S&P Capital IQ

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Arch Capital Group Ltd. NasdaqGS:ACGL

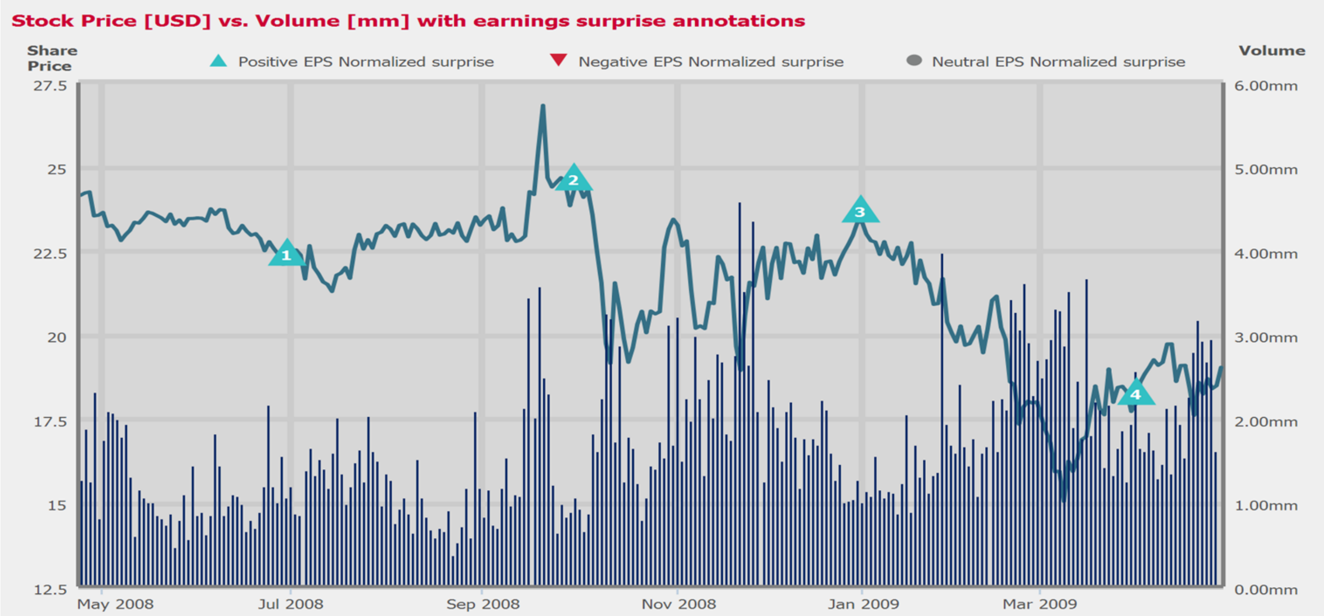
FQ2 2009 Earnings Call Transcripts

Friday, July 24, 2009 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2009-			-FQ3 2009-	-FY 2009-	-FY 2010-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.82	0.87	▲6.10	0.62	3.12	3.10
Revenue (mm)	687.94	693.85	▲0.86	703.00	2894.09	2994.53

Currency: USD
Consensus as of Jul-24-2009 3:58 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ2 2008	0.87	0.94	▲1 8.05 %
FQ3 2008	0.20	0.34	▲2 70.00 %
FQ4 2008	0.36	0.48	▲3 33.33 %
FQ1 2009	0.86	0.90	▲4 4.65 %

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

Brian Robert Meredith
UBS Investment Bank, Research Division

Dan Johnson
Citadel Investment Group

Ian Gutterman
Adage Capital

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Jay H. Gelb
Barclays PLC, Research Division

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

Stephen Tabb

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to Second Quarter 2009 Arch Capital Group Earnings Conference Call. My name is Karma, and I'll be your coordinator for today. [Operator Instructions]

Before the company gets started with this 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 Security 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 might affect future performance, investors should review periodic reports that are filed by the company with 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 forward-looking statements in the call to be subject to the Safe Harbor created thereby.

Management also would make reference to some non-GAAP measurements for 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 with the SEC yesterday, which contains the company's earnings press release and available on the company's website.

Ladies and gentlemen, this conference is being recorded for replay purposes. I would now like to turn the presentation over to your host for today's call, Mr. Iordanou and Mr. John Hele. Please proceed.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you, Karma. Good morning, everyone, and thank you for joining us today. On an operating basis, we had a very good quarter from both an underwriting and an investment perspective. Our reported underwriting results as reflected by the combined ratio of 87.2 was satisfactory in the current environment and were rated by light cat activity and favorable reserve development. The total return on our investment portfolio was 328 basis points for the quarter in local currencies and 389 basis points, including FX movements for the quarter. We remain cautious in our investment strategy as we believe that governmental responses and stimulus packages across the globe will eventually create significant inflationary pressures.

