S&P Capital IQ

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Arch Capital Group Ltd. NasdaqGS:ACGL

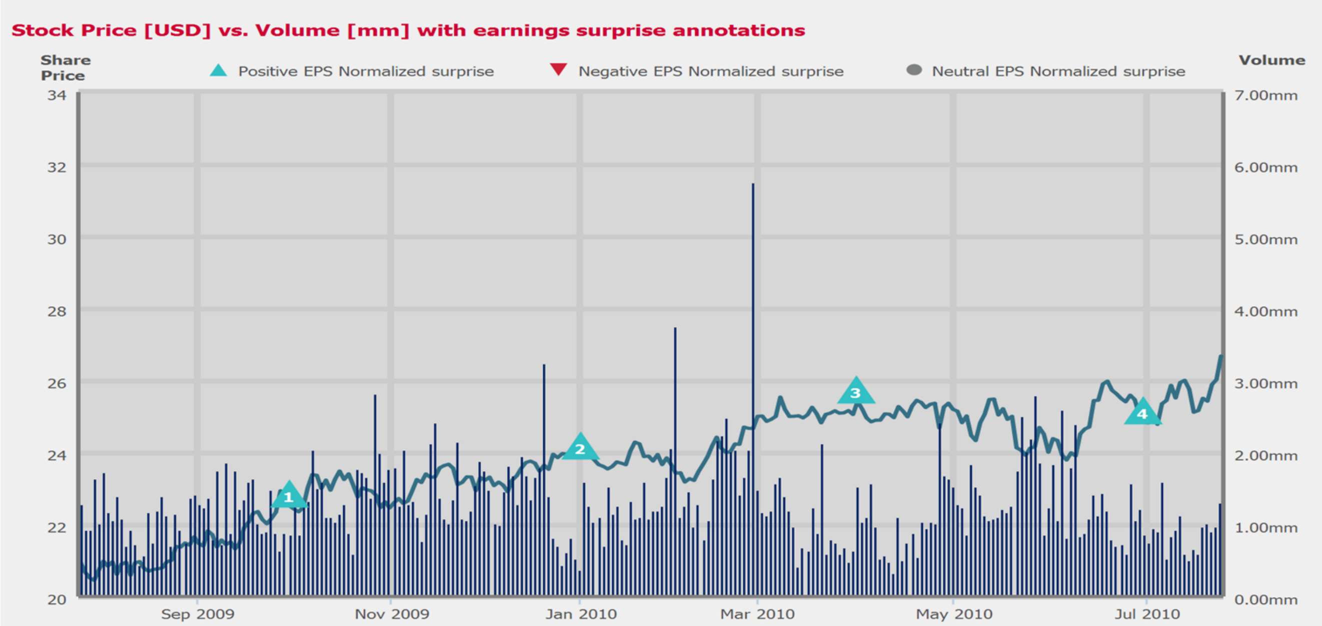
FQ3 2010 Earnings Call Transcripts

Tuesday, October 26, 2010 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2010-			-FQ4 2010-	-FY 2010-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.71	0.85	▲19.72	0.78	3.04	2.89
Revenue (mm)	706.23	636.12	▼(9.93 %)	554.66	2713.63	2656.22

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



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2009	0.79	0.85	▲1 7.59 %
FQ4 2009	0.84	0.89	▲2 5.95 %
FQ1 2010	0.53	0.59	▲3 11.32 %
FQ2 2010	0.77	0.83	▲4 7.79 %

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

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

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Third Quarter 2010 Arch Capital Group Earnings Conference Call. My name is Jennifer, and I'll be your operator for today. [Operator Instructions] I would now like to turn the conference over to your host for today, Mr. Dinos Iordanou and John Hele. Please proceed.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thanks, Jennifer, and good morning, everyone, and thank you for joining us today. Our performance for the third quarter was acceptable as we continued to operate in a challenging environment both for us but also for our customers. Our annualized return on average common equity was 12.3%, which, in our view, is reasonable for current market conditions.

These returns were not negatively impacted by major cat activity and benefited from favorable prior year reserve development. The New Zealand earthquake was a minor event for us and was contained well within our expected cat load for the quarter.

We continue to estimate that under current insurance market conditions and current investment environment, we are achieving, on a normalized basis, a 9% to 10% ROE on business written for the 2010 underwriting year.

This return is realistic given operating and financial market conditions even though it does not meet our long-term targets. In our most important measure for creating shareholder value, which is our ability to increase book value per share, we had an excellent result. A very good total return on our investments, acceptable operating returns on our underwriting activity and share repurchases helped increase our book value per share to $89.24, which is up 22.2% from year-end '09, 8.7% from June 30, 2010, and 28% from a year ago.

From an underwriting point of view, we achieved a 90.4 calendar year combined ratio, which in our view is six to eight points better than a normalized accident year combined ratio, which we estimate to be in the 97% to 99% range. Cash flow from operations remain healthy at $267 million, even though our current book of business is declining and our prior year's book is maturing.

In addition, our mix of business have moved more towards short-tail lines than in the past, which have faster claim payment patterns that affect cash flow.

From a production point of view, our gross written was down 11% and our net written premiums were down about 12.5%. Our Insurance operations went down 19%, as they continue to pursue a strategy of reducing writings in long-tail lines while moving to more XOL contracts on Property business and Property Cat business.

