S&P Capital IQ

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American Financial Group, Inc. NYSE:AFG

FQ2 2009 Earnings Call Transcripts

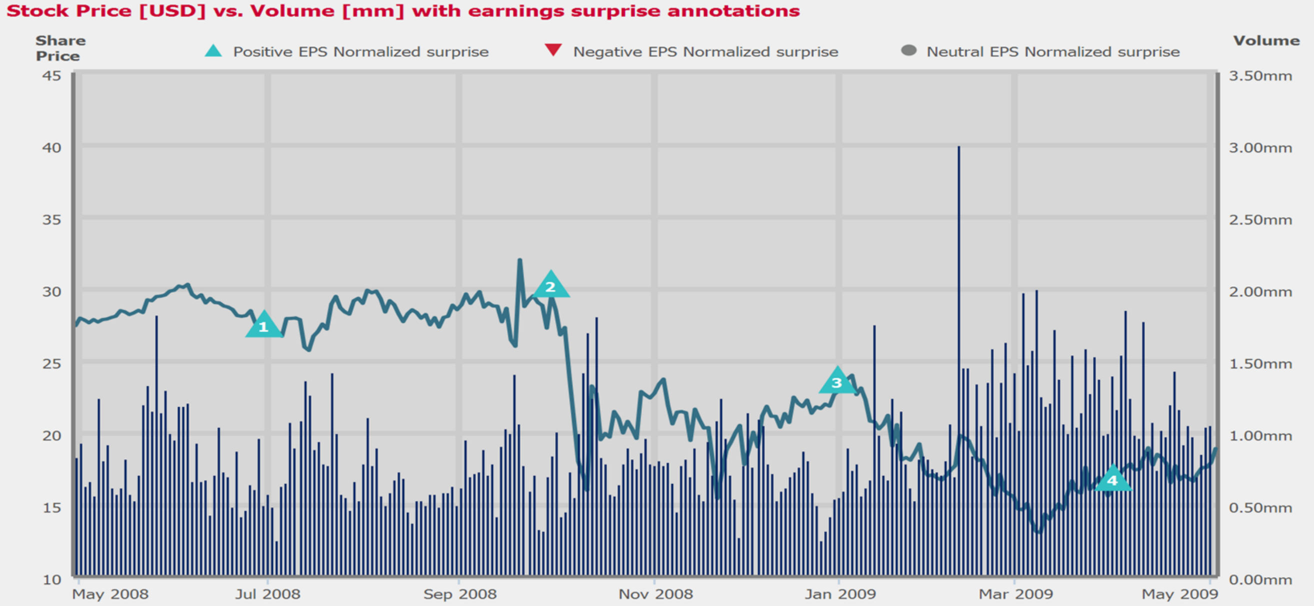
Wednesday, July 29, 2009 3:30 PM GMT

S&P Capital IQ Estimates

	-FQ2 2009-			-FQ3 2009-	-FY 2009-	-FY 2010-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.92	1.01	▲9.78	0.94	3.92	3.78
Revenue (mm)	522.50	589.00	▲12.73	853.60	2435.20	2519.40

Currency: USD
Consensus as of Jul-29-2009 1:38 AM GMT

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



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2008	0.90	0.96	▲1 6.67 %
FQ3 2008	0.95	0.98	▲2 3.16 %
FQ4 2008	0.94	1.04	▲3 10.64 %
FQ1 2009	0.98	1.11	▲4 12.12 %

Call Participants

EXECUTIVES

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

ANALYSTS

Amit Kumar
Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Presentation

Operator

Good morning. My name is Andrea, and I will be your conference operator today. At this time, I'll like to welcome everyone to the American Financial Group 2009 Second Quarter Earnings Conference Call. [Operator Instructions] Thank you. Mr. Jensen, you may begin your conference.

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

Thank you very much. Good morning, I'm here today with Carl Lindner III and Craig Lindner, the co-CEOs of American Financial Group. We're pleased to welcome you to American Financial's 2009 Second Quarter Earnings Results Conference Call. If you're viewing the webcast from our website, you can follow along through the slide presentation if you'd like.

