S&P Capital IQ

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Arch Capital Group Ltd. NasdaqGS:ACGL

FQ2 2011 Earnings Call Transcripts

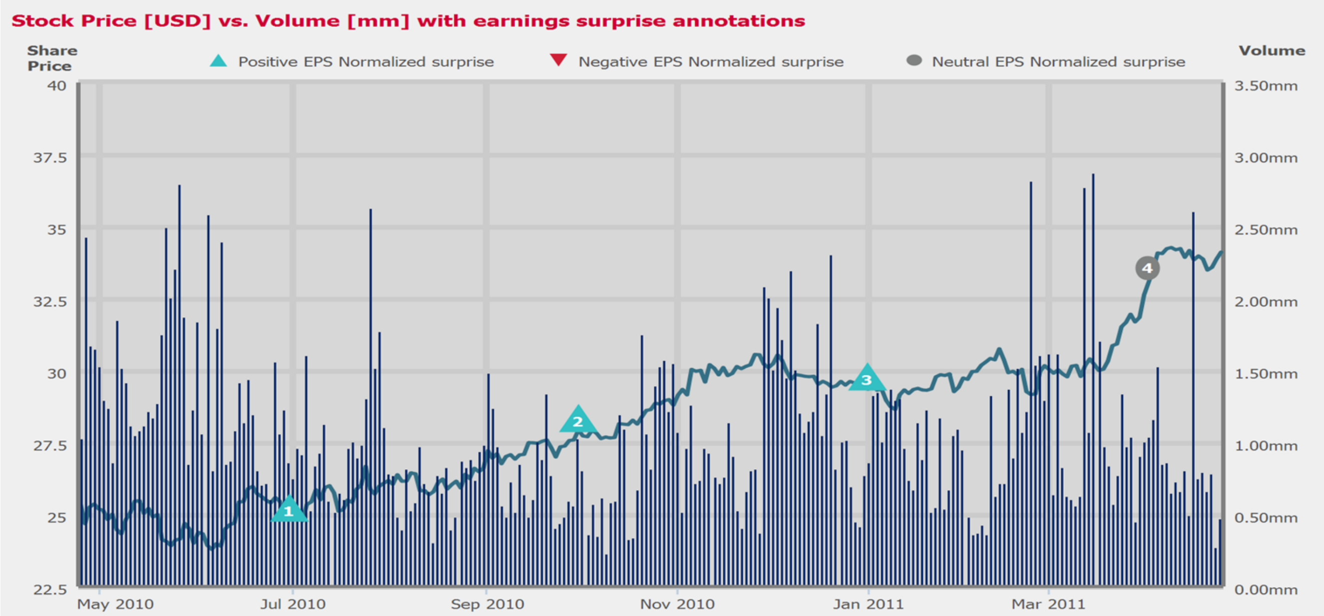
Tuesday, July 26, 2011 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2011-			-FQ3 2011-	-FY 2011-	-FY 2012-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.21	0.45	▲114.29	0.58	1.64	2.78
Revenue (mm)	640.31	706.54	▲10.34	658.85	2611.30	2689.67

Currency: USD

Consensus as of Jul-26-2011 1:05 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ2 2010	0.77	0.83	▲1 7.79 %
FQ3 2010	0.71	0.85	▲2 19.72 %
FQ4 2010	0.79	0.86	▲3 8.86 %
FQ1 2011	(0.33)	0.06	NM

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

Gregory Locraft
Morgan Stanley, Research Division

Ian Gutterman
Adage Capital

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Jay H. Gelb
Barclays PLC, Research Division

Joshua David Shanker
Deutsche Bank AG, Research Division

Keith F. Walsh
Citigroup Inc, Research Division

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

Matthew John Carletti
JMP Securities LLC, Research Division

R. Scott Frost
BofA Merrill Lynch, Research Division

Unknown Analyst

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Second Quarter 2011 Arch Capital Group Ltd. Earnings Call. My name is Modesta, and I will be your coordinator for today. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes.

Before the company gets started with its update, management wants to first remind everyone that certain statements in today's press release and discussed on this call may constitute forward-looking statements under the Federal Securities laws. These statements are based upon management's current assessments and assumptions and are subject to a number of risks and uncertainties. Consequently, actual results may differ materially from those expressed or implied.

For more information on the risks and other factors that may affect future performance, investors should review periodic reports that are filed by the company with the SEC from time to time. Additionally, certain statements contained in the call that are not based on historical facts are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The company 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.

I would now like to turn the conference over to your hosts for today, Mr. Dinos Iordanou and Mr. John Hele. Please proceed.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you, Modesta. Good morning, everyone, and thank you for joining us today. In the second quarter, we continue to see significant catastrophic activity, this time emanating primarily from severe weather events that occurred in the United States in April and May. The level and intensity of these storms were unprecedented and a departure from historic patterns and serves as another reminder that in the Insurance business, significant natural catastrophes do occur and need to be priced for.

I continue to be pleased with our underwriting approach and the discipline in which our insurance and reinsurance underwriting teams are executing our overall underwriting strategy. As the soft cycle has evolved, we have continually adjusted our book of business to lines and classes that are priced appropriately on a risk-adjusted basis in order for us to achieve the required return relative to the risk assumed.

As a result of executing this strategy, on a trailing 12-month basis, our short-tail exposures have grown to be about half of our premium. Our medium tail is roughly 25% of premium volume, and our long tail has been reduced to approximately 25%. This is significantly a different book of business than we had several years ago. Total net catastrophe losses for the quarter were $95 million, with North America weather-related losses contributing $79 million and the balance coming from the reestimation of our first quarter catastrophe losses and the second quarter New Zealand earthquake.

Our annualized return on average common equity was 6.1% on a reported basis, which was affected by the above mentioned cat losses, which exceeded our quarterly cat load. By our own estimation, we continue to believe that in the current underwriting and investment environments we operate in on an expected basis, we're still able to achieve approximately 9% ROE on an underwriting-year basis. This is essentially the same level we estimated for the entire 2010 underwriting year.