90% of the reduction in volume is attributable to casualty lines as a result of the difficult market conditions we're operating under. Our ratio of pro rata to XOL business is now 43% to 57% as compared to 52% to 48% as of a year ago. The actions we have taken in our Reinsurance business, which I just referred to, had an exaggerated effect on written premiums but a modest impact on overall profitability and a beneficial effect on returns.

On quota-share contracts, terms and conditions continue to remain basically stable, with most of the rate erosion occurring at the primary business level. Our Reinsurance Group continues to emphasize and move the book to less volatile lines and to reduce their writings in the long-tail lines. Over the past five years, our net written premium for short-tail lines in the U.S. and Canada increased by 50%, while our Long-tail business decreased by 16%, with casualty leading the way with a reduction of 70%.

Despite these actions, due to the challenging market conditions that exist, margins continue to be under pressure. Rate changes in the U.S. range from a plus 3% to a minus 10% depending on the line of business and size of account, except for Offshore Energy where increases were in the 20-plus percent range.

In the aggregate, across all of our insurance lines, rates were down approximately 3% for our book of business, which was the same level of rate change recorded in the second quarter of 2010.

Our capital management philosophy 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 in our business. As you can see, share repurchases for the third quarter were light as we are more cautious with our capital position during the hurricane season.

Since the inception of our buyback program, we have invested over $2 billion in our own shares, which is 1.5x the amount of common equity we raised from shareholders over the past nine years. This reflects a culture of shareholder focus that we're very proud of.

As of September 30, we still have $487 million available authorization for share repurchases, and expect to return to a more normal pace of repurchases in the fourth quarter. Before I turn it over to John for more color on our financial results, let me share a few thoughts on our cat writings and PML aggregates.

As of July 1, 2010, our one in 250 PML from a single event was $809 million, or 18.4% of common equity, up from $797 million at July 1, 2010. This PML is for the Florida Tri-County area, and is our largest PML area as expected. Our northeast wing area PML stands at $756 million, up slightly from $733 million as of July 1, 2010. Both zones are significantly below our 25% of equity self-imposed limitation.

With that, I'm going to turn it over to John for more commentary on our financials. And after John, we'll open the call for your questions. John?

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

Thank you, Dinos. For the 2010 third quarter, property and other short-tail lines represented approximately 49% of our net premium volume, compared to 45% in the 2009 third quarter. On a consolidated basis, the ratio of net to gross was 77% compared to 78% for the same period a year ago.

Our overall operating results for the quarter reflected a combined ratio of 90.4% compared to 90% for the same period in 2009. The third quarter loss ratio for 2010 included $24 million, or 3.9 points of current accident year cat activity compared to $5.3 million, or 0.7 points in the 2009 third quarter.

The 2010 third quarter cat activity was primarily related to the New Zealand earthquake, mainly in the Reinsurance segment. As of the end of the 2010 third quarter, the provision for the first quarter cat events, which included the Chilean earthquake, did not change materially. Moreover, both the Insurance segment and the Reinsurance segment experienced a lower level of attritional loss activity compared to a year ago, primarily in the property lines of business.

The 2010 third quarter combined ratio reflected 5.9 points, or $37 million of estimated favorable development net of related adjustments compared to 7.7 points, or $56 million in the 2009 third quarter.

The prior-year development in the third quarter of 2010 reflected favorable development, primarily in property and other short-tail lines, as well as the Reinsurance segment casualty business and the Insurance segment executive assurance from earlier years.

The current accident year loss ratio, excluding large cat events, reflects the lower level of attritional loss activity previously mentioned, as well as the overall impact of the reduced writings of Casualty business that Dinos mentioned.

The 2010 third quarter expense ratio of 33.1% was 3.7 points higher than a year ago, primarily reflecting lower premium volumes, as well as changes in the mix of business and changes to the seated reinsurance structures in the Insurance segment.

On a per share basis, pretax net investment income was $1.77 in the 2010 third quarter, compared to $1.60 for the same period a year ago, and $1.70 in the second quarter of 2010. This growth reflects the accretive impact of the share repurchase program, more than offsetting lower reinvestment yields.

Total return for the investment portfolio was 3.61% in the 2010 third quarter. Excluding foreign exchange, it was 2.94% in the quarter. The net total return benefited from lower interest rates, as well as from the devaluation of the U.S. dollar against many global currencies. However, the impact on book value was offset by a net $65 million increase to the liabilities for currency movements reflected in the income statement.

The duration of the Investment Portfolio increased slightly to 3.11, up from 2.90 at the end of the second quarter of 2010. The increase in duration during 2010 reflects a slight change in yield curve positioning, which benefited the total return as interest rates have fallen.

However, we are carefully monitoring the potential impact of the quantitative easing, now known as the QE2, which is expected to start in the fourth quarter. And we have maintained our ability to move quickly if required due to rising interest rates.

We continue to be conservative with regard to the credit outlook and maintain a AA+ average credit quality on the portfolio.

Our balance sheet is conservatively positioned, with total capital of $5.1 billion at September 30, up from $4.8 billion at June 30, which reflects the limited share repurchase activity during the quarter, the operating earnings and the overall investment results.

The cumulatively shared repurchases since 2007 added $0.17 to the diluted operating earnings per share, or 2.8 points to the ROE. Our debt plus hybrids represent approximately 15% of our total capital, well below any rating agency's limit for a targeted rating.

Last quarter, we gave you a slightly wider range of estimated excess capital to reflect the growing percentage of capital reflected in accumulated other comprehensive income, known as AOCI. To be more specific this quarter, as of September 30, we estimate that including AOCI, we hold approximately $900 million to $1.1 billion above our targeted capital level based on current rating agency models with an appropriate buffer.

