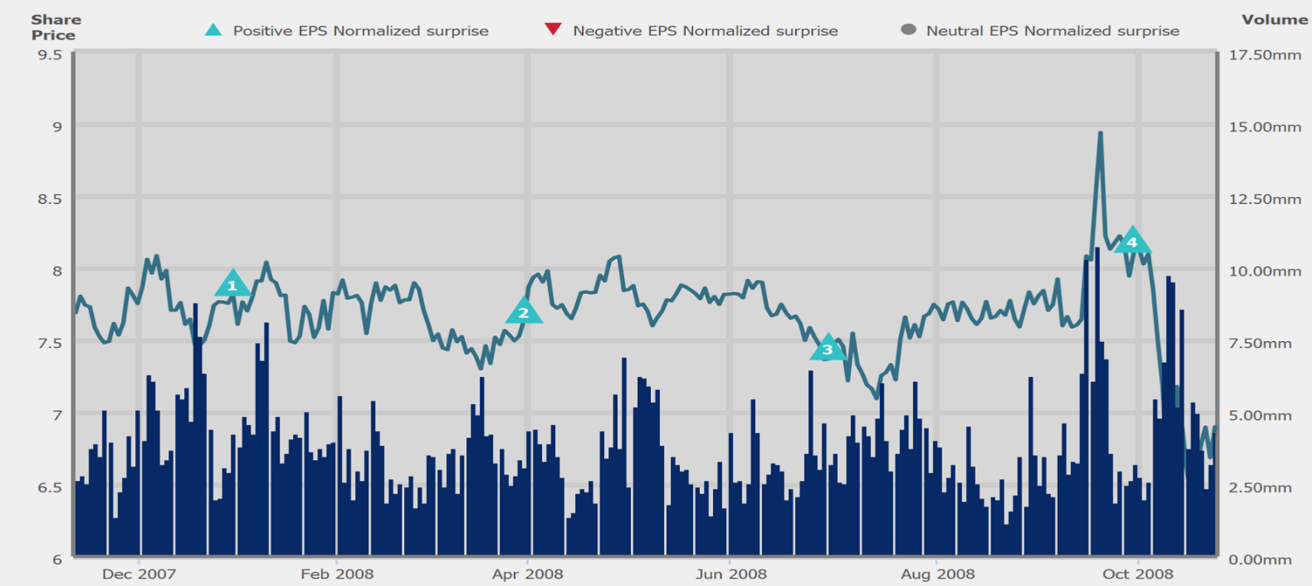
S&P Global
Market Intelligence

Arch Capital Group Ltd. NasdaqGS:ACGL
FQ4 2008 Earnings Call Transcripts
Wednesday, February 18, 2009 4:00 PM GMT
S&P Global Market Intelligence Estimates

	-FQ4 2008-			-FQ1 2009-	-FY 2008-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.14	0.16	▲14.29	0.28	0.91	0.92
Revenue	-	-	▲5.62	-	-	-
Revenue (mm)	582.82	615.57	-	845.10	2781.19	2805.73

Currency: USD
Consensus as of Feb-18-2009 2:53 PM GMT

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



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ4 2007	0.31	0.35	▲1 9.38 %
FQ1 2008	0.30	0.31	▲2 3.33 %
FQ2 2008	0.29	0.31	▲3 6.90 %
FQ3 2008	0.07	0.11	▲4 57.14 %

Table of Contents

Call Participants

EXECUTIVES

Dinos Lordanou

John Vollaro

ANALYSTS

Ian Gutterman
Adage Capital

Jay Gelb
Barclays Capital

Josh Shanker
Citi

Mark Dwelle
RBC Capital

Matthew Heimermann
JPMorgan

Vinay Misquith
Credit Suisse

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Fourth Quarter 2008 Arch Capital Group earnings conference call. My name is Demali and I will be your operator for today. At this time, all participants are in listen-only mode. We will be facilitating a question-and-answer session towards the end of today's conference. (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 assessment 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 the 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 will also make reference to some non-GAAP measures of financial performance. The reconciliation to GAAP and definition of operating income can be found in the Company's current report on Form 8-K furnished to the SEC yesterday, which contains the Company's earnings press release, and is available on the Company's website.

I would now like to turn the presentation over to your host for today's conference, Mr. Dinos Lordanou and Mr. John Vollaro. Please proceed.

Dinos Lordanou

Thank you, Demali. Good morning, everyone, and thank you for joining us today. The fourth quarter was a challenging finish to a difficult year for financial services companies with economic conditions being the worst we have experienced in many decades.

In view of this challenging environment, Arch, on an operating basis, had an acceptable quarter, in general, and a good year from an underwriting perspective. Our investment performance while acceptable on a relative basis was not as good on an absolute basis.

Our annualized return on common equity was 10.9% for the quarter and 15.8% for the year. Both the quarter and year results were affected by cat losses caused by Hurricanes Gustav and Ike. A significant part of the losses emanated from our onshore and offshore energy book of business, a sector that we increased our exposures post Katrina, Rita and Wilma in 2005 as rates increased substantially. For the year, we achieved a combined ratio of 95%.

Our book value per share was $51.36, down from $53.04 at September 2008 and $55.12 as of the end of 2007. The decline in the quarter and the year is attributed to unrealized investment portfolio losses, which we continue to believe are for the most part transient, and we expect to recover most of them over time. Having said that, we are not pleased when we have a decline in book value per share, which, along with return on equity, we use as our main report card.