Our investment performance for the quarter was good with a total return of 1.7%, aided by a slight improvement in treasury rates. As a result of our investment performance and despite the cat losses, we were able to increase our book value per share to $31, which is an increase of 13.3% from a year ago and 2.2% from a quarter ago.

From an underwriting point of view, we recorded 100% combined -- calendar-quarter combined ratio, which is an acceptable result in a period marked by above-average catastrophic losses. Cash flow from operations remains solid at $222 million. The broad market environment continues to be competitive, with most long-tail product lines having plenty of capacity available and which are experiencing slight price declines. For us, these classes represent about 20% of our quarterly volume and 25% of our trailing 12-month premium volume.

In the property and property cat areas, the environment improved with the best increases today reflected in international cat-exposed business. As noted earlier, our short-tail book of business in total was roughly 54% of net premiums for the quarter and approximately half of our volume on a trailing 12-month basis. For medium-tail lines, the environment is stable for some classes and improving for others. Our medium-tail business was approximately 26% of this quarter's volume and 25% of the trailing 12-month volume.

From a premium production point of view, our gross written premium was up 12%, and our net written premium were up 13%. Most of this production increase emanated from our reinsurance operations, which reported growth of 36% in gross-written premium and 33% in net-written premium. Part of this growth is attributable to one account that was renewed on a 2-year basis. And adjusting for this account, the percentage increases would have been 25% and 21%, respectively, still a very strong performance. Most of the balance of the increase in written premium was in short-tail and medium-tail lines.

Our insurance operations were up 3% on a gross-written-premium basis and 4% on a net-written basis. During the second quarter, we saw no significant change in market conditions, with rate levels for all lines of business either improving slightly or staying the same as in the prior quarter. The areas under the most pressure continue to be executive assurance and healthcare with mid-single-digit rate declines. All other lines report a flattish or slightly positive rate movements. In our reinsurance business, we saw good improvement in the property cat area, with average rate increases of 8% in the United States and 28% on average in international business, where increases ranged from as low as plus 5% to as high as 70%.

Across our business segments, even in the most difficult markets, we always look for opportunities to find acceptable books of business to underwrite without sacrificing underwriting standards. We're starting to see some of these opportunities from both our existing product offerings as well as from our new product initiatives, which have helped stabilize premium levels. Our insurance group continues to emphasize and move their book of business to smaller accounts and to relatively less-volatile lines with an emphasis on reducing their exposure to the U.S. casualty business.

The area with significant volume reductions in the second quarter was professional liability. This reduction in volume primarily resulted from the larger account sector of this business. As we mentioned on last quarter's call, we continue to monitor the primary casualty, E&S sector in the U.S. Although we continue to see price increases in isolated areas, we remain in a defensive posture in this line as we still believe that the rate improvements today will not produce an adequate return. I would like to reiterate that our capital management philosophy has not changed. We have consistently and will continue to return excess capital to our shareholders when we cannot profitably deploy it in our business. As is customary for us, during the hurricane season, we will temper our share repurchase appetite. Of course, should we find opportunities to buy our shares at very attractive prices because of market dislocations, we will continue to do so.

Before I turn it over to John for more commentary on our financial results, let me update you on our cat PML aggregate management. As of July 1, 2011, under RMS 10, our 1 in 250 PML from a single event was $740 million or 18% of common equity. This represents roughly the same level of exposure and percent of common equity as of last quarter's end. We are continuing our process of reviewing RMS 11 and its various changes and have not yet finalized our examination at this point. However, under RMS 11, based on the current iteration of the model, our preliminary estimates or PML for 1 in 250 year event indicate that these exposures estimates in comparison with the RMS 10 will produce increases which range between 10% to 30% depending upon the zone. We know of such preliminary amounts remaining within our risk-management limits.

So with that, I'm going to turn it over to John for further commentary of financials. John?

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

Thank you, Dinos. Good morning. Regarding our premium income, on a consolidated basis, the ratio of net premium to gross premium was 77%, about the same as a year ago. Our overall operating results for the quarter reflected a combined ratio of 99.6% compared to 90% for the same period in 2010. The 2011 second quarter included $95 million or 14.8 points of current accident year cat activity, net of reinsurance and reinstatement premiums compared to $7 million or 1.1 points in the 2010 second quarter. The 2011 second quarter U.S. storms and New Zealand earthquake had a gross impact of $98 million and a net impact of $82 million. The reestimation of the 2011 first quarter events of the Australian floods and Cyclone Yasi, the New Zealand earthquake and the Japan earthquake and tsunami added $21 million gross and $13 million net to the second quarter provisions for the 2011 cat events. The reestimation was mainly driven by further claims development and contingent business interruption expected claims from the Japanese events. The 2011 second quarter combined ratio reflected 8.9 points or $58 million of estimated favorable prior year reserve development net of related adjustments, compared to 5.2 points or $33 million, in the 2010 second quarter. The prior year development in the second quarter of 2011 reflected net favorable development primarily in property and other short- and medium-tail lines as well as in the reinsurance segment, casualty business, mainly from the 2002 to 2005 underwriting years and also included a $5 million reduction in the provision for the 2010 cat events. Moreover, excluding the connectivity in the quarter, we generally experienced better-than-expected claims emergence on most lines.

The 2011 second quarter current accident year combined ratio, excluding large cat events and net favorable development, was 101.8% in the insurance segment and 79.7% in the reinsurance segment, both consistent with results as of a year ago. The 2011 second quarter expense ratio of 32.5% was 0.8 percentage points higher than in the 2010 second quarter, resulting from higher cost in part from building the insurance accident and health business and foreign currency adjustments as well as higher incentive compensation accruals. On a per share basis, pretax net investment income rose to $0.63 in the 2011 second quarter compared to $0.57 for the same period a year ago and $0.63 in the first quarter of 2011. Our embedded pretax book yield before expenses was 3.23% at the end of the 2011 second quarter, down from 3.52% at year end, which reflects lower reinvestment rates and a short duration.