However, if we exclude AOCI, our excess capital position would be $500 million to $700 million. Our liquid cash, short-term investments and U.S. treasuries, represent about 23% of our investable assets. With these comments, we are pleased to take your questions.

Constantine P. Iordanou
Chairman and Chief Executive Officer
All right, Jennifer?

Question and Answer

Operator

Before taking any questions, management wants to 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 that 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 on the call that are not based on historical facts are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The company intends the forward-looking statements in the call to be subject to the Safe Harbor created thereby. Management also will make reference to some non-GAAP measures of financial performance. The reconciliation to GAAP and definition of operating income can be found in the company's current report on Form 8-K furnished to the SEC yesterday, which contains the company's earnings press release and is available on the company's website.

[Operator Instruction] Your first question comes from the line of Jay Gelb from Barclays Capital.

Jay H. Gelb
Barclays PLC, Research Division

I just want to follow up on the excess capital position. In terms of what Arch would consider the available excess capital in terms of deploying that into share repurchases, should we be thinking about the $500 million to $700 million range x AOCI?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, I think that's more of a safe number, too. Because AOCI can move and it has volatility, especially in the market that we're operating and the economic environment that we're facing. So if things stabilize, we might change our view. But for the time being, we don't -- it's that old expression that says, "don't count your eggs until they hatch." So that's our approach to it.

Jay H. Gelb
Barclays PLC, Research Division

Now that doesn't assume any further retained earnings going forward, right?

Constantine P. Iordanou
Chairman and Chief Executive Officer

That is correct. That's on static number as of the end of the third quarter of this year.

Jay H. Gelb
Barclays PLC, Research Division

Right. So how quickly should we think that Arch might look at deploying that excess capital into buybacks?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it will depend as where our share price is, and where the market is going. And based on those two parameters, and our ability also to operate within the Safe Harbor in share repurchases, it will determine as to how much we can do on a quarterly basis.

Jay H. Gelb

Barclays PLC, Research Division

And the other thing I just wanted to follow up on is the Reinsurance growth. The premium year-over-year declines, if my numbers are right, around 40% on a gross written basis in Reinsurance in the fourth quarter of 2009. So my sense is that, you're lapping an easier comparison for the fourth quarter of 2010? Is that the right way to think about it?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No. You can’t -- Reinsurance will look deal by deal. We'll look at the market. The major shifts on our book in the Reinsurance -- I'll give you the big picture. The zenith of our Reinsurance activity was back in '04, '05. The Reinsurance Group was about $1.6 billion. We're about -- we're tracking on activity of close to half of that as of today. But more importantly, the Reinsurance Group is mostly property today and property cat; 70% of what we do it in that territory. And we still view the property, property cat area attractive. So I wouldn't just try to see year-over-year comparisons because don't forget, a lot of the Casualty business we had in '09, it was already gone in '09 from '08 to '09. So the '09, to '10, it might be a totally different comparison for the fourth quarter.

Jay H. Gelb
Barclays PLC, Research Division

So I guess what I'm saying is, should we anticipate the overall premium volume in the Reinsurance business declining even more? Or now that you are down to this...

Constantine P. Iordanou
Chairman and Chief Executive Officer

We don't give guidance, so I'm not going to guide you on an answer. But let me give you the parameters. The drastic reduction in our premium volume in the Reinsurance Group is being predominantly Casualty, Long-tail lines, and some Professional Liability. A lot of those reductions already have happened. So we're down to very little remaining. So the pieces that remain is business that we like. As a matter of fact, some of them we’re growing, such as trade credit, or some other areas that we believe the profitability meets our target requirements. So it's not an easy comparison for us because we will look at the merits of our expiring book and make those determinations over the next three months. And probably, the reductions will be less than what we had a year ago. Because the business that we have is business that we like. And we don't see significant price erosion going on.

Jay H. Gelb
Barclays PLC, Research Division

And the mix shift has already occurred?

Constantine P. Iordanou
Chairman and Chief Executive Officer

The mix shift already occurred, that's correct.

Operator

Your next question comes from the line of Beth Malone from Wunderlich Securities.

Elizabeth C. Malone
Wunderlich Securities Inc., Research Division

I have a question on your tax situation. We've heard constantly here that people are looking at changing the tax status for companies located in Bermuda, and some companies have relocated. Just what is your strategy towards that? And are you considering relocating?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I mean, we're happy where we are. I can't predict what the U.S. Congress will do with tax policy for companies in the U.S. But let me remind you, we're a foreign corporation with U.S. subsidiaries. It might affect some of the activity we have with our U.S. subsidiaries, but it's very hard to shadowbox a shadow. At the end of the day, it depends what happens, and then we'll take action depending on that activity. For us, as we've said many times before, the Neal Bill that gets a lot of publicity, will have limited effect in what we do, because there is too many moving parts, excise taxes might go down and underwriting profitability tax might go up. But depending on the current market position, probably, the effect on the overall tax for the company will be insignificant.