Putting things into perspective, however, over the past seven years, we have grown book value per share at a compounded annual rate of 16%. Over this period, our shareholders have benefited from their long term commitment to us and from our disciplined focus on underwriting and conservative investment approach.

Our cash flow from operations at $166 million for the quarter and $1.13 billion for the year continues to be strong.

Our investment view continues to be conservative both on credit and duration and our portfolio has been constructed as such. For all of 2008, our investable assets returned a negative 200 basis points in original currency and a negative 280 basis points factoring in FX movements.

Our expanded supplement - and John Vollaro in his comments will provide more details on the portfolio's construct.

Our gross written premium for the quarter were flat at $825 million with reinsurance gaining $21 million in production or approximately 8.5% and insurance being down approximately $27 million or approximately 4.5%. On a net basis, reinsurance was up, 24% and insurance was down approximately 3% for a Group increase of approximately 6.5%.

Our reinsurance operations wrote a major contract with an effective date of December 31 at the client's request. Absent this transaction, the reinsurance group's volume will have been down approximately 5% on gross written premium and up 7% on net written premium.

Our property facultative business, which commenced operations almost two years ago has reached critical mass with a monthly premium run rate of approximately $5 million. More importantly they have reached their return on equity goals one year ahead of schedule.

From a mix of business point of view, in our insurance operations, property, marine, and aviation were flat, and professional liability premiums were slightly down, with programs and executive assurance volumes increasing slightly. Our insurance group continues to reduce their writings in casualty, healthcare, and surety lines.

Similarly, our reinsurance operations continue to decrease their casualty writings significantly. Today, our casualty business represents approximately 30% of our reinsurance volume versus approximately 40% in 2007. Conversely, our volume in property and property cat has grown to approximately 49% of our volume versus 38% a year ago. Our reinsurance volume in marine aviation was essentially unchanged.

Now, let me share a few thoughts on the insurance market environment and our January 2009 business. Clearly, the underwriting environment is improving. This improvement is more evident in our reinsurance business where the flight to diversification [ph] and the finite capacity availability in the cat area has created a good trading environment. We see buyers who are more willing to introduce new names to their treaties and who are a bit less loyal to their longstanding reinsurers irrespective of the share these reinsurance offered them in the past.

Buyers today are not as likely to maintain large participations with a single reinsurer as they have in the past. Over time, this change in buying behavior will benefit Arch, giving us opportunities to penetrate new clients and also to expand our geographical reach.

On the insurance side, rate improvements were mixed. Short tail lines such as E&S and global property that have cat exposure are getting rate increases. The same hold true for both onshore and offshore energy. The D&O area is achieving double-digit rate increases overall with financial institutions being the strongest sector. Professional liability rates for small accounts are flat to slightly down, an improvement from the trend we've seen in prior quarters.

Casualty, healthcare, and large accounts, professional liability, continue to be very competitive. While rate declines have moderated from double digits to mid- to upper-single digits, it is an improvement, but from our perspective additional corrective action is required to stabilize these lines.

Looking ahead, we expect the underwriting environment to continue improving. Having said that, the current economic conditions will have a negative on our customers. Rate improvements will not necessarily translate into more premium revenue as the exposure base is negatively affected by reduced payroll, sales, TIVs [ph], et cetera. In addition, some customers are limiting their purchases due to affordability by retaining more risk themselves or buying less limits.

For the U.S. property casualty industry, where premium revenue statistics exists going back to the beginning of last century, premiums for the industry were down 0.6% in ’07 and are projected to be 0.8% for ’08. This is the first time since 1932 and 1933 that the industry has experienced negative premium growth for two consecutive years. The last time premium growth was negative on a single year was 1943. As the market improves and with our capital position being excellent under various measures, we are very well positioned to benefit from opportunities in either the insurance or reinsurance markets.

Before I turn it over to John for more commentary on our financials, let me update you on our PML aggregates. As of February 1st, ’09 our one in 250 PML aggregate from a single event expressed as a percentage of common equity was slightly below a 25% self imposed limitation.

With that, let me turn it over to John.

John Vollaro

Thank you, Dinos. Good morning everyone. Our 2008 financial results were acceptable considering the insurance environment, the financial turbulence in the overall market, and the third worst catastrophe year in industry history. Despite these three - these challenges, we produced an operating ROE of 16% for the year. Although book value declined by about 3% during the fourth quarter due to mark-to-market adjustment, we believe that these adjustments will substantially recovered over the next few years.

With that said, I will briefly walk you through the components of our financial results. Before I start, though, I’d like you to please note that for the reasons discussed in the release all earnings per share date for the fourth quarter of 2008 or on a pro forma basis.

Dinos has already commented on some details on the premium volume, but as usual a few additional noteworthy items. Our segment mix remained relatively constant in 2008 with premiums written by the insurance segment representing about two-thirds of our gross volume and reinsurance the balance while property and other short tail lines represented approximately 47% of our net premium volume.

With regard to premium growth rates, it should be noted that the reinsurance group wrote a large property oriented quota share which Dinos mentioned that (inaudible) at December 31, ’08, and that included the transfer of the related unearned premiums of approximately $33 million. The unusual renewal date resulted in our booking what would have been a January 1, 2000 renewal in 2008. This obviously will negatively impact premium growth rates in comparisons to the first quarter of 2008 in 2009.