The total return of the investment portfolio was 165 basis points in the 2011 second quarter compared to 150 basis points in the 2011 first quarter. Excluding foreign exchange, it was 154 basis points in the quarter. The total return in the second quarter benefited from good returns on fixed-income assets, partially offset by negative returns on equities and some alternative assets.

We recorded net foreign exchange losses of $18 million in the 2011 second quarter due to the weakening of the U.S. dollar against the euro and other currencies. These losses resulted from revaluing our net insurance liabilities required to be settled in foreign currencies at each balance sheet date. However, this should be compared to the 11 basis points contribution to total return from foreign exchange on our investment portfolio, which offsets some of this income statement loss in the equities section of the balance sheet.

Our allocation equities was approximately a net 3.5% of our investable assets including cash at quarter end while alternative investment and equity method investments were consistent at 6.3% of our investable assets. We continue to maintain the vast majority of our investable assets in very high quality fixed income investment portfolio with an average credit rating of AA+. The duration of the investment portfolio was 2.87, about the same as 2.83 at year-end. We continue to maintain a shorter duration of our assets than our liabilities, which are approximately 3.5 due to a continued global uncertainty and potential volatility of interest rates. For the 2011 first half, our effective tax rate on pretax operating income was a benefit of 2.7% and 1.7% on pretax net income. The connectivity this first half year and low investment returns have resulted in a beneficial net tax position.

Our balance sheet continues to be conservatively positioned with total capital at $4.8 billion at June 30, 2011, up from $4.7 billion at March. In the quarter, we purchased 0.9 million shares for $29.6 million at an average price per share of $33.51 at a ratio of 1.09 to the average book value during the quarter, which fits into our expected return of under 3 years at this profitability level.

Our debt plus hybrids represent about 15% of our total capital, well below any rating agency limit for our targeted rating. Our book value per share ended the quarter at $31, up 2.2% from last quarter and 13% from a year ago. Our excess capital position, which we define as the rating agency actual capital in excess of the required for an A+ rating plus a buffer was estimated to be approximately $300 million at the end of the 2011 second quarter under RMS 10 and including AOCI. Depending upon the final implementation of RMS 11, we would expect our excess capital to be reduced by an amount yet to be determined. We are comfortable with our capital position heading into the usual cat season.
With these comments, we are pleased to take your questions. Modesta, we're ready for questions.

Question and Answer

Operator

[Operator Instructions] Your first question today comes from the line of Keith Walsh with Citi.

Keith F. Walsh
Citigroup Inc, Research Division

Dinos, you mentioned underwriting ROEs remaining in the 9% range, and I was just curious why that was. I would assume with the property cat and specialty growth that you were writing that well above the 9% you cited, and it was a pretty sizable chunk this quarter. So if you can just touch on that.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, the -- you got to look at the entire book of business. You're absolutely correct. I think the prospects of better returns on that portion of our business is there, but you have to also see where we're losing ground. In the executive assurance and healthcare, even though it's a much smaller part of our business, we're still giving rate reductions. So you're losing ground there. And then the rest of the lines, they haven't really -- even though we're seeing a little bit of an uptick on rates, flattish and maybe slightly up, I don't think they're keeping up with trend. Trend is still positive. So when you put all that in -- and you put the positives and the negatives, we didn't see any movement in the profitability I think that were achieved on an underwriting basis. And 9% is not really our target, but at the end of the day, it is what we can achieve in this market, so. The other part is on the long-tail lines, profitability is also dependent upon the new money yields. So as you saw from John's commentary, our embedded yield on new money invested is coming down because as we reinvest funds, new cash flow, it's going down. So that affects the ROE, too, because even though the duration of liabilities on the long tail is still the same, you're earning a lot less on the float.

Keith F. Walsh
Citigroup Inc, Research Division

Okay. And then just thinking about new business growth in the property cat area. Is this -- are you winning because of wounded competitors? Is that a major reason you're seeing new flow?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I wouldn't characterize it as such. I think in some parts of the world and even in the United States, we never really push the envelope to our upper limit of our tolerance. So we always had room, and we continue to have room to write more. So where we found the opportunities, and depending if they were opportunities overseas or opportunities in the United States, we did take advantage of it. At the end, we let the market determine where we have the best chances to get a good return, and that's where we go.

Operator

Your next question comes from the line of Jay Gelb with Barclays Capital.

Jay H. Gelb
Barclays PLC, Research Division

Dinos, with the excess capital position potentially coming down a bit more with the implementation of RMS 11, does that mean ours could be more geared towards premium growth as opposed to share buybacks going forward?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I think we're going to do both. I mean, if we find opportunities for premium growth, we'll take them. That's our #1 priority. We're in business to produce underwriting profits for shareholders. So where we have an opportunity to expand our business to underwriting, we're going to take those opportunities. Having said that, though, we're not going to keep excess capital on the balance sheet. So depending where the market goes, how this hurricane season fares for the industry and us, we're going to reevaluate where -- our capital position and we'll continue with share repurchases if we can deploy the capital in the marketplace.

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

And Jay, and because we're underlevered, if the market does turn more and it becomes quite hard, we have great capacity to increase writing if we see the ROE is there.

Constantine P. Iordanou
Chairman and Chief Executive Officer

It gives flexibility. There's plenty of flexibility in the balance sheet. So I don't -- from a directional point of view, I don't think it's any change would be as steady as we go. In prior years, we kind of wait and see on the third quarter. We -- maybe our share repurchase has been the lightest usually in the third quarter because we want to see where the hurricane season takes us. But we had significant activity usually in the fourth and first quarter. And that pattern I see has been around for you guys for, what, 3 or 4 years now so -- since we started our buyback program.