Elizabeth C. Malone
Wunderlich Securities Inc., Research Division

And then one other question on your investment portfolio. Would you be comfortable increasing your exposure to alternatives and other more, I guess, you'd call them aggressive-type investments because you're well below what the rating agencies would be comfortable with already? And with the yield so low on traditional type of fixed income securities, what's your strategy for that?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Let me give you more of a philosophical answer, and then I'll turn it over to John to tell you a little more specifically as to how we think about this. At the end of the day, we never want to be aggressive in the investment strategy that we have. We view investments as a necessary part of what we do in our business. And of course, when you have excess capital and your primary business, which is the Underwriting business, is not in the best part of the cycle, you look to try to enhance that. But we're only going to enhance it by taking conservative, measurable investment risk. People who buy our stock, our shareholders, they don't make the determinations to own Arch because we're brilliant investors. I think we're very good investors. We like to be well above average in that, but in a conservative fashion. And we want people to buy our stock because they think we're good underwriters, and we can make very good underwriting decisions. And that's the philosophy that guides us as to what we're going to do with $12.5 billion of investable assets in tough times like now that we're in the down cycle. John, you want to add anything?

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

Sure. I mean, we mentioned in the press release as well as you'll see it in the investment side under investable assets, we are increasing our -- they're labeled other investments by accounting and credit funds and some equity securities. Credit funds is a little over $200 million, about $200 million in equity securities and others. These are a series of portfolios that we're looking at in natural resources and some basic equities, some emerging market debt. These are still under 3.5% of the total portfolio. But we think these offer some nice attractive opportunities right now, relative to other opportunities that are available to us. So as Dinos said, this will always be quite a conservative portfolio across the board in total, but we're just taking this opportunity now to fix some spot to play.

Operator

Your next question comes from the line of Vinay Misquith from Credit Suisse.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Was this quarter's results favorably impacted by some extraordinarily low-level of large property losses?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. It was a quarter that, both on the Reinsurance side and Insurance side -- and it wasn't just property. I think it was aviation too and short-tail related. The attritional activity was better than expected, especially from large type of losses. And in a company like ours, we write a lot of these specialty covers, you can get quarters that behave as such.

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

And I think we mentioned this on prior calls, that as our book is shifting more to short-tail lines of business property and other things, it's going to be a little more volatile from quarter-to-quarter in terms of what happens. If a building burns down or if it doesn't, and that flows through.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

And did I hear you right when you said that the normalized or combined ratio with cats would be about 97% to 99% x favorable development?

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

Yes. That is a normalized cat activity. So if you take normalized cat and eliminate favorable reserve development from prior years, and you look at the business you're writing today, based on the investment climate that we have, new money invested, we believe that the ROE is in the 9% to 10% range, and the combined ratio is somewhere between 97% to 99%, combined ratio.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

And with rates are coming down, do you see that declining to the mid- to high-single digits next year?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, don't forget, I can't predict what's going to happen next year. Don't forget, our mix continues to change. We try to move to lines of business that give us better returns. So not trying to predict the mix, it's very hard to answer that question. Not every single line of business is experiencing price reductions. Some lines have stabilized and they're in the slight positive from a rate point of view. Of course, we have a lot of lines that's still in the negative, and you have trend working against you. And that directs you to continue changing your mix of business. And as you've seen, some of our areas of growth came from unusual or areas that we found more profitability in the last year or two. And then we took advantage of those opportunities.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Could you comment on frequency and severity trends, please?

Constantine P. Iordanou
Chairman and Chief Executive Officer

The frequency trends continue to be favorable. Severity is starting to stabilize and inching up a little bit. But those trends, they're positive in nature. The big question there, Vinay, is do you believe that they're going to continue, or do you think that they might change in the future? I mean that's a judgment for managements, and reasonable people can get to different conclusions. Some people might be more optimistic than we are, and would think that this thing will continue forever. And others they say, well, enjoy it for the year that it happened, and it's going to get a more normalized over the future. We watch those numbers, our actuaries spend a lot of time looking at frequency and severity trends, and we do it by being a family, each one of our product lines. But in general, the environment is still good. From that perspective, from the frequency, severity perspective.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Has frequently not stabilized at very low levels?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

And this frequency's really at all-time lows now versus the past?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I'm sorry? I didn't get the question.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Are frequency levels at all-time lows now versus the past?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. Well, it depends how far back you go. But for the past, I would say five to 10 years, yes. They're in very -- they're trends, they've been very favorable now for four, five years in a row.

Operator

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

Joshua David Shanker
Deutsche Bank AG, Research Division

I wanted to ask this question: what's happening in the National Account businesses? You grew it well last year and it seems like this quarter, there is this different pullback in premium volume. Is there more competition there? What's happening exactly?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it's not pullback. We lost a couple of major accounts. I mean the National Accounts business is a lumpy business. It's a big accounts, they come with big premiums. A lot of it is retrospectively rated, and a high-service intensive kind of business. But we had one major account that, through a merger, we lost the opportunity to participate. And you're going to get that lumpiness on a quarter-to-quarter basis because when you're hunting for elephants, sometimes you shoot them, and sometimes you don't.

Joshua David Shanker
Deutsche Bank AG, Research Division

I was thinking maybe, you can clarify, I thought it was kind of sticky business because nobody wants their employees to have to change their servicing.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Absolutely. It's very sticky business, but when you have a merger of two large companies, and they're going to merge the program, and you happen to be two different carriers, the acquiring company didn't want to change. And unfortunately, the client we had was being acquired. So in essence, we lost the opportunity. Some cases, you're going to lose some of these accounts also on the basis that underwriting, they might want to extract terms that you may not be willing to do. So you have to have the willingness to walk away from business if you believe that the profitability is not consistent with your long-term targets.