On a consolidated basis the ratio of net to gross written premiums in the fourth quarter of 2008 increased to roughly 75% from 70% in the 2007 quarter. That’s still primarily resulting from the non-renewal of the Flatiron treaty. On a reported basis, we ceded only $4 million of written premium to Flatiron in the fourth quarter of ’08 compared to $35 million in the prior year quarter. On an earned basis, premiums ceded under this treaty amounted to $21 million for the fourth quarter of ’08 in comparison with $76 million ceded during the 2007 quarter.

The overriding estimated profit commission recorded on the treaty with Flatiron are reflected as a reduction of acquisition expenses of the reinsurance segment and this improved the expense ratio of that segment by 100 basis points in the 2008 quarter while the impact on their expense ratio in the comparable 2007 period was 410 basis points. The change in ceding commission was primarily due to a lower level of earned premium in 2008 and the effect of higher loss estimates of Hurricane Ike in the fourth quarter. The unearned premium remaining on business ceded to Flatiron was approximately $18 million at year-end 2008.

Turning to our operating results, our consolidated combined ratio was 101.2% in the 2008 quarterly period, which was 17 points higher than the comparable ’07 quarter. 2008 underwriting results include 22 loss ratio points mainly from the re-estimation of claims from catastrophic events, primarily Hurricane Ike, while the effects of cat losses in the 2007 quarter were not significant.

In addition, the loss ratio was also affected by an increase in large individual risk losses as well as from an increase in our 2008 loss pics [ph] for intermediate and long tail business. The sum of these impacts was partially offset by a higher level of favorable reserve development net of related adjustments, which totaled $116 million in the 2008 quarter and $32 million in the fourth quarter of 2007. Approximately 43% of the net favorable development in 2008 quarter was from long tail lines with the balance coming from short and medium tail lines. The development primarily was from the 2002 to 2005 accident years.

In general, reported and paid claim activity for business written in prior years across most lines of business continued and better-than-expected levels and IBNR and ACRs combined represented approximately 71% of total loss reserves at quarter-end.

The consolidated expense ratio was 210 basis points higher on a quarter-over-quarter basis primarily due to an increase in the acquisition expense ratio. Most of this increase was due to the elimination of the Flatiron treaty discussed earlier.

The operating expense ratio was essentially unchanged as the decrease in the reinsurance segment's ratio was offset by an increase in the insurance groups. The increase in insurance segment's operating expense ratio reflected charges of $2.8 million or 40 basis points on a consolidated expense ratio. Our cost incurred is part of an expense reduction initiative that will primarily benefit the expense ratio beginning in 2009.

Turning to investment results, in the 2008 quarter pre-tax net investment income per share rose by approximately 5% on a quarter-over-quarter basis to $1.79. On a sequential basis, net investment per share decreased by 4% primarily due to the effects of lower risk-free rates available in the markets.

The increase in investment income per share on a quarter-over-quarter basis was due to a higher level of average investable assets and the accretive effects of share repurchases earlier in the year. The growth in investable assets primarily resulted from the continuation of strong cash flow from operations during 2008. This quarter's cash flow brings the total flow produced since the recapitalization of the Company to just under $10 billion. After reflecting cash flow and financial market turbulence, which I will comment on in detail in a moment, investable assets on a reported basis stood at approximately $10 billion at year-end. And the portfolio remains well positioned.

Taking into account yields, realized and unrealized gains, and certain investments accounted for under the equity method, the total pre-tax return of the portfolio excluding the effects of FX movements was slightly negative at 76 basis points for the fourth quarter of 2008. As we have indicated in prior calls, we have excluded FX from this calculation because most of the investments in foreign securities are held as a hedge against our insurance obligations denominated in foreign currencies and for which there is a corresponding credit in earnings.

The average credit quality of the portfolio remains high at AA+ and the reported duration was relatively short at approximately 3.6 years.

I would like to caution everyone that given the current state of credit spreads in the market that the correlation of the interest rate sensitivity between treasuries and non-treasury securities has changed dramatically. And accordingly, the conventional duration calculation for non-treasury securities may not be appropriate for evaluating the interest rate sensitivity of our or any other portfolio for that matter.

During the quarter, we did expand the portfolio's duration using interest rate futures based on our view at that point in time of potential interest rate movements over the short term. The portfolio continues to be comprised primarily of high quality fixed income with essentially no investments in hedge or private equity funds and no direct exposure to public common or preferred equities. In addition, we continue to have no CLO, CDOs or credit default swaps in the portfolio.

We have, as we have done over the last several quarters, included additional information on the asset-backed, mortgage-backed, and commercial mortgage backed portions of the portfolio as well of a schedule of the ten largest corporate names in our bond portfolio. We hope this data is useful and in encourage you to review it.

In addition to that data included in the release, I would like to share with you some additional information that we have used to gauge downside risk on a part of the portfolio. For instance, in the non-agency commercial mortgage backed sector of our portfolio in stress testing the value of these securities over a three-year horizon, we would breakeven on an economic basis today even if cumulative default rates reached 50%, a very high level by almost any standard.

In the bank loan area, cumulative default rates would have to rise to 60% over the next three years and recoveries would have to be reduced to 50% from a long-term average of 70% to 75% to bring the economic returns on the loans to zero.