Jay H. Gelb
Barclays PLC, Research Division

Right. Okay. And then on the reinsurance segment, the 36% growth as reported, I mean, a big portion of that clearly was the renewal of a multiyear deal, then you probably also had some reinstatement premiums coming in. On a normalized basis, what do you think that, that growth rate was in 2Q?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, on a normalized basis, I think it's in the 20% range. The reinstatement premiums weren't that significant. The one large deal is I gave you the delta was like 11%, 36% versus 25%. And that's a deal that has always been written on a 2-year basis. So for year-over-year comparison, it throws off our numbers a bit for you guys. But you've known it for years. We skip a year and then it comes in. On a earn basis, it makes no difference because you're earning the premium over 24 months, anyway.

Jay H. Gelb
Barclays PLC, Research Division

All right. And then just to follow up on the reinsurance segment, what do you think is a reasonable expectation for growth going forward? My guess is it wouldn't be in the 20s.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. Listen, if I was that good, I can predict future, I'd be in Vegas betting on the tables. I mean, it's whatever the market shows us. I -- we don't shy away from underwriting and taking risk as long as we believe that there is a profit in the transaction. So we found opportunities in the first and second quarter of this year. We took advantage of those. If those opportunities continue to be presented to us, you'll see growth. If not, we'll -- we're not ashamed to go back to our defensive underwriting posture and have no growth or even negative growth.

Operator

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

Joshua David Shanker

Deutsche Bank AG, Research Division

I hope -- I was well -- I was wondering if you guys could detail a little bit on the loss trends by line? We've got a few conference calls here and not getting a lot of detail, but everyone sort of agree that loss costs are up a little bit. Maybe you could add a little bit of detail for that?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I can give you the ranges, Josh. We've seen as low as 2.5% in some lines to as high as 6.1%. I think -- but you know our philosophy. We don't change trend projections on a quarterly basis. One set of data on another diagonal, it's not going to change those projections. Our actuaries, they take a longer-term view, and they look at both frequency and severity. And they do it by what we call IBNR family or product line and then we use that in pricing our business. So the range is as low as 2.5% and as high as 6.1%. That's what we have by line of business. Of course, the highest is in the medical mal area. Executive assurance has a high trend, too, because of severity, so.

Operator

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

Gregory Locraft
Morgan Stanley, Research Division

I wanted to actually just take your temperature on, again, the capital side. I'm trying to understand. I know you have $300 million today. And obviously, we're entering an RMS 11 world. If it's just a normal hurricane season, how will things look into year-end and what impact does that have into the marketplace from a pricing perspective into 2012 and beyond?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, to give me a little leeway to answer your question is what is a normal hurricane season? Would you define that for me?

Matthew John Carletti
JMP Securities LLC, Research Division

$18 billion is the average 10-year losses.

Constantine P. Iordanou
Chairman and Chief Executive Officer

So having one hurricane with industry losses of about $18 million, that -- for our book of business, it will probably be contained in a normal cat loads, so it won't have any effect on our capital.

Gregory Locraft
Morgan Stanley, Research Division

Okay. Okay, great. So then it's sort of you're just trying to navigate from an RMS 10 to an RMS 11 world, and you feel pretty good about where you're sitting. How about...

Constantine P. Iordanou
Chairman and Chief Executive Officer

Don't forget, RMS 10 and 11 is just another recalculation on the same set of exposures, right? We've been operating with RMS 10 now for a couple of years, so we have an idea as to what our exposures. It's how you measure them, et cetera. That's why we're very, very careful before we fully implement RMS 11 that we do understand all the changes that they have made to the model, and we agree with them. Don't forget, even with RMS 9 or 10 or going back, we always made our own customary modifications ourselves. And if you look at our cat management over the years, I think we get pretty good marks. So I'm pretty confident in the ability of our teams to not only understand the external models but also how they internally make tweaks to them in order to serve our underwriting needs. And that's the process we're going through right now. That's why I didn't want to just plug in RMS 11 without having a full understanding of what modifications they made. Do we agree with them and all that. Does the empirical data that we have that jibes with that or do we have to make some of our own changes? John, you want to -- you spend a lot of time with the cat teams, so.

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

Yes. So Greg, I think what's important when you look at us and also think of other people in industry as well is when we say RMS 10 is our -- as Dinos mentioned, it's how we have implemented RMS 10. And we'd already done a lot backtracking of various storms and how that maps the model and had increased some exposures in certain areas. And likewise with RMS 11, we are looking at it the exact same way. We are looking at their changes and their empirical research also from other vendors and looking at their research before we finalize and zero in on our final numbers. So the percentages may be different from us from other people. It also depends on where the locations are. The RMS 11 versus 10 raw models have changed quite a bit by region. So it's going to depend a lot upon your book of business. And this takes some time to make sure you're really comfortable with it. But overall, we think we have sufficient capital for all this, and we'll continue to looking to write some good business.

Constantine P. Iordanou
Chairman and Chief Executive Officer

There is no restriction in our ability to respond to market opportunities. We will stay within our risk management programs. We're not going to increase that. We're comfortable at 25% of common equity. We're going to manage the book within that. And we're comfortable where we are today. And RMS 11 will be implemented within the company shortly. We're in the process of doing it right now.

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

Finally, Greg, just one point. When we say excess capital, that's from our target. And our target number is A+ plus a buffer. So the buffer is there to get through big storms or bad events in the world, and that's how we run the company. So excess is really an amount above A+ and above a buffer. So it's quite up there.

Gregory Locraft
Morgan Stanley, Research Division

Okay, great. And just again on the capital side. How do you think of the impact of 2 events in the fixed income markets. One is higher interest rates, just -- let's just say they go up 100 basis points or 200 basis points. And secondly, with the sovereign downgrades on the U.S. side, how would that impact your thoughts around your excess capital position?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I'll let you...