Joshua David Shanker
Deutsche Bank AG, Research Division

And do you have an opinion as to the degree to which -- some competitors of yours is saying that pricing is perhaps, showing some signs of improvement. Obviously, you don't agree with that. To what extent do you think -- where are we in the cycle? How long before there is some sort of pricing term?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I didn't say I disagree with them. It depends where they are. Overall, I think, and as you've seen it, we believe it's still -- the environment is more negative than positive. But on different sectors, especially if you're in the small account business, et cetera, if there is more pricing power for those accounts, we see with our program business, you've seen it, but the smaller the account and the more dependent on distribution, that it doesn't have a lot of competition, you have more price stability. The larger the account, that's where most of the mega battles go on with premiums being cut significantly. And we have readjusted our posture and the book of business over the last four, five years because these trends are not new trends. These trends, they continue now for about four, five years. We haven't seen an uptick yet that is significant in pricing. When that happens, is because there is stress in the system, and the reverse will happen. The small accounts are not going to get a significant increase because probably they’re priced reasonably well, and it's the large account that's going to get the most significant increases. So the volatility of the business will depend by size of account. And it always happens. In every cycle I went through, large accounts usually, they're more volatile on the way down and on the way up in pricing.

Operator

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

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

First, I was wondering if you could discuss the -- with respect to the Executive Assurance, the premium declines there, was any of the decline related to accounts maybe reverting back that you picked up during the financial crisis that reverted back to precrisis carriers? Or was all of that driven by just pricing indication?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I will attribute most of it on account selection and pricing, especially on the financial institutions and commercial D&O space. And we think we have a terrific team underwriting. And we allow them to make those judgments. There's been pressure on pricing, and we don't believe that's justifiable. Some of our competitors think it's still very good business, so we have walked away from accounts.

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

And then with respect to the PML, or the excess capital, I guess, as I think about, I kind of at this point, it seems like the mix shift PML is probably the biggest or disproportionate driver of your excess capital. One, do you think that's correct? And two, I would presume that you probably, in this type of environment, don't want to go right up against kind of the 25% threshold? Given that if something did happen, you probably wanted to have room the next day to write business? My other question would be, is that a correct assessment as well?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, in general, yes. I mean, we always want to maintain our capital requirements on the A+ level by the rating agencies. Plus a cushion above it that the combination of expected earnings for a year plus the cushion, will give us enough room that if we have the one in 250 then we begin the year and we end the year with A+ capital adequacy based on the rating agencies' models. So in essence, your question is correct. I want to be standing even if I get a little wounded. It might be small flesh wound and be able to capitalize the day after a major event. And that's the way we've been running the company for the last nine years. And as long as this management team is around, it will continue to be in that fashion.

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

Matt, maybe just -- I want to clarify that so you understand that. When we talk about our excess capital, this is the amount above our target rating for capital which is A+, plus the buffer that Dinos just spoke about. So the numbers we give you are above that -- our targeedt level is the rating plus a buffer. And the buffer is there in order if there is a big cat event. That, plus the earnings in the year, we have lots of capital left to write business.

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

I guess I'm just trying to translate that into an easier metric for us on the outside to look at. And that's why I was wondering if whether it was reasonable to think about in the current environment, given cat prices have come down, that they're probably -- is that fair then that the 25% is probably too aggressive to kind of...

Constantine P. Iordanou
Chairman and Chief Executive Officer

I don't view 25% as too aggressive. But you're also right. If pricing was better, you'll see us more -- as a new terminology, being overweight than underweight. So we're a little bit underweight right now and probably it's because of pricing.

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

Which would impact our excess capital. We would tend to use some of that more for going to 25% if that was good returns versus other things.

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

The other question, just John, to follow up on your yield's curve positioning, a comment relative to potential changes in the bond market related to quantitative easing. And I think you're talking more about the consequences out over the next 12 months than what the bond markets has already done, I think, in response of potential easing. But I guess, could you just give us a sense of tactically, how you think you’re positioned today relative to any increase in -- or I guess what's your base case for kind of how the yield curve may change over the next 12 months and if you reposition, where would you likely expect those changes to come kind of across durations?

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

Well, we increased the duration this year, these past few quarters, primarily through buying slightly longer treasuries. And we did that so that they're liquid, they're easy to sell out of if you need to quickly. Or you can always add a derivative on top if we want to move quite quickly and then go shorter. And the reason is it's very hard to predict what the impact of this is going to be. If QE2 works well, like I think the Fed hopes it does, then rates are going to go up. But it may not. I mean we're on uncharted territory here, so we're trying to be well positioned no matter which option happens.

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

I guess maybe a different way to ask that question, I guess, today, are you disproportionately exposed to a parallel shift and the curb relative to flattening, or vice versa?

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

No. I wouldn't say disproportionately, I guess it depends on your baseline. We're spread out evenly. The whole duration's 3.11, and it's spread out over the next period of time to get you that sort of duration. But it's not super barbelled or anything if that's what you're thinking about.

Operator

Your next question comes from the line of Brian Meredith from UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

First one on back on the excess capital. I'm just wondering, your appetite potentially to take on some additional debts here given the incredibly low rate environment and potentially using that for excess capital and buying back stock?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We don't aspire to that philosophy. In the way we construct the balance sheet, we always want to have room for debt and hybrid in case of the unusual event. Because we believe that if the market turns on a dime because of something big, and we have competitors that -- they're in difficulty from a capital point of view, we'll be able to take advantage of that opportunity without us having the necessity to go and reissue common stock. Also, depending where the cycle is, we have much more of a willingness to have more financial leverage on the balance sheet. In a good cycle, I don't mind financial leverage going up to 30% or thereabouts, where in the soft cycle, I'd rather have less financial leverage than most, because it gives me that flexibility. At the end of the day, you have to be preparing for the day after, after a major event. And not only our philosophy about keeping excess capital but also, how the capital structure is constructed is very important to us. So for the time being, we want to continue to have low financial leverage on the balance sheet.

