's always been. So but let me ask John Keogh to first comment on the BP and then the other guys will come back.

John Keogh

I guess post-BP, and we're a player in this business. Its first end property, you are seeing it, and in fact the property market really limited to the Gulf of Mexico business and there you're seeing property rates rise anywhere from 15 points to 30 points. Now whether that's adequate or not given what's now understood to be the operational exposure as well as the weather exposure in the Gulf of Mexico is for people to decide, but rates were up there on the property side. Really no effect on the onshore market coming from BP, rates continue to on-property, onshore go down.

As respects the liability market, there we are seeing and have seen in terms of submission an increase of activity coming from both E&P companies and drillers, looking primarily to buy more insurance as a result of what they saw going on with BP and what we are seeing there is additional limits being purchased in the neighborhood about $100 million roughly on average, so someone who may be had $750 million of liability cover is now buying $850 million as a general outcome over the last 60 days of purchasing.

On the pricing side, a very different buy type of risk. The big exploration or petroleum companies are seeing market and serious increases in their rates. We've seen renewals go anywhere from 100% to 300% increases in rate per mill for excess liability for the big E&P companies. On the other hand, drillers are seeing more moderate 5% to 15% rate increases as a result of the BP situation. So I think that's a sense of what at least we are seeing in the activity as a result of that catastrophe.

Operator

Jay Cohen, Bank of America/Merrill Lynch.

Jay Cohen
Bank of America/Merrill Lynch

As I look at to your 2Q result and if I back out the favorable development, it looks as if, call it, the accident year ROE is about 10.5%. I don't know it's going to vary a lot by line of business, but you think in general that kind of describes the ROE that you are writing business at today?

Evan Greenberg

Well, Jay I think it probably understates it, because as you know, as we've talked about, we do have capital flexibility and so if I looked on a required capital basis, the ROE on an accident year is higher.

Jay Cohen
Bank of America/Merrill Lynch

I guess on the capital issue, could you give any update of…

Evan Greenberg

It does vary by line of business. Clearly, there are lines of business and look, let's maybe look at perspective here. In ACE, you want to insure you are going to earn roughly 15% minimum in any line over a cycle, okay? But during the cycle, there would be years where you are not going to earn 15%, but our natural governor on that, the way we run our company, is combined ratio.

So you may be a line that's not earning 15%, but if you are still earning an underwriting profit on a reasonable basis not some wild-eyed optimistic, if you are running a true underwriting profit, then we will stay with that line of business, where it crosses our line is when the combined ratio is at or above 100, then what we're shrinking it like mad and that's kind how we see it.

Jay Cohen
Bank of America/Merrill Lynch

I guess on the capital flexibility, are you seeing any more potential opportunities to deploy capital, whether it's potential acquisitions or teams of people or new businesses?

Evan Greenberg

Yes. Pipelines of opportunity are pretty robust right now, the M&A environment around the globe right now, so in total is more active and it will remain to be seen what that all turns into, but it is, and in certain parts of the globe while we are seeing less opportunity in some places, we are seeing, as I described like a Brazil or other parts of Latin America or parts of Asia, we're seeing more opportunity and we're actually quite excited about that and some of those required capital.

Operator

Greg Locraft, Morgan Stanley.

Evan Greenberg

Greg, but before you go, our Chief Actuary, Sean Ringsted, who always want to jump out and talk, actually wants to answer Cliff's question on California workers' comp.

Sean Ringsted

I was just conscious that the call cut away. So you didn't want to think we were ignoring your question. On California, it's a little difficult to look at the tea leaves. If you look at industry data that's come out on the 2009 accident year, the combined ratio for the industry is running well in excess of a 100% combined ratio. What the data does show is little interesting. Severity is down; frequency is up, which is a reversal of prior trends. What's difficult to figure out though is how the economy has impacted in various sectors, so construction, manufacturing are down. So you've got to shift more to services and so on.

So, I guess the punch line for the industry in California is under lot of pressure from Reg erosion. How it impacts our book, that's something we are going through in our portfolio. It depends where you are write, the type of self-insured retention high-deductible that type of business with your primary and so on. So I hope that provides a little color for you.

Evan Greenberg

Greg, sorry, please go ahead.

Greg Locraft
Morgan Stanley

No problem. I just wanted to follow up on the capital deployment question and I guess what I'm struggling with in our numbers is how we should treat that excess capital that's on the balance sheet. Is that capital that's designed to earn a 15 in the future from a return perspective? That's a sort of question one. The second is just, can you just refresh us how you think about share buybacks at this point in time, and the return that it offers versus other opportunities that you're considering in the M&A marketplace.

Evan Greenberg

Sure. First, your question on how to think about it from a return point of view, ACE has an objective to earn 15% return on capital over a cycle, and that means on all capital. So hardly are we going to deploy capital whether it is organically or for acquisition where it will not meet that standard and any acquisition has to stand up to that exact same standard, number one.