Certain statements made during this call are not historical facts and may be considered forward-looking statements. It based on estimates, assumptions and projections, which management believes are reasonable, or by their nature, subject to risks and uncertainties. The factors which could cause actual results or financial condition to differ materially from those suggested by such forward-looking statements include, but are not limited to, those discussed or identified from time to time in AFG's filings with the Securities and Exchange Commission, including the annual report on Form 10-K and quarterly reports on Form 10-Q. We do not promise to update such forward-looking statements to reflect the actual results or changes in assumptions or other factors that could affect these statements.

Core net operating earnings is a non-GAAP financial measure, which sets aside items that are generally not considered to be part of ongoing operations, such as realized gains or losses on investments, the effects of accounting changes, discontinued operations, significant asbestos and environmental charges and certain other non-recurring items. AFG believes this non-GAAP measure to be a useful tool for analysts and investors in analyzing ongoing operating trends, and will be discussed for various periods during this call. A reconciliation of net earnings attributable to shareholders to coordinate operating earnings is included in our earnings release. Now I'm pleased to turn the call over to Carl Lindner III, Co-Chief Executive Officer of American Financial Group.

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

Good morning, and thank you for joining us. We released our 2009 second quarter results yesterday afternoon. Even with the continuing challenges in the economy, we believe AFG's strong operating results reflect the successful execution of our specialization strategy.

Turn to Slide 3 of the webcast for some highlights. Our record second quarter net operating earnings of $1.01 per share were up 5% from the second quarter of 2008. Improved underwriting results in our Specialty Property & Casualty Operations and higher investment income were offset somewhat by lower results in the Annuity & Supplemental Insurance Group. Record core earnings per share for the first six months of 2009 were up 4% over the same period in 2008. In the first half of 2009, our annualized core operating return on equity was a strong 18%. Our net earnings of $1.09 per share and for the 2009 second quarter, and $1.98 for the first half of 2009 were substantially higher than the 2008 periods, primarily because of realized gains on investments which include the offsetting effects of impairment charges.

As you'll see on Slide 4, we were very pleased with AFG's book value per share, including all unrealized gains and losses on investments, increased to $26.48 as a result of improvements in the net unrealized losses on investments, coupled with our strong earnings. That was about an increase of 23% from the $21.54 per share reported at the end of 2008, we're very pleased with that. AFG's generated a annualized return on equity of about 17%, including realized gains and losses for the first six months of this year. Craig and I thank God, our great management team and our dedicated employees for the great quarter.

In addition, our capital adequacy, financial condition and liquidity remain strong, and are key areas of focus for us, particularly in this unstable economic environment. We've maintained capital on our insurance businesses at a levels that support our operations and that are consistent with amounts required for our rating levels. Our financial leverage is at the level committed to the rating agencies and the capital markets.

In June, we were pleased to complete the offering of $350 million of the ten-year 9-7/8% Senior Notes. Proceeds were used to pay down our revolving bank line of credit that matures in 2011. This offering provides us with additional financial flexibility and liquidity, albeit at a higher rate of interest. Annual interest expense associated with the notes will increase approximately $16 million after tax or $0.14 per share based on average short-term borrowing rates on the bank facility over the past 12 months.

At the end of June, available liquidity at the parent company was in excess of $400 million, with cash and cash equivalents in our operating companies approximating $1.4 billion. We anticipate continuing to generate additional capital and cash through operations during the second half of this year. Last week, our wholly-owned subsidiary, Great American® Life Insurance Company, was approved for membership in the Federal Home Loan Bank of Cincinnati. This will also provide our Annuity and Supplemental Insurance operations with a substantial additional source of liquidity.

Now if you turn to Slide 5, Great American®, we're pleased to say, was recently named to the 2009 Ward's 50 list of top performing property and casualty insurance companies. Each Ward's 50 company has passed various safety and consistency screens, and achieved superior performance over the five years analyzed satellite. Considering that over 3,100 property and casualty companies were evaluated by Ward's, we're pleased that our performance has been recognized in this manner for the third consecutive year.