I would also like to take a few minutes if you will indulge me to share our thoughts with you on one of the 'the topics of the day,' other than temporary impairments or as it's infamously now know OTTI. First, it is important to understand that we - when we at Arch take an OTTI provision that amount does not necessary reflect our view of the economic value of the security. For example, if a bond has a market value that is substantially below cost and meets the required - the criteria, therefore, for OTTI, and if we expect to recover most, but not all of the principal on the security in the future, we may have to record an OTTI charge, which is then reflected in the financials as a realized loss based on the market value of the security. It should be noted that in our case there is no impact on book value per share or capital as our portfolio is all mark-to-market and that is the accounting used by the rating agencies.

So, to illustrate the point I made a second ago, hypothetically, if we have security with a cost of $100 and a market price of $50, and an expected realizable value of $90, we would record an OTTI provision or a realized loss as it would be reflected of $50, not $10. The point I am trying to make is that OTTI losses, which are recorded as realized losses are not necessarily realized losses. In my view, the accounting rules involved are not consistent with the economic reality in the current environment because the OTTI rules are based on an implicit, but flawed assumption that the market price of a security is always a reasonable proxy for its actual value or if you will that the markets are always efficient.

I hope that this additional information regarding OTTI is useful to you and I think it's certainly something people should bear in mind in particular in the current environment.

Let me quickly turn now to our financial condition. Our balance sheet remains in excellent shape and our financial flexibility remains strong with total capital amounting to approximately $3.8 billion at December 31st, at year-end debt represented approximately 10% and hybrids represented less than 9% of our total capital.

From a liquidity standpoint, the hybrids are all perpetual preferred while our revolving credits borrowings mature in August of 2011 and our long term bonds mature in 2034.

We began 2008 with a significant level of excess capital and we continue to hold a very comfortable cushion over the capital required to maintain our current ratings. Our liquidity is also at a very healthy level as cash, short-term investments, and treasury and agency securities represent about 23% of our investable assets.

The strong capital and liquidity position should allow us the necessary flexibility to take advantage of insurance market and/or investment opportunities that may arise provided, as always, that they meet our risk-reward requirements.

With respect to capital management, we currently have $450 million remaining under our current share repurchase authorization. However, given the current financial market conditions and the potential for attractive opportunities in insurance and reinsurance markets, we are continuing to take a wait-and-see approach to further share repurchases.
That concludes our prepared remarks and Demali we'll take questions now.

Question and Answer

Operator

(Operator instructions) Your first question comes from the line of` Jay Gelb with Barclays Capital. Please proceed.

Jay Gelb
Barclays Capital

Thanks very much. Good morning. First, I just want to circle back on you commentary about potentially the impact of price increases being offset - with benefit of price increases being offset by the impact of the recession. What does that translate into in terms of your outlook for premium growth in 2009?

Dinos Lordanou

Well, Jay, you know we don't give guidance and in essence we don't even try in this Company to project the future. My commentary was basically there is always a confusion between rate increases and premium revenue and the two - they are two independent forces moving at their own pace depending on the environment. Let me give you a specific example. You might have an electrician that used to run 15 crews with 15 trucks and approximately 60 employees, four in each truck. And you might park five of them in the yard. That means you've got five vehicles off your exposure base and you got probably one-third of the payroll and probably one-third of your sales going down and in essence your exposure is down. You might be getting 10%-15% rate increase on that account per unit of exposure, but at the end of the day you're going to end up with 20% less premium. So, that was my commentary and usually I like to look at history not that always history predicts the future, but history has a way to repeat itself. And it's really amazing that it's the first time that we are going to have two - on the U.S. P&C market, we are going to have two consecutive years with negative premium growth. And it didn't happen until 32 and 33. I am not saying - I am not predicting that the environment is bad or the depression era, but I think you - we are having a difficult time understanding how much our customers are going to purchase. And for that reason we don't try to predict the future. What we instruct our guys to make sure is that we stick to our underwriting guidelines. We price our products correctly. And we try to manage our operation that we have a balance between revenue and expenses, from that perspective. And then you play the game good, I think good things will happen. The score board is going to be right at the end.

Jay Gelb
Barclays Capital

Okay. And just a follow-up on that, directionally do you think Arch could show positive premium growth in 2009?

Dinos Lordanou

Yes. I think that's - that is a possibility because there is - in that mixture you have to put the other variables that are surrounding us. There is companies that they have less capacity maybe their capital base has been impaired. Don't forget, a significant amount of the excess capital has disappeared because of the revaluation of the asset size of the balance sheet. And there is a few companies that they have I will call distress situations that they are working from out. And in essence there is a - even though I don't like to use the phrase "flight to quality," there is some movement from customers from what they perceive to be better companies today than what they perceived the more strong companies were a year ago or two.

Jay Gelb
Barclays Capital

Good point. And then, John, on the OTTI commentary, will Arch be adopting FAS 159 in 2009 so that unrealized gains and losses show up in the same line as -

John Vollaro

No -

Jay Gelb
Barclays Capital

-as realized? Or are you saying that whatever the marks are whether or not they go through OTTI -

John Vollaro

They have - they go to -

Jay Gelb
Barclays Capital

It doesn't impact book value?