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

And Brian, even though -- interest rates are relatively low rates. The spread over treasury is not at an all-time low. It's getting better slowly throughout the year, but not something you would say "I'm going to rush out and do this because this is a deal of a lifetime." And I think we work off the spread when Arch issues debt. We immunize it with matching treasuries on the other side. So the net cost to the shareholder is only to spread.

Brian Robert Meredith
UBS Investment Bank, Research Division

And then the second one, on the 9% to 10% ROE, Dinos, I guess, a couple of questions there. One, what are you assuming with respect to investment yields? Are you assuming whatever the yield is in your current portfolio? Is that new money yields? And then also, what do you assume with respect to trend in that number?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We were assuming new money investment yield.

Brian Robert Meredith
UBS Investment Bank, Research Division

Which is below where you are right now?

Constantine P. Iordanou

Chairman and Chief Executive Officer

I'm sorry?

Brian Robert Meredith
UBS Investment Bank, Research Division

It was just probably below where your current portfolios yields are right now, right?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, but not significantly below. Because in the -- when I talked to our Chief Investment Officer et cetera, he's able to maintain. Don't forget our portfolio turns significantly every year. We've got $3.5 billion to $4 billion turning over between new cash flow and things maturing. And he's finding opportunities to maintain close to our embedded yield. So we view that as the normalized capital that you're going to use to write that business, not a lot total including the excess capital, because that will be fooling you on the calculation. And also, what is a normalized yields on new money invested. That's the calculation we go through when we give you those numbers. That's why in my prepared remarks, it says normalized.

Operator

Your next question comes from the line of Mark Dwelle from RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

First, building on the answer to the last question, your preferreds come up for redemption early part of next year. So to the extent that you decide to redeem those, would you be just diverting then funds from common stock buybacks in order to do that? Or would you be more looking in terms of a refinance there?

Constantine P. Iordanou
Chairman and Chief Executive Officer

If we redeem them it's because we have the ability to replace them with the same kind of securities at a lower cost. So if that happens, the option to call them is ours. We're going to exercise only that option if I can improve the economics. But I'm not changing the capital structure.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

And second question is, you commented in the report about exiting the aviation market. And there was a fairly sizable reduction then in the amount of business written in the marine aviation energy line. Was all of that reduction, simply the aviation going away? Or was a portion of that declines in those other items that are in the…

Constantine P. Iordanou
Chairman and Chief Executive Officer

It was predominantly the commercial aviation and some space business. And our decision to exit it was more as to what we think the prospects of that business is over a 30-year period of time. We didn't think that when you put the good years, the bad years and you mix it all together, the return over a long period of time is not good enough for us.

Operator

Your next question comes from the line of Jay Cohen from Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Last quarter, you had mentioned that some of your casualty reserves in the most recent accident years had shown some deficiencies. And I'm wondering if you can update us on that? Did you see a similar thing this quarter?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No. There was no change in casualty reserves for this quarter. And basically, what we said last quarter, it was -- we had something specific to a big account we wrote back in the '03, '04 year. And then it was a little bit on the Executive Assurance area because made of related. That's the only thing we talked last quarter. And none of that had any affect on this current quarter.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Another management team in a conference call earlier today suggested that they were seeing less of a trend of standard insurance companies taking business from the E&S market. So that trend was declining. Are you seeing any signs of that happening in your business given that you are a big E&S player?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it is off a bit. But let me tell you, in the last two years, it was a massacre. They haven't seen anything on the E&S that they didn't like to write it on an admitted basis. But that movement has happened already. So the E&S market will shrink and expand based on the cycles. And right now, it has shrunk enough, in my view, maybe more than it should have. But I wasn't on the call, I don't know whom you're referring to. But if it's a directional issue, I think, it's accurate, that it's less now than it was maybe six months, a year ago. But it's still happening. It's not zero but directionally, there is a little less of that.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Last question, broker renumeration, what's happening there as far as overall commissions?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, there is pressure for increased commissions. And at the end of the day, you negotiate on account by account, and you got to factor that in your pricing. But if you look at our numbers, probably year over year and you've got to adjust for mix, which is why you don't have all the clarity that we have. We're probably paying close to another point or so in commission, if you take it product by product. So the effect -- and that effect, it wasn't just overnight, it happened over the last couple of years. When premium rates -- let me rephrase that. When premium volume for the whole industry is coming down, and this is the fourth year in a row we're going to have less premium written, there is more pressure for the brokers and agents to be asking for a little more on commission and eventually, finds its way into our financials. So there is pressure there.

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

Well Jay, in our published ratios, if you look at the long-term trend, it's what Dinos has mentioned, plus this mix, it's quite a big impact. Because we shipped into much a smaller business, SME-type businesses, mid-sized accounts, and that really has quite an impact.

Operator

Your next question comes from the line of Keith Walsh from Citi.

Keith F. Walsh
Citigroup Inc, Research Division

Most of my question have been answered, but just one, if you can comment on, what are you seeing out there in the competitive market regarding terms and conditions on policies? I'm getting a lot of -- I'm hearing a lot of deterioration going on there?