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

Yes, so the duration of our entire portfolio, which includes everything, is 2.87. So if interest rates went up around the world because we have business in other currencies, but -- would be about $300 million, if you take our total investment portfolio and multiply that out via the 2.87. That though is -- that's a very big move from where we are. On the whole yield curve across the board, more likely, you'll see -- you see this in Europe. It's not the whole curve moving for these countries. Its shorter term is moving up more. It's hard to predict, but I think we feel, with our buffers we have, and versus our capital position that we can withstand some pretty big shocks here that happen around the world. When it comes to sovereign downgrades, we don't have any exposure to the PIGS or the risks in Europe. There -- it's very hard to predict secondary impacts on what would happen around the world to these things. And the U.S. downgrade is also hard to predict what might happen. You may think rates may go up instantly. History show that when Japan was downgraded from AAA to AA+ in 2001, the 10-year Japanese bond actually went down 24 basis points in the subsequent time. So we're in a very bit of uncharted territory here. And by being short is really one of the best protections and being conservative on credit quality.

Constantine P. Iordanou
Chairman and Chief Executive Officer

And we do own a muni portfolio, which is a little over $1 billion in the U.S., but the muni story is specific to each bond. And we do a lot of the credit analysis within our walls. We just don't depend on outside advisers on that, and we feel pretty comfortable where we are with our muni portfolio because even in some states that there might be a lot of stress, et cetera, and there might be some municipal defaults, when we run that against what we own, we feel very comfortable with the positions that we have on the muni side.

Operator

[Operator Instructions] Your next question comes from the line of Matthew Heimermann with JP Morgan.

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

So I was -- sorry to beat the dead horse here on...

Constantine P. Iordanou
Chairman and Chief Executive Officer

If it's not dead, we'll kill it.

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

Okay. So let's work towards that. So just in terms of -- I was just curious on kind of how RMS might impact a couple of things. So specifically, just in terms of what's driving the increase, is that likely to be -- is there any specific region driving the increase? And I think last quarter, historically, Southeast has been your biggest zone. Is that potentially going to change under -- when you -- once you fully implement the new model?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Let me give you some preliminary color -- and we haven't finished all the analysis. It seems to us that it has less of an effect in Florida for us because of the changes that we were doing to how we were viewing Florida risks. It has more of an impact in Gulf states, meaning Louisiana, Texas, et cetera. And most of that is coming from the changes in storm surge and also inland damageability going in 30, 40, 50 miles. So when I gave you those ranges of 15% to 30%, to be more precise, it was like 14%-something to 29%. The 29%, it was mostly for the Gulf states, not for Florida. But I want to reemphasize again, these are our preliminary numbers because we like to be very thorough, and our team is spending a lot of time and a lot of effort on not only implementing the model but on understanding it. And we don't do things that we don't agree with. So we got to get agreement as to what we're going to implement by our own cat teams.

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

Matt, there are 3 major areas that everyone has to analyze with the RMS 11. The first one is the short-term frequency. The model has a higher frequency assumed in the short-term due to ocean warming, the cyclical ocean warming cycle. So there's a long-term average of frequency over 100 years or more. But there is a shorter-term cycle. And it's decide, do you really agree with that and how do you want to implement that? The second is the vulnerability or, as Dinos mentioned, further inland, how far the storms come in and what the damages are. And the third is the storm surge. So getting comfortable with all those takes some time, and we're analyzing and we're running it. We're backtracking it versus prior storms and also reading all of the empirical research and speaking with RMS to truly understand where they're at.

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

Okay. And then just taking this a little bit further. Any -- is there -- is insurance or reinsurance or is it similar between the two, that's disproportionately responsible for whatever increase we'll see?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, the -- you know that to a great extent, on the reinsurance side, we are -- we take 100% net. We do buy some retro and some ILWs to protect different parts of our book, and we do that. That's more, I would call that, managing PML aggregates. On the insurance side, we buy a lot of cat cover. So there is scenarios that if you cycle over, let's say you take $75 million deductible or net retention on each storm and you buy $325 million above it, it's only when you go over the $400 million that -- and there is some scenarios that in our insurance group, there is potential for us to be cycling over. And now, there is 2 ways to deal with that. Either you reduce exposure and/or you buy more protection at a cost. You can always go and buy another $50 million or another $100 million of protection. So that's the kind of evaluations we're going through analyzing our book of business and getting to an agreement. Don't forget, we're taking the risk. We have to agree to it. Working with RMS and their scientists in explaining everything that they have done to the model, and then we're going to make determinations. Right now, we're very comfortable with the exposures that we have and where we're at. But this is -- we're spending a lot of time, and it's going to evolve. It's going to evolve over the next month or 2. It has not changed what we have done in the cat business because that season is pretty much over, up to July 1. And even at the worst possible escalation, if we did 30% across-the-board, it was still within -- well within our tolerance. So from that perspective, it didn't give us any angst, and it won't become an issue again until January 1. And so we have plenty of time to analyze and refine and make determinations on the model.