I'd like to review the results of our Specialty Property and Casualty Operations now. Overall, underwriting profits in the 2009 second quarter were excellent, generating a combined ratio of 82, a six-point improvement over the second quarter of 2008. The largest component of this improvement was $42 million of underwriting profit from our run-off automobile residual value insurance operations, which resulted from significant improvement at used car values during the first half of the year. Additionally, lower catastrophe losses contributed to these results.

Recognizing that our financial results have benefited from these favorable developments, we're pleased that we achieved the accident year returns in the mid-teens. In general, we've not seen widespread evidence, inflationary influences in our claims trends. We set reserves using loss development factors that spanned 15 to 20 years and reflect a number of economic cycles. In addition, we take changes in case reserves into account. As a result, we believe that AFG's overall reserves are sufficient, though we continue to monitor the impact of the increasing federal deficits. We continue to price our business to achieve appropriate returns. Average renewal rates in the specialty operations in the first half were approximately about the same as in the prior-year period.

The overall decreases in gross and net written premiums for the 2009 second quarter were the result of soft market conditions and planned volume reductions in certain of our businesses. In addition, higher premium sessions under our crop reinsurance agreement contributed to the lower net written premium. Excluding crop, the overall decrease in net written premium for the quarter was about 9%. Gross investment income, related to our Property and Casualty Operations, was up approximately 6% for the quarter when compared to the same period last year, as we benefited from higher yields in the segments portfolio.

Now let me review the results for each of our specialty business groups in Slides 6 and 7. Property and Transportation group generated excellent underwriting results during the second quarter and the first six months, reporting increased underwriting profit and improvements in the combined ratio. Higher underwriting profits were driven primarily by the lower catastrophe losses in our Property & Inland Marine operations and improved results in our transportation operations. Gross and net written premiums declined during the second quarter, primarily due to volume reductions in the Property and Inland Marine and Transportation operations. These declines resulted from continued adherence to our underwriting discipline in a competitive marketplace, as well as a decision to further reduce near-coastal property exposures.

As I mentioned earlier, net written premiums were also impacted by an increase in crop business ceded under our reinsurance agreement. Excluding crop, net written premiums for this group decreased 10% both for the quarter and the first six months of '09. This group's average rates on renewal for the first six months of the year were down 1% when compared to the same period a year earlier.

Specialty Casualty Group continue to produce strong underwriting profits in the second quarter and first half of '09, but at lower levels than last year. The combined ratio was 81 in the second quarter and 79 in the first half of 2009. Gross and net written premiums decreased in the second quarter compared to the 2008 period, largely due to the slowdown in the homebuilders market for our general liability products, and strong competition in our Excess and Surplus Lines business. These declines were partially offset by additional premium growth from market form, which has served as a platform to expand overseas distribution in several of our product lines. Average renewal rates for the first half of 2009 were flat compared to 2008. Rates did increase for some of our casualty businesses and the level of decrease moderated in others.

Specialty Financial Group reported excellent underwriting results for the second quarter and first six months of '09, driven by the improved results in our run-off RVI business that I'd mentioned earlier. Underwriting profit in our run-off RVI business was a result of the favorable trends in used-car prices during the first half of the year. Our remaining RVI reserves relate to domestic and Canadian RVI contracts with Honda. The majority of the domestic leases will terminate by the end of the third quarter this year. Our remaining $52 million of Canadian RVI reserves relate to leases that terminate through the end of 2010. If frequency and severity continue at current levels, we could expect some additional favorable development.

Gross and net written premiums were down for the quarter, as a decision to exit certain automotive-related lines, dampen volumes. Growth in the fidelity and crime and financial institutions businesses offset these declines somewhat. The average renewal rates for the first half were about 3% higher than in the year earlier, due to primarily to increases in rates in our foreign trade credit operations.

Our California Workers Comp business reported a small underwriting loss for the second quarter and first six months of 2009. The group's combined ratio was 101 for the second quarter. Underwriting results were affected by lower prices due to the competitive environment, the potential adverse impact of a disability claim ruling and lower favorable development in the quarter. We are seeing some increases in severity trends in this business, primarily related to increases in medical costs. Gross and net premiums decreased in large measure to the rate reductions in our traditional Workers Comp business in California and reductions in employer payrolls.