Constantine P. Iordanou
Chairman and Chief Executive Officer

The terms and conditions were not an issue in the last three, four years prior to the last year. It's in the last year, 18 months that -- so the softening of rates, it was mostly pricing. Prices that were coming down but terms and conditions they were pretty stable. We've seen -- they beginning -- well, it's not today, it's been for about 18 months or so. We've seen the beginning of the erosion of terms. But it's not in the same fashion or craziness we've seen in '98 or '99 or 2000. And what the future will bring is anybody's guess. But there is more pressure, more requests by clients, the brokers for broadening terms. And in some cases, some companies acquiesce to that.

Operator

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

Ian Gutterman
Adage Capital

Can you remind me on the fac side, what limits your rate to?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Which side?

Ian Gutterman
Adage Capital

The facultative business, how big is the offer?

Constantine P. Iordanou
Chairman and Chief Executive Officer

On the property fac?

Ian Gutterman
Adage Capital

Yes.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Net or gross?

I guess, net.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Our net is $25 million. Our gross line is $100 million.

Ian Gutterman
Adage Capital

And then what sort of -- I mean obviously, I spent a favorable line as far as experience this year, what sort of a normal, if you will, a normal once-a-year type of bad quarter? I mean is that several $25 million losses? Assuming it's not from a...

Constantine P. Iordanou
Chairman and Chief Executive Officer

Our average limit on that business is a little less than $12 million. So we don't write a lot of accounts without the big net. So we haven't yet had a $25 million loss. So it's lumpy business but we've been at it now for over 3-plus years, and we have done very well. I think we have one of the best teams and the very good underwriters. And we're happy with the product line and what they do for us in the marketplace.

Ian Gutterman
Adage Capital

I was just trying to get some sense to the sensitivity if you do have a bad quarter...

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's lumpy, as we said. I mean this quarter's accident year was better, because we didn't have any large -- what we would call attritional losses, right?

Ian Gutterman
Adage Capital

And then if I can take another stab at the excess capital. John, if I just do some math here, right, the 18% PML you discuss is obviously $800 million of P&L, over $4.4 billion of equity. If I take that to your 25% limit, that's $3.2 billion of equity, right? $800 million over $3.2 billion, which implies $1.2 billion difference. So that implies, if I take away the $900 million to $1.1 billion of excess, that your cushion you're talking about is only $100 million to $300 million, is that right?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No.

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

Did you put the expected earnings over a year?

Ian Gutterman
Adage Capital

Well, I'm seeing -- but if we had a big cat event tomorrow, I mean, why do we have to assume that the earnings come in in a year?

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

Because the goal is we want to have it over a 12-month period. We would recover enough to have the business. So we get the count, the expected earnings that will flow out from our book of business.

Constantine P. Iordanou
Chairman and Chief Executive Officer

And the other area you have to go, Ian, is from a rating point of view, is your total capital, not just common equity capital. But you left some $625 million out of that equation. Because we've got $300 million long-term debt and we have $325 million of perpetual preferreds, so that counts as capital. So you can't ignore that as part of the calculation as to what is your rating agency capital requirement and how do you go about it.

Ian Gutterman
Adage Capital

But when you talk about an excess, I thought you give the PML target as a percent of equity. So when you're talking this excess, is that including that capacity or is that just equity?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, it's total capital, right?

Ian Gutterman
Adage Capital

I mean the excess number, the $900 million to $1.1 billion, is that including your unused debt capacity? Or is that $900 million to $1.1 billion of excess equity plus you have excess debt capacity on top of that?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Let's start from the beginning. At the end of the day, rating agencies, they look at all your total capital you're operating with. The common, preferred and debt. 30-year debt that you get credit.

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

What you have today.

Constantine P. Iordanou
Chairman and Chief Executive Officer

What you have today, okay? So in essence, that's the part that we allocate to the operating units and that's the part that we got to give them some cushion to operate above it. The fact that we chose 25% of common equity as a target, it's immaterial to that calculation. That's a risk measure. It's a risk tolerance measure. And I don't count my long-term debt in my perpetual as my own capital. So in essence, I don't want to take risk on that. I'm only taking risk on the common equity.

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

What comes from the PML.

Constantine P. Iordanou
Chairman and Chief Executive Officer

So if you do your calculations now in the same fashion you've done with common, you get to the same place as we are.

Ian Gutterman
Adage Capital

I understand that part. I guess what I'm concerned about is, if I took $1 billion out of your equity, right, if I assumed you did $1 billion buy back tomorrow just for argument's sake, you go from $800 million divided by $3.4 billion, you’d be at a 23% PML. And then if you had an $800 million event the next day, the $3.4 billion goes down to $2.6 billion, which would be 30% of equity. Knowing the way the rating agencies work, although you and I would argue that you should have a year to earn back and get back to your 25%, realistically the. . .

Constantine P. Iordanou
Chairman and Chief Executive Officer

No. Even if that happens, don't forget, you've got to add up the other capital that I get credit for it, right? So this is a company who writes $2.5 billion of premium, and if you do the calculations correctly, you will know that I would still have A+ added with capital.

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

Plus, Ian, this target is our target, Arch's target as a percent of common equity that we've set as a risk measurement system. It wasn't dictated by the rating agencies to us. And rating agencies will, in major events, they do give you some time to recover because not everybody calls. We have the time to repair our balance sheet and they take that into account in all their ratings when they look at it.

Ian Gutterman
Adage Capital

I guess I’m trying to do this math on the fly here, but your 25% equity limit is about a 21% of capital limit. I guess -- so is your rating consistent with the 21% limit? Or are you able to go up to a 25% of capital and still maintain your rating?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We can go to 25% of capital and still maintain our rating.