John Vollaro

Correct. And the way the rating agencies view our Company and many others, not all of them, there is a difference. In our case, everything is mark-to-market. That comes out of capital and that's how that's viewed. So it's all - when you do take an OTTI provision, in our case, it's simply geography, just moving a number that instead of going straight to the balance sheet it's running through the realized gain account before instead of the unrealized gain account.

Dinos Lordanou

Yes, they always view us on a GAAP basis where various companies they view on a statutory basis and you get a different answer on a statutory basis.

Jay Gelb
Barclays Capital

Understand. And the - for the OTTI, is Arch adopting FAS 159?

John Vollaro

No, we are not adopting FAS 159.

Jay Gelb
Barclays Capital

Okay, thank you.

Operator

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

Vinay Misquith
Credit Suisse

Hi good morning.

Dinos Lordanou

Good morning, Vinay.

John Vollaro

Good morning.

Vinay Misquith
Credit Suisse

Could you add some color on why you chose to write the large or quota share reinsurance contract so early in the season rather than waiting a little bit longer for pricing to rise?

Dinos Lordanou

Well you know that's a good question. As I said before in other calls, first of all, we try to service our longstanding customers and make sure that we have available capacity for them throughout the years. In this particular case, I think the transaction was very beneficial to us, not only gave us significant premium revenue, but also on a PML basis this transaction didn't need much of the PML because there is a portion of the deal that gives you attritional losses. And also geographically, this particular situation because it's a national contract, didn't add a lot to our pic [ph] zone. So, it was a very attractive transaction. We had a relationship with this client predominantly on the cat area and on an excess of loss basis in the past and in essence this year we have less PML exposure on the same client than we had a year ago. So, from that perspective, we didn't use as much as we used a year ago. But we are not going to abandon the clients waiting for June 1 or July 1. Our commitment to our clients is that we want to get an acceptable rate for a good return for our shareholders and be there for them throughout the year. So, that's basically our approach to the business.

Vinay Misquith
Credit Suisse

Okay, fair enough. So, just want to (inaudible) critically, this is not at significantly pure PML for this year and so did not probably restrict you from writing anymore business -

Dinos Lordanou

Vinay, that's correct. As a matter of fact, for the same client, you reduce - our last year's PML based on an excess of loss position we had on the client was higher than the PML we have today through this quota share.

Vinay Misquith
Credit Suisse

Okay, fair enough, fair enough. The second question was primary insurance. You just clear as to why the accident year loss ratio ex cats was about 102.6%, I am sorry, the accident year combined ratio of ex cats was about 102.6%?

Dinos Lordanou

Well, I mean, the - we have moved up the accident years because, let's face it, rates have been coming down now for a few years. And also, you remember early in the year we had one-off losses especially in the not cat related losses - large losses in the property area. John, you want to add something to it or -?

John Vollaro

Yes, Vinay, how did you get the 102 because -

Vinay Misquith
Credit Suisse

Right now that's within the primary insurance segment, so you have 108.6, you add back the 9.2 of favorable -

John Vollaro

Yes. Yes, okay, within the -

Vinay Misquith
Credit Suisse

And then you minus

John Vollaro

-within the insurance segment's. But I thought you were talking consolidated.

Vinay Misquith
Credit Suisse

Yes. And then you minus the 14.1 for the large cat.

John Vollaro

Yes. The biggest impact there would be one the specific risk losses that we cited, those predominantly occurred in the insurance group. And secondly, as what Dinos said, we have clearly been moving up on the longer tail lines, we are writing less of them, but - in particular on the casualty area we have moved it up as rates have moved down and to a lesser extent the professional liability lines that we would consider long tail. Those have been moving up too. So, it’s a combination of the two. I think, probably if you took the specific large losses out, you’re probably looking at maybe four or five points on that ratio.

Vinay Misquith
Credit Suisse

Fair enough. So, it should be high 90s versus -

John Vollaro

Correct.

Vinay Misquith
Credit Suisse

Okay. That’s it alright. Thank you. And one last question, if I may. Curious about your investment in the bank loan funds as to why that investment went up this quarter?

Dinos Lordanou

Sure. We made those investments through external managers. And that’s why we have to account for them on an equity method. Second, some of these managers they had some leverage, one and a half to one, two to one in some cases. And us and some other participants chose to de-lever these investments because we have the liquidity, we can hold them. This is secure bank loans. The fact that we have marked them down and I believe we marked them down to $0.50 on a dollar, we are down 50%-52% from original valuation. That’s not what our belief is that these bank loans will return. So, we still feel very, very comfortable with investments. And by de-levering them now we can hold them to maturity and we are going to benefit from the returns these bank loans over time they are going to give us.

John Vollaro

Yes. Plus these additional investments generally we got even more protection than we have on the first set. So not only are they coming in where we think the valuations are really attractive, even more attractive than they were before, but we are also on a more protected position than we were on the original.

Vinay Misquith
Credit Suisse

So, did you get these at $0.52 on the dollar or was it a higher valuation?

Dinos Lordanou

Well, you’ve got to go - it’s not just one transaction. There are several transactions, so we did get a significant discount -

John Vollaro

Discount.

Dinos Lordanou

And also we got seniority to the original investors. Of course, we were an original investor too, but for these tranches, we got more seniority. So, all in all, we felt these were attractive investments for us.

Vinay Misquith
Credit Suisse

That's right. Thank you.

Operator

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

Matthew Heimermann
JPMorgan

Hi good morning everybody.