Our Republic Indemnity subsidiary filed for rate increases that resulted in a blended premium rate increase of 8% effective July 1. Renewal rates for our business in the first six months of '09 were down about 1%. However, I am encouraged by indications that we're -- we got about 6% plus in the month of July, which is a good trend.

Now I'd like to move on to a review of our Annuity and Supplemental Insurance Group on Slide 8. We continue to be pleased with the year-to-date operating results in this group. Profitability of the fixed annuity line has benefited from the impact of increased spreads during the first six months of '09. Our focus on fixed annuities is particularly advantageous in the current investment environment. Our annuity and supplemental insurance operations help us fulfill our specialization strategy and balance the ebbs and flows of the overall property and casualty insurance market cycles. The Annuity and Supplemental Insurance Group generated pretax core operating earnings in the second quarter of '09 that represented a decrease of approximately 8% from the comparable period in '08. However, through the first six months, these earnings are 13% above the same period.

We believe the focus on healthcare reform and Medicaid cost reduction could expand demand for our supplemental health products. Statutory premiums for the second quarter of 2009 were lower than those in the second quarter of 2008, primarily due to lower sales of indexed annuities in the single premium market. The decrease in premium is consistent with our strategy of exercising financial discipline in the pricing of our annuity products.

We did recently complete the previously announced comprehensive studies of AFG's asbestos and environmental exposures relating to the run-off operations of our P&C group and exposures related to former railroad manufacturing operations and sites, the studies that were done with the aid of respected outside actuarial and engineering firms and specialty outside legal counsel. Similar studies were completed in 2005 and 2007, with an internal review completed in 2008. As a result of this study, we recorded minor increases in the property and casualty group's asbestos and environmental reserves.

At June 30, 2009, the property and casualty group's A&E reserves were $397 million net of reinsurance recoverables as outlined on Slide 9. During the course of the study, there were no newly identified emerging trends or issues that management believes significantly impact the overall adequacy of our A&E reserves. Our survival ratio for asbestos reserves is 10.7 times paid losses and for A&E reserves, it's 9.9 times paid losses. As you can see, these ratios compare favorably with the industry A&E data published by Conning Research and Consulting in June 2009. According to Conning, three-year survival ratios were 8.1 for asbestos reserves and 7.6 for total A&E reserves at the end of 2008. Consistent with our current practice, we plan to perform an internal review next year and an external study in 2011.

Please turn to Slide 10 for a few additional -- for a few highlights regarding our investment portfolio. During the second quarter of 2009, we recorded after-tax realized gains on investments of $10 million, including the offsetting effects of other than temporary impairments of $32 million or $0.28 per share. Stabilization and market conditions particularly with respect to residential mortgage-backed securities and corporate fixed income securities, have led to an improvement in after-tax unrealized losses on investments. After-tax unrealized losses were $344 million at June 30, 2009, compared to $683 million at December 31, 2008. Market conditions continued to improve subsequent to June 30. As a result, we expect continuing improvement in our unrealized loss position.

I'd like to now review the components of our investment portfolio. The vast majority of our portfolio is held in fixed maturities, with approximately 92% being investment grade. Attractive pricing on many fixed income investments has allowed us to achieve healthy returns on this component of our portfolio. We continue to hold approximately 32% of our fixed maturity portfolio and mortgage-backed securities. As of June 30, 92% of our mortgage-backed securities were rated investment-grade, with 81% being rated AA or above. We believe the ultimate risk of economic loss in our MBS portfolio is not likely to be significant in relation to the level of investment which is principally a function of owning almost exclusively senior tranches, as well as having a low cost basis in many securities. Our holdings in non-agency residential mortgage-backed securities are currently running off at a rate of approximately $700 million per year. The book yield on these securities is in excess of 10%. As these securities mature, there will be downward pressure on our investment portfolio yield, as the cash is principally re-invested in high-quality corporate bonds that yield significantly less.