Operator

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

Gregory Locraft
Morgan Stanley, Research Division

I wanted to get a sense on -- from a bigger picture perspective, the mix of business between Reinsurance and Insurance. And bear with me, as you guys really shrink the Reinsurance business based on your commentary, the total overall book seems to be more and more skewed towards Insurance, not because you're growing Insurance but because it's shrinking less. My question is that that segment has not generated nearly the profitability for the last couple of years that the Reinsurance segment has. So how should we be thinking of that mix shift? Or do you even think of it at your level going forward, over the next several quarters and years?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We think about it, but we don't have any targets for it. Because at the end of the day, you've got to allow the business to run independent, and see what is available in the market and what they are writing. All I can tell you is that the major adjustments in Reinsurance have taken place already, because most -- unless the property and property cat business, which is a possibility, goes extremely negative and is unprofitable. Then you will see further actions. [indiscernible] of that, I think, you're probably getting more closer to a steady, steady kind of run rate there. Having said that, Insurance had significant shift even though volume-wise, it might not be noticeable to you. When you look at the portfolio from the inside out, you will see that we're writing a lot more small- to medium-sized accounts than ever before, and we're in lines of business that they were insignificant a few years ago and they're more significant today that give us pretty good profitability. Collateral protection, for example, it's an area that we've been in it since the beginning. This is a company we have in Kansas City. It writes predominantly a GAP program. For those of you who don't understand what the GAP program is, you buy an automobile and you buy your insurance, but let's say it’s on a lease, and then you have an accident, or the automobile is stolen, and then your primary insurance, under the comprehensive, will give you the Blue Book amount. And that might not be good enough for the balance you have on the lease, the GAP program covers that differential. That business has been a small part of what we did. We went through the financial crisis. It performed extremely well, and now there is more opportunities to grow it, and we have chosen to grow it in the last year, year and a half with excellent results. So there is transformation in our book of business that might not be totally visible to you. And it happens based on what we believe the ability of ours is to get an adequate return. Now having said that, probably because of certain lines of business, which is more volatile property, property cat, it has more volatility in those, you have a higher return expectations. And since we do more of that on the Reinsurance side, over the long term I can tell you our Reinsurance operations will have better ROEs than the Insurance operations. Having said that, there will be more volatility on top line for the Reinsurance Group. They will grow exponentially in the good times, and they will probably shrink significantly in the soft to maintain that ability for us to have the higher ROE performance.

Gregory Locraft
Morgan Stanley, Research Division

And you had mentioned just now in the thoughtful answer that the ROE in Reinsurance is higher than Insurance, I guess that's across the cycle. Why is that? What structurally is the reason?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, structurally the reason is because there is more volatility on that business and for that reason, your return expectations have to be higher. If you give me a contrast that to a low-frequency, low-severity type of business, I will probably accept that 10%, 12% ROE, because it comes steady with very low volatility over a long period of time. But I will not write property cat over a long period of time with the same ROE expectations. My ROE expectations have to be in the 20s for that type of business.

Gregory Locraft
Morgan Stanley, Research Division

So embedded in your pricing model then, there's a lower ROE expectation in Insurance given the more predictable income stream from that segment?

Constantine P. Iordanou
Chairman and Chief Executive Officer

In general, that is correct. But you got to go line by line and product by product.

Gregory Locraft
Morgan Stanley, Research Division

And then just a miscellaneous question, how do you guys think about the mortgage put back in foreclosure issue? Anything we should be concerned about in your particular book, or no?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Not from a liability point of view. It's a non-event for us in our book of business. Having said that, maybe we might get a little uptick on the investment side. Because in essence, when Pimco and BlackRock et cetera, they're doing this on behalf of clients. And I'm sure somewhere in our mortgage-backed security portfolio, we may have an issue. We might get a little benefit. But it's insignificant. It's nothing that worries us.

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

And so far in the MBS, where all the prices -- the pricing hasn't really fundamentally changed with all this noise in the paper so far. I mean we'll have to wait and see how it all develops.

Gregory Locraft
Morgan Stanley, Research Division

Just your thoughts on solvency, too? Does it have any impact to you and what do you think it does to the the marketplace?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, they haven't finalized it all. Two things are clear is that capital requirements will go up more on the life sector than the P&C sector. And when capital requirements go up, if you're reinsurer, which is another form of capital for potential clients, you might give us some opportunities to deploy some capital when that happens, especially in Europe for companies that they may not want to access the capital markets, and they might want to do it through Reinsurance. So for us, solvency too, other than other than the administrative, bureaucratic process is that it might add a little cost, is more of a positive from a capital point of view, because we are a company, through our reinsurance operations, that is willing to be a capital provider to clients if they need it through reinsurance contracts.

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

I think it's still early to understand the amount of the impact. All firms, European firms, including our European subs are working on the quantitative impact study #5. That's due at the end of October. And that will be assimilated and gone through. And then next year, they'll probably recalibrate the models once again. And then everyone has a better idea as to what it would be. But I think the general consensus is it's going to result in higher capital, and it will be interesting for how European mutuals and others look at this. So we think there could be an opportunity here for Reinsurance solutions to help with that.

Operator

There are no further questions at this time. And we'll now turn the call over to Mr. Dinos Iordanou for closing remarks.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thanks, Jennifer. Thanks, everyone, for attending. I know it's lunchtime, so enjoy your lunch.

Operator
Ladies and gentlemen, that concludes today's conference. Thank you for your participation. You may now disconnect. Have a great day.