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

Okay. That's helpful. And then if we just translate this back to the capital discussion. I mean, how should we think about the proportionality of the increase in the PML relative to how much excess capital you have? Because simplistically, one could come from it -- and this is why I'm asking -- that you can come with an approach and say, "Okay, well excess capital is the difference between wherever you're 1 in 250 PML is relative to common equity versus what the required equity would be at 25." But I think in reality, right, the models are more complicated. So could you give us a sense of how would that $300 million look if it was up 10 versus up 30 or some kind of range of outcomes like that?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, let me reemphasize what John said before, because there is rating agency required capital. And then there is Arch management required capital. We always calculate our excess capital on the Arch management required capital, which is a bigger number than what the rating agencies require us for our current ratings. And the reason we have that buffer as we call it is because we always try to operate with the simple principle that I want to begin the year and end the year with rating agencies required capital by having enough of a buffer that if I have a 1 in 250 year event or if I have a 200 basis points parallel movement on the yield curve and my a balance sheet can absorb that shock $500 million, $600 million and between the earnings of the year, potential earnings, and the shocks, I begin the year and end the year with the rating agencies' required capital. And that's a very, very, very conservative position. Now as the models become more robust, you're never going to eliminate the variability of the models around the mean. But as they become more robust and we're getting more and more confidence, that means we might not have to keep as much cushion as we have in the past. But that's our own internal determination. And that's why we're spending a lot of time in trying to understand the changes in the model and what these numbers mean and how much cushion do we need in order for us to be feeling comfortable. And right now, I can tell you, based on preliminary numbers, I feel that maybe we won't need as much cushion to bridge us between what the rating agencies want from us and what Arch management with a cushion needs. But we haven't made those determinations yet because we're still in the process of analyzing. The principle, though, we're not going to change. We want -- independent of all these stress events, independent if it's a financial event with a significant movement on the yield curve, 200 points parallel move on the yield curve or a $50 billion or $60 billion or $100 billion storm, we want to be able to begin that year and end that year with rating agencies' required capital, so our rating doesn't suffer. So we will be the company that is going to be the go-to company by clients because financially, we will continue to be a very extremely strong.

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

Matt, we aren't in a position yet to give you any guidance on how the excess capital rating agency model works because they were both with single and also aggregate and how these add up across the board, how intimate RMS 11 can have an impact on that. So that's why it's still too early for us to...

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

Yes, that's fair. And that's -- I appreciate the color, Dinos, because I think what you're saying is very fair and very thoughtful in terms of how to think about capital. And there are definitely some -- the yins and yangs to how you implement this and shapes your total view of capital. But I guess what we're struggling on this side is just to try to think about -- and this might not be the right way to think about it, but just for a reference point, getting a sense of what the potential change in PML does to kind of capital on a static basis. And so I mean, if you held your buffer the same and let's say we just kind of held things constant, and the PML went up, let's say, under RMS 10, let's just say, you wrote more -- that might not be fair, but if [indiscernible]

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, if you do...

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

How does that $300 million change, because I recognized [indiscernible]

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it's a simple calculation, Matt. It's a simple calculation. If you take it in a simplistic way as you put it, you take your worst case scenario, 30% on $700 million is $210 million. So the excess goes from $300 million to $100 million. But it's not as simple as that. I don't want you to leave with the idea that it is as simple as that. That's why we do spend time on analyzing and understanding what we have. Don't forget, putting -- we don't run the company because we want to be right that we have this excess capital, this short in cap. We're run the company on the basis we're taking good exposures, appropriate for the size of balance sheet we have and, independent of major events, financial events, catastrophic events, et cetera, we stand as strong or stronger than most of our competitors. That's the thought process. And because there is the day after and is how you feel day after a major event that is critical to us, and we want to always be the company that is first, able and willing to satisfy the needs of their existing customers because they continue to have capacity and also acquire new -- and it's all interrelated. It's our thought process about what kind of balance sheet we have, how much room we have on the balance sheet, what the financial leverage is of the balance sheet. It's all interrelated.

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

And so Matt, we don't think this constrains our ability to grow this implementation of RMS 11 from the preliminary work we're doing because, as I mentioned earlier, if we can see great business around the world, we can issue some more debt and grow as dramatically. There would be a constraint, a local constraint. I mean, we may cap out and be at our 25% common equity in one zone and then cap out. Obviously, we will never take too much risk at any one place no matter how good the pricing looks. But overall, we don't think this is a business-constraining implementation.

Operator

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

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Three questions. I think this should be relatively short. On the investment side, if interest rates in the markets stay where they are, when would you think that the book yield would equal the new money yield?

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

Well, we have a duration of 3, so the rollover within -- it's in rolling down. But we're not only invested in treasuries. We're investing in a series of investments around the world as well, mostly in the U.S. and other places. So it'd be next year to the year after some time.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Second one, this is a short one, on the reinsurance side, the growth in the cat business, did some of that growth come from retro deals? Because as I know there was obviously some demand in the market for retro cover?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, we're not fond of retro. We don't write, buy the [indiscernible] a little piece of retro. Sometimes we're buyers of retro, but not sellers. But no, it came from traditional x of loss opportunities, both internationally and domestically. There was also some reshifting on our domestic book as to what part of the tower would participate. So our guys always look to see based on their own curves as to where they think they're getting the best rate in relationship to the capacity they've put up. So that's what the changes were. And of course, we wrote some medium-tail business that we thought it was attractive and it gave us good ROE characteristics.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And then the last question, you mentioned claims trends, that 2.5% to roughly 6%. I'm assuming that's what your assumption is for claims trends when you're pricing and reserving the business. But I guess the question I had was, are you seeing any changes in the claims frequency? Anything in this quarter that suggest the trend might be changing? Even if you're not changing your view from a pricing standpoint, does the data suggest the world is changing at all?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, Jay, you're conflicting me because you say trend and then you want me to -- trend to me is something -- takes over a longer period of time of one quarter. As John said, and I think in his prepared remarks he touched upon that, our expected claim emergence was lighter than what we...

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

Excluding cat events.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes. Put the cat aside, but the -- on the regular book, I expect both on a incurred basis and on a paid basis. But it's only one quarter. So do you change your view for everything you do? We don't. At the end of the day, when we talk about trend is more longer term and looking at a lot more than just one quarter's data.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

I probably misused the word "trend" then, I guess. But it sounds as if there was no data, no new information this quarter which suggests a change in environment, in the claims environment, frequency, specifically.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well I can only -- we do the trend analysis by -- as I said, by line of business, usually once a year. It's not always at the same time. One quarter, they will do one product line, next quarter, they're going to do another product line. And they cycle over because you got to divvy up the work. What John said, though, we always look at, but we don't pay a lot of attention to it, is that yes, we have an expectation, right, every quarter as to how much emergence we're expecting and how much both on a paid and on an incurred basis, and it was lighter than usual. On the other hand, I had other surprises. My attritional losses on property, they were a little higher than what I expected. But that happens. One quarter you got attritional going up, another quarter you have attritional going down. It's not always coming smooth. That's the reason we don't take one quarter -- an indication of one quarter, and we say that's a long-term trend and everything is going to change and it's going to be based on that.