John Vollaro

Good morning, Matt.

Matthew Heimermann
JPMorgan

Hi. A couple of quick ones I hope, just with respect to the PML, I just been curious how the PML if it's slightly less than 25% now would change based on what we know about pricing today. If you went through the year and your portfolio didn't change at all will that come down a couple of hundred basis points more than that or just - and am I thinking about that correctly?

Dinos Lordanou

I don't really understand the question -

Matthew Heimermann
JPMorgan

Well, here let me restate it then. I guess my thought process is with pricing going up rate per exposure is getting better. So presuming that - presuming, well I guess it depends on whether customers retain risk or not, but I just been curious based on what you've seen through one-one if customer behavior is the same combined with pricing whether or not your PML would stay flat if you just renewed your portfolio -

Dinos Lordanou

Well, let me - now I understand.

Matthew Heimermann
JPMorgan

Does that make more sense?

Dinos Lordanou

I understand where you are going. PML is an exposure based calculation. You run your data set how many buildings ain't [ph] sure what location they have the - and the various scenarios of different storms you come up with a probability of what the loss is going to be. That has nothing to do by how much you charge. Of course, in this environment and I think our average increase in pricing for Southeast wind was approximately 15%. So, if we renew the portfolio exactly as we had it a year go, which is not always the case, because we move layers, we go higher, we go lower, et cetera, so it changes that. But in a hypothetical, we would have renewed exactly the same, we would have 15% more premium because the effective rate increase was 15%. Having said that, you see different changes. For example we just talk about a large contract that we took from 100% excess of loss buying cat capacity that company decided to both buy some cat maybe at a higher level and also buy a quota share for surplus relief and also cat protection. And that changes the economics of the deal. You still get attractive returns and you get much bigger premium and you don't use as much PML.

John Vollaro

And I think - you are thinking of it sort of in essence of the aggregate loss.

Dinos Lordanou

Right.

John Vollaro

-over the PML on the business, whereas when we set that PML number that is set purely on a loss number.

Matthew Heimermann
JPMorgan

And all that was helpful. I - it was just a purely worded question. I was actually more simplistically, if you just assume the premium collected was the same rather through - if rates are up 10% to 15%, is it fair to say a 24% PML simplistically comes 22, is it that easy to think about that way?

Dinos Lordanou

Yes. If you retain the same amount of premium. But if your premium goes up, your PML will remain constant.

Matthew Heimermann
JPMorgan

Yes. I am sorry, poorly worded question.

Dinos Lordanou

No, no. You know it's my greatness. Sometimes I don't understand.

Matthew Heimermann
JPMorgan

It's my German. So, the other question I - try to stick two more and if I could then, just when I compare where you are marking your RMBS and CMBS and non-agency, that is fair to assume that the vast majority of the difference between the mark-to-market relative to par is frankly a function of subordination?

John Vollaro

That's the primary mover. You have other factors and you know we've outlined them in the release - they are all there and you've obviously studied them - the other things such as the weighted average loan to value, all the factors effective, but I yes, I would agree that the primary move - difference between the two would be the difference in credit support.

Matthew Heimermann
JPMorgan

Okay, that's helpful. The only other question I had was, I just wanted to make sure on Ike that at this point there is no more attention left on any of the primary exposure?

John Vollaro

On the primary side? I mean on the primary side, we are very - we haven't attached our cat cover yet, but we are very close to it.

Dinos Lordanou

Well, everything but the - (inaudible) the offshore - this is on the onshore - the offshore, we have attached a cat cover, but we have significant - we only penetrated the cover by I think 15%. So we got tremendous room. So, from the insurance perspective, it's very little movement that might happen. Movement can happen on the reinsurance side, but I believe we set up our reserves extremely conservative. I think very conservative, especially on the offshore because there is a lot of uncertainty on the offshore. Even though the surface damage, how many platforms got damaged totally or partially early on didn't give us a significant amount of loss, it's the underground destruction of the wells and the big question as to are these wells are going to get re-drilled or there are going to be plugged and abandoned? And you get significant variability in the answer as to what reserves you are going to set.

Matthew Heimermann
JPMorgan

Okay. Now, that's very helpful.

Dinos Lordanou

In the prior hurricanes, Katrina, for example, only a little over 10% of the wells got re-drilled, the rest of them they were plugged and abandoned. A lot of our reserves we set that a significant number north of 60%-70% will be re-drilled. The problem with that is we don't know what's going to happen. Clients have 18 months to make those determinations. Price of oil, if it stays where it is, probably you are going to have a lot of plug and abandonment versus re-drilling. If well goes to 70, 80, 90, or 100 bucks, you make a different determination. But we wanted to make sure we put this behind us and we calculated, in my view, in a conservative way, and we put up the reserves up and we feel very comfortable where we are.

Matthew Heimermann
JPMorgan

Okay. That's helpful. Thank you very much guys.

Operator

(Operator instructions) And your next question comes from the line of Josh Shanker with Citi. Please proceed.

Josh Shanker
Citi

Good morning.

Dinos Lordanou

Hi Josh.

Josh Shanker
Citi

Hi there. So, let me play double basket a little bit. In addition to the declining economic conditions, some of your competitors and - I hear from lot of industry personnel about the rampant degree of unfair competition or at least priced out in coming from some wounded players in the marketplace. How widespread is this and how does that affect the idea that - of margin improvement? Or are we just waiting for these firms that are struggling to capitulate?