Our holdings of cash and cash equivalents are higher than our historical levels, which provide us with additional liquidity in the current environment and some potential upside in earnings, as we reinvest some part of them. Our holdings in publicly traded common equities are approximately $50 million. We continue to hold a small portion of the portfolio in real estate. We have a history of opportunistic investments in hotels, resorts, marinas and apartment complexes. We have less than $60 million in what would be deemed alternative investments, principally private investment funds. In the aggregate, these holdings represent less than one half of 1% of our portfolio. We have provided additional detailed information on the various segments of our investment portfolio in the investment supplement on our website.

Now I'd like to cover our expectations for the remainder of 2009 on Slides 11 and 12. Because of the strong second quarter results, we've increased our core net operating earnings guidance for 2009 to be between $3.80 to $4.10 per share. The 2009 expected results exclude the potential for significant catastrophe and crop losses, significant adjustments to A&E and large gains or losses from assets sales or impairments. We expect to maintain adequate rates in our specialty property and casualty operations because of our strong underwriting culture, and expect to achieve a combined ratio of about 83% to 86%. That said, we're targeting flat to modest increases in overall average rates for the remainder of the year. We expect net written premiums in our specialty property and casualty operations to be down 17% to 20% from 2008 levels, primarily due to increased reinsurance sessions under our crop quota share agreement and the weakness in the economy. If you exclude crop, we expect a decline of 6% to 9%.

Property and Transportation Group is expected to maintain its excellent underwriting track record with a combined ratio in the 82% to 86% range. This guidance assumes accident year crop earnings that are in-line with 2008 results. We expect net written premiums to decrease by approximately 30% to 34% as a result of changes in our crop core this year and lower crop commodity prices. Excluding the decrease in crop, we expect net written premiums to decrease between 7% to 10%. We expect the Specialty Casualty Group to generate strong underwriting profit with a combined ratio in the 82% to 86% range. We anticipate decreases in net written premiums between 5% and 8%, as continued pricing pressures in some of our operations will offset growth from our new initiatives. We look for Specialty Financial Groups' combined ratios to be between 79% and 83%. We project net written premiums to be down 7% to 10%, as we expect to further reduce our exposure to auto-related risks in 2009. And we project the combined ratio between 100 and 104 for our California comp business. Despite our 2009 rate increases, we anticipate that net written premiums will be down about 22% to 25% this year, due to competitive pressures and the economy's impact on payrolls.
Based on recent market conditions, we expect full-year core operating earnings in our annuity and supplemental insurance group to be 12% to 15% higher than last year. We expect the spread in our annuity reserves will contract somewhat because of the decline in the return on available investment opportunities, as well as our current investment strategy, which is focused principally on high grade corporate bonds. Thank you and now we'd like to open the lines for any questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Jay Cohen with Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

I guess just first, it's not a big line of business for you, but it has gotten some attention in the industry trade credit. Can you talk about how big that business is and what your claims experience has been over the last year?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

Sure, in general, this is our foreign trade debt or Foreign Credit Insurance Association, and it has run volumes annually in the 25 million range. That's been up this year because pricing has improved substantially, but as you said, it's been a relatively small portion in the hole. We have been profitable in that line from an underwriting perspective really for decades, so it's been a very strong performance although, as you said, one of the smaller portions of our business.

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

And as last year and in this environment this year, we've probably been reserving more conservatively there just to cover ourselves for anything where we think we're missing there.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Have you seen a big uptick in claims or an uptick in claims?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

There have been a few more issues than normal. But again, nothing that's material or that we're worried about at this point. I think in reserving at a higher combined ratio and a more conservative basis, we think that were prudent.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And then I believe you said -- moving to the crop side, I believe you said that the underwriting results for your crop book this year would be similar to '08. Would you describe '08 as a normalized or a normal year? We have some people looked at '08 and said, gee, it was kind of a rough year given the drop in commodity prices given the flooding-in towards the middle of the year, and I'm wondering how would you view '08 relative to other years?