Operator

Your next question comes from the line of Scott Frost with Bank of America Merrill Lynch.

R. Scott Frost
BofA Merrill Lynch, Research Division

You talked about you didn't have any exposure to euros on issues, no peripherals. Is that mainly in the sovereign portfolio, or is it also in the corporate portfolio? Maybe if you could just go over your exposure to Eurozone credits in your investment portfolio?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, in contracts that we have, we don't usually hedge positions. We have what we call a natural hedge. If I write contracts that I have to pay in euros and I get paid in euros in premium, we try to invest the reserves we have or the obligations that are going to come in that same currency. Most of that, we do by buying German bonds, some corporate, and we buy some gilts in the U.K. for the British pound.

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

British pound, right. Well, we don't have Italian banks, Greek banks. [indiscernible]

Constantine P. Iordanou
Chairman and Chief Executive Officer

We have no Spanish or Italian or Portuguese debt or anything of that sort. None on our book.

R. Scott Frost
BofA Merrill Lynch, Research Division

No exposure to Santander? For example, I saw it in the -- I think it was in your Q, it was -- must have been in a special structure this year?

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

Yes, we have a covered bond from Santander, which is backed by mortgages, so.

R. Scott Frost
BofA Merrill Lynch, Research Division

Right. I mean, I guess that's the thing. Is there some sort of breakout of just sort of issue or exposure in, I guess, Eurozone, especially peripherals by -- however characterized. I mean, is that something that you guys can provide or can give some color on?

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

Well, we just said, other than -- in fairness, we don't have any.

Operator

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

Ian Gutterman
Adage Capital

A comment you made to Jay, I guess, a minute or so ago about the attritional losses being up, in fact. Does that mean that actually by -- that you actually had improvement in your accident year sort of x the fac? Because [indiscernible].

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

[indiscernible]

Constantine P. Iordanou
Chairman and Chief Executive Officer

I didn't say it was fac. I said attritional losses in property, they were a bit up this quarter.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Is that in the insurance or the reinsurance?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It was in insurance.

Ian Gutterman
Adage Capital

Okay. So that's what I wanted -- because you reported, I guess, a flat accident year x cat, but if the attritional fac was worse this year, then [indiscernible] actually sort of an underlying [indiscernible].

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes, but also, you got to look at the change in mix, too. The change in mix is -- don't forget, our casualty business is coming down. The highest loss ratio is associated with long-tail casualty. So when you're going to writing less of that and then you're writing more in the small accounts and short tail, who has a lower loss ratio, so you it's -- you can't go from one to the other unless you had a static book. You've got to look at it by component.

Ian Gutterman
Adage Capital

Understood. I just want to make sure that's what [indiscernible]

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes.

Ian Gutterman
Adage Capital

[indiscernible] something new. Okay. Also your comments at the beginning about the 9% accident year return across the book, how does that differ insurance versus reinsurance? I assume it's higher in reinsurance?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Yes.

Ian Gutterman
Adage Capital

Can you give some magnitude? I mean, are we sort of double digits, reinsurance [indiscernible].

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, I don't want to embarrass my guys, so.

Ian Gutterman
Adage Capital

Okay, fair enough. But I guess I'm just wondering if insurance is pulling its weight [indiscernible].

Constantine P. Iordanou
Chairman and Chief Executive Officer

Listen, insurance is not a business you can navigate as well as reinsurance. Reinsurance, you can be a bit more opportunistic and fluctuate volume in more significant ways than insurance. But I can tell you -- and also, the reinsurance business has the cat business, which is probably the best performing sector in the market, which the insurance business doesn't have the benefit of it. So it's a bit unfair to try to compare one with the other. One strategy is working in -- but I would say our reinsurance folks are in the double digits, and our insurance folks a bit less than the 9%. But we look at it as a combined company, and those things will change depending on where the market is.

Ian Gutterman
Adage Capital

And then just my last one is I think, John, when you were commenting about RMS 11 and the different drivers, I guess what surprised me is some data I saw recently. It seems most of the companies are talking about the storm surge and the inland wind being the main drivers. But I guess what I had seen was that the actual biggest driver was this change in the short-term environmental impact, which I guess surprised me because I didn't think there was anything new in the science that would have made that worse since they introduced that 5 years ago. Is that consistent with what you guys see when you look at it? And if so, is that where your biggest concern is?

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

Well, it's not really a concern on the frequency. AAR had already published documents and papers on this, and RMS is now agreeing with. It's really the magnitude. I think people agree that the warmer sea surface temperatures, which is a cyclical fact. Because there's very different reasons why people think it's happening, but it has happened, and the data is quite clear that there is a higher frequency when the sea temperatures are warmer. There are other factors that can also drive it as well. The sort of El Niño effects and things like that, but it's really the magnitude, I think, by which this frequency -- where you come down versus the long-term trend. And that's been subject to some interesting discussions and debate. On that piece, I think our teams are kind of coming down that we think there will be a more frequent event of the storms while the sea temperatures are higher in the cyclical time. But you've got to go backtrack it against all of your data and really come to grips with this. And I think that's what's going to be -- all 3 of these are going to be interesting as a companies across the industry analyze this and implement this.

Ian Gutterman
Adage Capital

Okay, that's fair enough. I mean, I certainly agree that there should be some component for it. It just surprised me that they really hiked it up a lot. It doesn't seem like anything's really changed from what we learned in '06. And if anything, from what I understand, some of the scientist they worked with have now refuted what they put out in '06. It was surprising that was the main driver as it seems the most flimsy. But I mean, there's not the data to support it like there is on the wind speed or the storm surge. Is that fair?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Ian, you will never get enough empirical data to feel 100% comfortable. That's why you got to make judgments on these things. And you can get very smart people on both sides of the table, and they can have very good arguments, and they both -- by definition, they both cannot be right, but the arguments can be very logical. So that's why it's taking us some time to understand it and implement because it will have implications as to what happens to us as a company and what happens to the marketplace.