Number two, on how we think about it and how we think about buybacks? Look, regarding the equity capital, I think we've been good fiduciaries of shareholder money. We do have a successful track record for acquisitions and organic growth. As we have demonstrated, we've generated superior book value for share growth and ROEs over the last five years and ten years, especially compared to U.S. and P&C industry peers.

By the way, I think our ROE right now is still running pretty good. I mean, you look at it on a risk-adjusted basis, I think it's excellent. We are running the company for the long-term. Our job is to grow the company's book value by growing the company. That is our first objective, our first priority. We need capital to do this. Therefore, we do hold shareholder capital for growth and whether that means through organic means or through acquisitions and the growth would come. We're confident about that. It's just a matter of time. We're patient and the money is not burning a hole in our pocket.

We're also aware, by the way, that we live in turbulent, very uncertain times and there is a lot of risk and a lot of volatility, and you just look at the current environment sub [ph], country crisis, debt crisis, fragile nature of recovery in U.S. and Europe, political or regulatory risk around the globe. So the notion of access to capital markets also, there is sort of just in time capital management that'll always be there for you at any given time at a reasonable price is overly optimistic.

Look at financial market volatility. We're mindful of our responsibility to be good stewards of shareholder money and this means achieving a reasonable return on shareholder capital over any reasonable period of time. If we cannot put it to work productively over a reasonable period, we're not opposed to employing tactical strategies to return that to shareholders, including repurchasing shares.

Frankly, at the end of the day and we give it a lot of thought; we're very confident that the company's interest and those of our long-term shareholders are clearly aligned. Now, making any decision about capital management it includes our Board, and we evaluate the amount of capital we're holding above that which we believe we should hold for risk, we measure that against the environment and have potential opportunities over a reasonable time horizon. We look out two years to three years and we do see plenty of potential opportunity in many parts of the globe, and it is just a matter of timing. So we're patient, we're mindful, and I think we're pretty balanced in our approach about those.

Greg Locraft
Morgan Stanley

Just one follow-up on that is, do you see or implicit in that are share buybacks, and do you think of them as a short-term kind of a way to enhance shareholder returns or do you actually think it works over the longer term?

Evan Greenberg

I see it as short-term.

Greg Locraft
Morgan Stanley

Okay. And then also just on growth, if we look at just the core earnings, ex-reserves and catastrophes, which is admittedly one way to look at it, there hasn't been much growth for five years in the business, and that's given you the high end this year. At what point are the per share growth metrics, i.e. book value per share, etc., so compelling that you might consider something? Or maybe said differently, are there actually going to be a few deals that we can't see coming in the next, let's say, several quarters to a couple of years that will start to change that dynamic in the business?

Evan Greenberg

First, two comments. One, Greg, stay tuned. Number two, when I look at book value growth or any of that or look at earnings, I don't remove reserve development. You wrote that business. It's just what period are you recognizing the earnings in from that business. It's all part of what we've done as a company part and parcel to the businesses that we're in and so we generated that, and whether it comes from current or it comes from prior, I get the difference, but frankly, when I look at book value growth overall, I don't. For me, it's for measuring other indices and other things you talk about.

Operator

Ian Gutterman, Adage Capital.

Ian Gutterman
Adage Capital

I hate to ask a guidance question, but if you see how many emails I've gotten in during this call with confusion about the guidance, I just want to hopefully clarify it for people. The original guidance correct was $390 million of pre-tax cats and no prior period, right?

Phil Bancroft

Correct.

Ian Gutterman
Adage Capital

Okay. So what was the first half cat assumption in that $390 million?

Phil Bancroft

We don't break it out. We don't do that and we're not working on worksheets here.

Evan Greenberg

I get it. It's a slippery sloppy and so we give an annual cat guidance.

Ian Gutterman
Adage Capital

Okay. Even though it might be unsaid, the cat assumption for the year is now going to be higher than $390 million just because first half was above average, correct?

Phil Bancroft

Correct.

Ian Gutterman
Adage Capital

I think that's where some of the confusion is.

Evan Greenberg

Ian, what it is correct, we did not change our assumption, our own assumption for cats in the second half of the year.

Ian Gutterman
Adage Capital

Thank you. That's what I thought, but some people are having a hard time with that.

Evan Greenberg

I understand. Look, I will say it again if it's helpful. There is out of the range of possible outcomes, we have selected the top end of our range as a reasonable and conservative estimate of how our year will turn out.

Ian Gutterman
Adage Capital

And then just one quick question back on the taxes on the non-operating side, it looked a little unusual that you had pre-tax realized gains but after-tax unrealized losses, just what happened there?

Phil Bancroft

Well, we had the benefit from the release of reserves on the IRS exempt.

Ian Gutterman
Adage Capital

That just affected the investment portion then?

Phil Bancroft

Well, we also had the VA realized loss that's not taxable.

Operator

At this time, we have no further questions. I'd like to turn it back over to Helen Wilson for any closing or additional remarks.

Helen Wilson

Thank you, everyone, for your time and attention this morning. We look forward to speaking with you, again, at the end of the next quarter. Thank you and good day.

Operator
Once again, ladies and gentlemen, that concludes our conference. Thank you all for your participation.