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

I think '08 was, for us we didn't -- early in the year we didn't think it was going to be a great year as, it ended up it was a pretty decent year, kind of a normal year. This year looks solid right now. Actually, probably the '09 yield projections right now are higher for corn and soybeans versus last year. Probably the biggest risk, because of some of the late planning, would be the impact of an early frost, and that we're not big in Texas, so the Texas drought is not really a big issue for us. On wheat, Texas wheat and some of the wheat have a little bit of a -- had a rough go, but we took a very conservative position there in putting most of that in the heavier government-insured bucket in the program and that. So we kind of like the way things are shaping up. When you take a look at the spring strike prices, soybeans are pretty close to that. Corn prices are down some 20%, and that most of our businesses done on a revenue basis, but again I think I've talked about in the past that the average farmers' deductible is 20% to 25%. So even on corn, our corn prices are down 20% when all said and done. The farmer really kind of -- if yields are good, that doesn't concern us at this point.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Right.

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

Bottom line, we feel the crop picture looks pretty good right now.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Last question, California comp. It's kind of –- it's such a small part of your business, I just noticed the number, I guess it's been shrinking for the last three or four years. Do you see -- this might be a tough question -- do you see the 2009 underwriting results as kind of at the bottom or is it reasonable to expect that this is to continue to deteriorate? I know there is a lot of unknowns in there, but how do you view the business as you look out beyond 2009?

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

Yes, I think nine could be a bottom. I think the one key question is, is the impact of the on-bank decisions and whether the appeals on those -- whether those get thrown out. And so one big unknown is really on a few of those disability claims rulings, how much of an impact will those have on results. That could take a couple of years to play out, if it's not thrown out -- those aren't thrown out on appeal. So I think '09 through '10, depending on the impact of those, I think you're getting to a bottom. I think one positive thing that's happened and I mentioned is that we got 6% rate increase in July. And as you know, everybody files rates, but they're still credits insurers can apply, credits or debit and that. So what the real key number to me is not what's filed, it's really what insurers are achieving. July was the first month that we achieved a positive increase for probably five years or so. So to me, that's very keen and my expectations are, is that we'll probably be able to achieve that or hopefully more through the end of the year. Particularly as our competitors -- particularly some of the competitors that have been more aggressive or some of the new competitors start seeing what the results really are. My guess is the industry could be, in '09, there are no numbers out there, but my guess is the industry could be 115 to 120 on an accident year basis in '09.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

That's a wake-up call?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

Yes, we're publicly feels [ph] probably 111 with the disability stuff, if those get thrown out, we're 107, 6% plus in rate helps. We definitely need rate on our book. The industry, I don't know what they're thinking, but the industry clearly needs double-digit rate, would be my guess.

Operator

Your next question comes on the line of Amit Kumar with Fox-Pitt Kelton.

Amit Kumar
Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division

I guess just staying on the crop book here for a moment. Were there any crop losses in Q2? What's the number on a gross basis?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

No, there weren't. Basically what we do, Amit, for the current accident year, unless there's a significant event that takes place, we don't recognize really gains or losses through the first couple of quarters because it's just premature, and you don't know what your yields are going to be and we don't really have a good sense of the pricing. In the second quarter, there was a small amount of favorable development coming forward from 2008 half.

Amit Kumar
Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division

And could you just remind us what the premiums were? I know you mentioned that if you take out the crop numbers, it's a 10% delta. Could you sort of give us the comparable crop premium numbers on a gross and net basis for this quarter, as well as Q2 '08?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

Sure, the crop for -- again, this is early in the year, and so we don't record much premium. The crop for '08 was 32 million and because of the reinsurance -- this is net, because of the reinsurance arrangement, it was actually a -4 million for the current year. And in the -- And then year-to-date crop hail gross is 148 versus 165 last year.

Amit Kumar
Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division

In terms of the marketplace, and if you sort of go back and look at Ben Brookley's [ph] commentary yesterday on what's going on or even if you look at the RIMS' [Risk and Insurance Management Society] survey, I think, which came out yesterday, it does seem that the economy is obviously having an impact, and there is still a lot of talk about aggressive competition. When you sort of look at what's going on out there today and if you sort of go back in 12 months, how has your perception changed in terms of a market turn?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

I think that things are still competitive today, probably with fewer outliers as competitors, meaning outliers being competitors that are burning their way through the market. And obviously, when we have -- when our renewal rates are flat and as I see in other earnings reports, in the RIMS report and that with the rate changes, clearly prices have stabilized at this point. And as I mentioned, we've gotten some positive increases in places, in excess liability in the -- or the parts of our D&O [Directors and Officers] book, parts of our non-profit book in July and in California Workers Comp. So I definitely see some momentum and clearly, when you look at underlying accident years, combined ratios for the industry and different lines of business, there's clearly a need for that. With continued low interest rates, it is not going to earn the right returns unless the pricing changes.