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

And Ian, I mean, I would not say that one is dramatically that much more important than the other because it depends upon where you are and where your coverage is at. Where are your exposures. Because these can have different impacts dependent upon where you are. I would just like to clarify on the prior question about our exposures in peripheral European countries. We do have the 35 -- we still have the $35 million Santander covered bond in our portfolio. That's our only exposure.

Operator

Your next question comes from the line of René Mesquite [ph] with Evercore Partner.

Unknown Analyst

Question on the property cat business. Since capital is rising and 10% to 30%, those are requirements, and pricing is up maybe 8% to 10%, how do you look at the profitability of the business? Has the ROE actually improved? And how does it impact your decision to write less or more business?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, there is 2 areas that you got to look at. One is your absolute tolerance. That is zonal tolerance that says is 25% of equity capital. That might only be a affecting 1 or 2 or 3 zones. This is a big world. Now the second part is where do you see price improvements, especially in areas that you did not have significant participation in the past. And it had nothing to do about your capacity from a balance sheet point of view to engage those areas, but you just didn't like the price. And there is a lot of room for us. Depending what happens with pricing. In a lot of zones, Japanese quake, South American quake, New Zealand, Australia, European wind, et cetera, in all those zones, we're still significantly under-leveraged or underweight from -- the areas that we're getting close to our risk tolerance is mostly in the United States: Northeast, Florida, maybe the Gulf Coast. So you got to look at it from that perspective, too. So sometimes individual pricing gave us more opportunity to write in parts of the world that we were not a significant participant in the past, and we took advantage of it.

Unknown Analyst

So has some of the increase in the property cat reinsurance this quarter been from Japanese covers and non-U.S. covers?

Constantine P. Iordanou
Chairman and Chief Executive Officer

No, some of it, it was from international covers. Some of it, of course, from the U.S., but some of it was from international covers, yes.

Unknown Analyst

Okay. The second question is on more general pricing. Where do you think we are in the cycle right now? And your retentions are rising, just curious what's happening on the competitive landscape?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, no different what I said in the prepared remarks. I think we have pretty much bottomed out. I don't think there is significant pressure for further deterioration with the exception of a couple of lines. Having said that, in some lines, getting 1% or 2% increases doesn't even keep up with trends, so you're losing ground on that basis. Our retentions for us is because -- not because we like the business more. You're seeing a change in our retentions because in the shift on the book of business. The more we write in small accounts, which we keep 100% net, it will have an effect into the net-to-gross numbers. And as the -- where we buy the most reinsurance is on the large accounts, the Fortune-1000 type of accounts, and as we write less of that, you see the changes in the retentions. So part of the retention is not a change in strategy to buy the reinsurance in a different fashion, but is more as the outcome of the shift in the book of business that we write.

Operator

Your next question comes from the line of Ron Bobman with Capital Returns.

Ron Bobman

I have a question about Japan. The severity of the quake I'm told was not part of sort of the data set the modelers had sort of previously put forth. And I guess sort of the knock-on effect of it actually being an offshore quake yielding a tsunami and the nature of the losses. Are there any sort of lessons learned or just observations that sort of -- or your takeaway as a result of the Japanese quake and how losses are unfolding and the types of companies that are incurring losses at the insurance and I guess reinsurance level?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I mean, there is lessons learned. I think everybody, including us, were surprised about the devastation a tsunami can have. And you've seen the pictures and you've seen the force, et cetera. And I think at some point in time, all that will going to get recalculated into the model. It never really changed our view that we always view Japanese cat pricing to be inadequate. And for that reason -- and we were patient for many years because in the year that you have no events, any price looks adequate, right? you take in premium and you have no losses, so it looks adequate. It's only when the event happens. So I think we benefited of having way below our norm tolerance for risk in Japan because of pricing. So has the pricing come up to the level that it makes us want to go in with both 2 -- with both feet? Not yet. We still -- there have been very good corrections in the right direction. But also I think, not everybody has digested the total loss that is going to emanate from that because the business interruption and contingent business interruption issue, we still don't believe it's a big issue, but it still has not been settled. And we're only going to find out in the next 2, 3 years as it evolves. So I think you will see, over time, readjustments as to how those covers get priced and if it gets to the point that we think it's attractive, we have plenty of capacity to commit. But right now, I think our appetite for Japan is limited.

Ron Bobman

I have another sort of broader quick, really, question. With the some degree of probability of aftershocks producing meaningful insurance losses after an initial quake, how do you -- how does anyone really get comfortable and maybe -- and obviously, how does Arch get comfortable even entertaining participating on a program renewal that suffered a quake loss during its prior 12-month contract life?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, I mean, it's a complicated question, but you do anticipate aftershocks -- it's not proven to us that the aftershocks do significantly more damage to the existing damaged buildings. Usually, there is a lot of damage that happens when the quake happens. And when a structure has significant damage an aftershock is not going to change your loss potential. A lot of these buildings, they get declared total losses. They have to be demolished and rebuilt. So the aftershock doesn't have a major effect. Now our underwriters have empirical data and statistics, and we know less about quakes than we know about wind. Wind is a much better area, but in essence, you got to go with the long historical averages, and people who say that "I wrote this cover for half, and I don't want to write it for 2x because I'm afraid of an aftershock," sounds illogical to us. Unless they have significant scientific evidence that an aftershock is going to happen, and it's going to be significant and it will damage new exposures.

Operator

Ladies and gentlemen, that does conclude our question-and-answer portion of today's call. I would now like to turn it back over to Mr. Dinos Iordanou for closing remarks.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, thank you all for listening to us, and we're looking forward to talking to you 3 months from today.

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