Dinos Lordanou

Well, there is some of that happening, people willing to knock out, but cut. This is fire sale, I wouldn't say gouging, but more fire sale. They are willing to hold on to accounts. They've been longstanding accounts. They can't sell them on stability and vision and great client service, so they sell them on a deep discount. And it affects the business. We shy away from those situation when we get into that. And it only affects new business, Josh, because a lot of our existing customers they are not looking for their renewals to go to these facilities. So, our competition for our own business is going to go to other strong carriers. It's their renewals that they might be moving as new business to others that (inaudible) happens and we shy away from it. Having said that, it has an effect in the market, and at some point in time they can't do it forever. Eventually the accident year numbers are going to start showing and they are going to get weaker and weaker. You can't sell below cost for a long period of time even in a business that has three, four-year duration - yes, you can do it for a year or two or even three and - but at the end of the day, it's going to stop percolating through the numbers and as long as we are disciplining our underwriting we are willing to wait it out. And that's what we are doing right now.

John Vollaro

One way to think about it, Josh, is if you take a long tail line and you cut the premium enough eventually. When your losses start to emerge, they start to - it's starts to look like a short tail line.

Josh Shanker
Citi

Right. And in terms of the - how - in new bids, how willing are competitors seeming to go with some of the (inaudible) parties that you compete against?

Dinos Lordanou

It can get naughty. We had one - I will give you one example, there was pricing on an excess order [ph] that the market price from about six competitors was somewhere between 400,000 and 550,000, and that's a reasonable range. And one company did it for 128,000. That's naughty to me.

Josh Shanker
Citi

Sorry. Well, appreciate the example and good luck.

Dinos Lordanou

Yes, it's one-off. I mean you can't translate that. These things happen occasionally, but it can get really naughty.

Josh Shanker
Citi

Okay. Thank you.

Operator

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

Ian Gutterman
Adage Capital

Hi guys. First, just a follow-up from Vinay's question on the insurance accident year. I thought you - John, you also mentioned in your commentary some change in the pics and so in the longer tail lines. Can you just talk about that -?

John Vollaro

You know what we do on the longer tail lines, Ian, the way we are looking at it is we have a base year, which we are rolling forward all the time, and then we are looking at the effective rate change and when I mean that's the rate change, not just the premium change, but the change - it takes into account terms - deductibles, limits, all that. And then of course we factor in loss trend, which we move around for different lines. It depends on where you are, what you are looking at. And since rates have been declining in certain areas - casualty, some of the professional lines over the last year or so, we have obviously been moving the pics for those up and as you move through the year, it's going to have more impact on your earned premium in late year than it will early in the year as you right to do business.

Ian Gutterman
Adage Capital

Now that makes sense. I just wanted to make sure it was more the pricing impact as opposed to that - you know I think some other companies have talked about having to raise their accident year to put an extra cushion on professional liability -

John Vollaro

No -

Dinos Lordanou

So, Ian, as a matter of fact, I think, because of our starting years being back in ’03, some of them they are coming down. As a matter of fact we have readjusted and you might have even toned down what you otherwise do to an accident year. If you are losing 15%-20% rate and you have some trend, you can really move a 60 loss ratio by 10-12 points just on a 20% rate movement alone. And the fact that they are not moving that much is because if we thought it was 60, the original number maybe was close to 45-50. And you get into a different - but we have systematic way of looking at that by each class of business, sit down with our actuaries and we look at all the years and how they are evolving and we are always looking to factor in changes in pricing that we have experienced. This is actual pricing based on our book of business that we know and we measure on a quarterly basis.

John Vollaro

Yes, the flip side of it is obviously the lines that we’ve seen the largest rate erosion and we have shrunk the most so the book is shifting more of it’s towards short tail. So, some of that impact gets muted if you see you can't translate it directly. But that’s what drove it.

Ian Gutterman
Adage Capital

Okay. And actually that response leads into my follow-up, which is for the year and insurance it looks like your ‘98-‘99 I know there were large losses and it is more than the 90s, but again that’s an ex-cat accident year and cats do happen. So, with a normal cat load, maybe that’s closer to 100. Should you be cutting back even more in the insurance lines until price hardens up and shift in mix for this year and more towards reinsurance and wait till the AIGs and so forth start acting more responsibly before you start growing the insurance again?

John Vollaro

Well, we are not - I mean you can't cap to nothing. You know you got markets, customer relationships, et cetera. We try to really get acceptable returns with everything that we do. But there is no absolute. You can't go from 4 billion to a billion and back to 5 billion automatically as such. So we try to manage within the realities of running an operation that you have employees, customer relationships, agents, broker relationships, et cetera, but not making the mistakes that we are going to be writing business that have no returns.

Dinos Lordanou

Yes, plus, Ian, if you looked at the lines, the areas where most of the craziness you are referring to is going on, we’ve cut the most.

Ian Gutterman
Adage Capital

Very fair, yes.

Dinos Lordanou

It’s a diversified book. Some things are going up. We are seeing rate increases in some lines now. So, in the areas where pricing has really continued to go down, we’ve really cut back a lot. Our Casualty book in insurance in 2004 was the biggest sector. I think we were, maybe, 20% plus and now it’s less than 10% of the mix in the insurance group. That’s the casualty. So, we have really, really changed the mix. It didn’t happen yesterday. It happened over a period of time. But if you go back and see some of our numbers in ’04, you will see a totally different mix than what we have today.