Amit Kumar
Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division

And then, what is your opinion on the cycle turn? When do you see that happening?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

I wish I had that kind of a crystal ball. We're trying to keep our heads down and make the right decisions, business-by-business and that. And if our volume was softer than others, that's fine for right now. I probably see some -- I probably would say that there'll probably continue to be a gradual improvement. If there's some larger event, major competitor that goes down or ratings change or major catastrophe here, where multiple companies are exposed in a heavy way, things like that could accelerate that trend.

Amit Kumar
Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division

On the Specialty Financial segment side, I presume the reserve releases came because the domestic leases, well, sort of run out in Q3? Is that -- there is over lease number from or are there still reserves associated with the domestic quarter?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

They are still some reserves associated with the domestic. There's about 30 million in reserves left on the domestic. The 40 million that we took this quarter is primarily a result of the fact that we've got another quarter behind us. And the second quarter had a substantial number of vehicles coming off leased, and so we got to a point where there was certainty. As you know, Amit, when you look back over the last six to 12 months, there's been huge volatility at the end of last year. The used car prices were pretty weak and they've strengthened. We're pleased for that but we continue to hold reserves because there has been volatility.

Amit Kumar
Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division

And then, I guess, all else being equal, if nothing changes, that 30 million will be released in Q3?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

It would be unfair to say that all of it gets released because there will certainly be some losses, but as Carl said, if we maintain current severity and frequency, we would expect some releases.

Operator

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

Jay Adam Cohen
BofA Merrill Lynch, Research Division

One thing that seems to be emerging, as we hear from a number of insurance and reinsurance companies, is that the claims environment has remained accommodating, I guess, for the lack of a better word. And you alluded to it as well, you're just not seeing much in the way of claims inflation. And I'm wondering if you can flush that out a little bit, maybe some reasons why you think that is. And what are some of the early signs that you look for to see that claims inflation? Is it severities or frequency? I think it's an important part of the story for the group and certainly for you guys as well. I'm wondering if you can just give us more color on it?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

It seems to me that from a severity perspective or the value of claims, I wouldn't expect that you'd see dramatic changes across the board there unless you had dramatic changes in the overall inflation in the economy as a whole, and of course, we're not seeing that yet. In terms of frequency, I think the nature of our business there's nothing in the inflation world, for the most part, there's nothing in the inflation world that affects our frequency. There would be clearly a few lines but nothing significant, so I don't expect that to be a linear relationship between claims and frequency and the economy as a whole in inflation. And as we indicated, part of what we do, we certainly look at what the developments are with respect to case reserves because we try and keep those fresh and responsive to what's going on in the economy at the time those reserves are established. But in addition to that, when we look at loss development factors, because we look at them over 10 or 15 to 20 year period, we've certainly taken it into account whether an overall normal kind of inflationary trend would be enduring the 15 to 20 year period. Of course you have times of almost deflation and times of more rapid inflation. So we think those things kind of play in, and it's just one of those things where we're going to have to monitor it and if we see more inflation in the economy as a whole, then I think we'd become a little bit more worried about it.

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

Yes, I mean, we do quarterly reserve evaluations and month-to-quarterly combined rate, accident year combined ratio projections, so we have plenty of opportunities to adjust our inflation factors every year as we do those calculations in that. California comp, probably because of these disability rulings, potentially could be the most inflationary or impact the severity in the line of business that we have. Conversely, in the crop business, it's deflationary because of the crop price decrease declines from last year and in corn. So keep in mind that 45% of our business is Property and Transportation, which a shorter tail and maybe, as in our reserve leverage, is a little bit lower than probably a lot of commercial insurers for that reason. So kind of the impact to -- potential impact on earnings and potential impact on capital, whatever is a little different.

Operator

[Operator Instructions] Your next question comes from the line of Marvin Weinstock [ph] with Maximum Group.

Analyst

It's Abe Schloss [ph] here. With our stocks starting below book and also our AFE preferred selling way below its phase, any chance of a buyback on these items?

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

We believe that in this environment it's prudent to for us to maintain some excess capital as opposed to using an on-stock buybacks today.

Operator

[Operator Instructions] Your next question comes from a follow up from Amit Kumar with Fox-Pitt.

Amit Kumar
Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division

In terms of the unrealized loss reversal in Q2, do you have sort of a guesstimate for what the number might be for the month of July?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

It's very preliminary, but in the month of July, we would be probably in the 200 range plus or minus pretax and pre-debt.

Amit Kumar
Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division

Could you just remind us, and I might have missed this, where exactly you're putting new money into? And then just give some more color on that.

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

We are buying principally high-grade corporates, generally single lay or above corporates. We will buy a few BBB rated non-financial corporates but most of the new money is going into the high-grade corporate volumes.

Amit Kumar
Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division

I guess, finally, can you sort of talk about the Chinese drywall issue, and if you have any exposure on that front and what trends you might be seeing?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

Yes, we do have some exposures through our mid-continents subsidiary and some builders liability. We have about 300 claims at this point. We've put up reserves of about 15 million, which we think is more than adequate for what we're seeing. And so far, the primary things that we had to deal with is replacement of drywall and repairing the homes that have used the drywall. I know that there are some assertions out there that go beyond that but at this point, that's what we're seeing.

Amit Kumar
Fox-Pitt Kelton Cochran Caronia Waller Limited, Research Division

And is that being debated on the policy language or what exactly is going on? There seems to be sort of conflicting thoughts coming out, where one side is saying that you could argue for sort of policy language exclusion. What is your sense? Does this -- did you get any sense that this issue could sort of expand further or based on where you are right now and the trends, do you think some sort of a lid can be put on it?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

Of course, it's really in its early stages, as you know, but our expectations, based on what we're seeing right now in our legal review of policy language in just breadth of exposures, we don't expect it to explode into something major. But again, with the caveat, we're probably still early in the process as is the rest of the industry.

Operator

And you have a follow-up question from the line of Jay Cohen with Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Since we're talking about issues in the liability side and potential claims, credit-crisis-related claims, I know you guys are on a big player in financial institutions but if you can give us an update on what you're seeing from a claim standpoint?

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

I think if you -- let me start off with things that have happened to credit crisis around subprime. We've looked at that in our D&O side. We have seven suits that have been filed and two notices of potential claims. If we had limit losses, which we don't expect to be at limit or even close limit, we'd be at about $46 million. We, again, have no reason to believe that we're going to get close to the limit but that's where we bet on the D&O side. On the surety side where there could be some exposures, we don't have any significant direct exposure to subprime lenders or some of the folks that would be generating exposure for other carriers. So when I look at the subprime mortgage part of the credit crisis, that would be where we're at. And I think when you look at our D&O book as a whole, a fairly modest portion of it is in financial institutions. And we have really repositioned that book over the last five years or so, away from the Fortune 500 and the financial institutions to be in a large portion of the book and not-for-profit side of the equation. So we really don't look at this as a major exposure area for us.

Carl H. Lindner
Co-Chief Executive Officer, Co-President and Director

Yes, financial institutions or less than 1% of our D&O policy count. I think we have 260 policies today, 121 are insurance companies and I think 21 are banks. And other 260, I think 227 are private institutions, with the remainder being public.

Operator

There are no more questions at this time. I would like now to turn it over for closing remarks.

Keith A. Jensen
Former Chief Financial Officer and Senior Vice President

Thank you very much. We appreciate the opportunity to have this discussion with you, and we appreciate your interest in the company. We'll be looking forward to updating you at the end of our third quarter. Have a great day. Bye.

Operator
Thank you, ladies and gentlemen. This concludes today's conference call. You may now disconnect.