Ian Gutterman
Adage Capital

Very fair. And then if I can ask on the bank loans, again just to clarify, when I am looking in the supplement, at the end of ’07 you had $235 million and for the year you had something around $175 million of marks on that.

John Vollaro

Correct.

Ian Gutterman
Adage Capital

So, that would take it down to $60 million and end of the year $300 million. That means you added about $250 million to that in new funds you got right?

John Vollaro

Well, yes, if you go back, we started to really - we added early in the first quarter and into the second quarter we added a fair amount. And then of course we added some more in the third. It’s about $90 million Vinay was referring, its was in the third quarter.

Dinos Lordanou

In the third quarter.

John Vollaro

The balance was early - most of it earlier in the year.

Ian Gutterman
Adage Capital

Okay. And can you tell us more about what’s - what these loans look like? Are they (inaudible) by industry mix or collateral or things like that? Some kind of better essence of -

John Vollaro

Well, first of all, they are pretty well diversified across industries (inaudible) they are sort of tilted toward - right now towards the defensive areas given the recessionary environment like healthcare, things like that. These are senior loans. All secured. They are floating rate. If you look historically as I said when we stress test them you have to get - to lose money particularly from here you’ve to get a combination of a very, very high default rate and a very low recovery rate to cause these things to have economic losses from where we sit right now. The spreads they are getting won't float. And remember these are amortizing loans for the most part. I can't say that 100%. So, they are paying, in many cases and coming down. Some of - a little bit - it is about 30% or 40% of these loans are in Europe. So, you’ve got some FX in that $175 million number too. So I want you to keep that in mind a little bit. It’s not all just purely write-downs. So, when you look beyond the surface and then start looking at what’s there and you look at it from an economic standpoint as opposed to - yes, we are very cognizant of the importance of the mark-to-market, but at the end of the day, its’ economics that drive us and we still think from an economics standpoint it makes sense to be there.

Ian Gutterman

Adage Capital

Now, that makes sense. Yes, I just want to understand better just so we can get comfortable with it. Are the loans mainly to private companies, public companies?

John Vollaro

It's a combination. It's probably more private than public.

Ian Gutterman
Adage Capital

Okay. Are those companies rated? I am just trying to get a sense of what the rating on the loan facility -?

John Vollaro

Some would be rated, some wouldn't, I don't have that data available. We'll think about in the next supplement and/or the press release maybe we'll get additional data for everyone.

Ian Gutterman
Adage Capital

You can kind of sorry in getting, if they were all say LBO loans, just because they are senior loans, are they all LBOs?

John Vollaro

Yes, they are all - that's one characteristic -

Ian Gutterman
Adage Capital

Then (inaudible) it's a lot different than if were a AA company.

John Vollaro

Absolutely.

Dinos Lordanou

Absolutely.

Ian Gutterman
Adage Capital

So, that's really what I was just hoping to get a little clarification [ph]. Again, next quarter maybe that will help.

John Vollaro

I think that's fair. We'll think about - we know what kind of data to be useful.

Ian Gutterman
Adage Capital

Very good. Thank you guys.

Operator

Your next question comes from the line of Mark Dwelle with RBC Capital. Please proceed.

Mark Dwelle
RBC Capital

Yes, most of my questions have been asked, but I had one quick numbers question, you had mentioned what the operating cash flow was for the quarter and the year, could you have that again -?

John Vollaro

Yes, it was $166 million for the quarter and $1.139 billion for the year.

Mark Dwelle
RBC Capital

Okay. Thank you. And then the last question that I had was considering that you put up a pretty decent combined ratio in reinsurance and a lot of your peers did as well despite fairly heavy load of catastrophes both in the U.S. and globally, how sustainable do you think further rate increases are absent some further increase in demand?

Dinos Lordanou

Well, it's a complicated question. You got to understand a lot of the cat business is capacity availability and the supply and demand. What you don't want to see in the marketplace is most of the (inaudible) that provided capacity they are not there. A significant capacity from what we will call the fully funded unrated vehicles is not there. There is still some operating and they have capacity. And there hasn't been a significant amount of issuance of cat bonds. So, in essence, it's not just the asset side of the balance sheet that reduce available capacity, but also of all these peripheral or alternative facilities they are not in operation. So, for that reason, I think the available capacity got reduced. The demand has not changed. That allows prices to go up. And of course when you have a cat event, like it was the third worst cat year in history, always has an effect on the market. It was not a disastrous year from that perspective. But most that they participate in that business, their cat book paid above average cat losses for the year as it happened with us. For us, our swing was only approximately $100 million. So, in a good year, we'll make $100 million better, so we will be $200 million from where we are today. And on a year like this, we will be a $100 million worse based on the PMLs and the aggregates that we take. But you take that lumpiness because the return over time is attractive. So, it was not a disastrous year for us. It was above normal cat activity. We paid for it and we move on to the next year.

Mark Dwelle
RBC Capital

Okay. Thank you. That's a helpful response.

Dinos Lordanou
Okay, operator, I think, our allotted time is over. We passed the one hour, so if there is no more questions, we will like to thank our listeners and look to talk to them three months from today.