We also remain cautious of the effects of the global recession on creditworthiness. As a result, we have kept the duration of the portfolio short at approximately three years and continue to be very conservative on the credit quality of new money invested. John, right after me, will give you more detail on our investment portfolio and performance that we achieved in the second quarter.

Our annualized return on common equity was 18.6% and our book value per share grew by an impressive $6.15 to $60.76, an 11.3% increase from March 31, '09 and an 18.3% increase from the end of 2008. Our cash flow from operations continue to be strong at $224 million for the quarter. Now let me comment on the performance of our two operating units. Our gross written premium and net written premiums for the quarter grew 2.8% and 1.1% to $912 million and $694 million, respectively. On a quarter-over-quarter basis, our Insurance Group was up 2.4% on gross, and down 0.5% on net. The slight decrease in net writings was attributable to a change in business mix and adjustments to the structure of certain of our reinsurance placements.

Our Reinsurance Group gross written premium for the quarter were up 1.9% and their net volume increased by 3.7% due to the renewal of the large two-year cat [catastrophe] treaty. Adjusting for this transaction, their volume was down 7% as reductions in casualty and non-standard auto lines more than offset growth in Property and Property Cat business.

We did have many additional opportunities in the quarter as more reinsurance buyers are diversifying their reinsurance panels and gravitating to more financially secure reinsurers. The environment for our Reinsurance business was actually better than we had anticipated as we have seen a significant increase in business flow. Although it has not yet translated into many new accounts, we're in good position to seek growth in our Reinsurance business, should we see improvement in underlying pricing.

The pricing environment generally continues to improve in both the reinsurance and insurance sectors. In the quarter, our reinsurance operations continue to decrease their exposure to Casualty and Non-standard Auto business. And let me remind you that in our Reinsurance Group, we grouped together all of our D&O [directors and officers] and professional liability lines as Casualty business. Conversely, our volume in property and property cat grew. This growth is coming from both our treaty and our facultative books of business.

Our outlook with regard to price levels, profitability and growth, continues to be positive for these lines of business. Our Insurance Group recorded growth in travel and accident, executive assurance and low-sensitive large construction accounts. The D&O growth results from both rate increases and new accounts penetration while travel and accident and large construction accounts are growing because of new market opportunities we see.

The new account penetration and opportunities were primarily due to the difficulties encountered by certain of our major competitors that participate in these sectors. Our Program business was basically flat for the quarter as we continue to evaluate many opportunities, but rarely find acceptable ones. We continue to be cautious on primary casualty E&S and excess casualty, as well as healthcare because of our view of the absolute rate levels we see in the market.

We'll remain in a defensive mode on surety because of the economic environment. We're continuing to substantially reduce our aviation and onshore energy exposures as we have not yet seen appropriate rate movement. If rates in these segments improve due to the recent claims activity affecting the industry, we are prepared to change course and increase our writings.

Let me now give you a bit of flavor on how we view the rate environment. We remain of the view that the best opportunities in the Cat business are U.S. Southeast win, and rate increases in June and July range from 15% to 25% on average, and of course, we like U.S. quake. We have deployed significant aggregates in both of these sectors. Rates in offshore energy for Gulf of Mexico exposures have grown significantly, triple digits in many cases, which allows us to continue to commit PML to that zone. However, we have continued to see significant buying resistance from our customers. Our volume in this area, although flat on a quarter-over-quarter basis, was less than we anticipated and projected.

On the insurance side, the rates stabilization and improvements we saw in the first quarter of '09 continue in the second quarter. This strength is spreading to more lines of business. However, with the effect of the credit crisis on claims inflation, and the impact of low-risk free rates on the returns for certain types of business, we continue to believe that additional rate improvement is required in some lines.

Despite the improvement in the rate environment, current economic conditions are still having a negative effect on our customers. Rate improvements, while they would produce better risk-adjusted returns, will not necessarily translate into more premium revenue as exposure bases are negatively affected by reduced payrolls, sales and insurer values.

We have seen this manifest itself as certain insurers are purchasing less limits and retaining more risks. As you know, from our recent press release, Dave McElroy joined our U.S. insurance operations as President of the Financial and Professional Liability Products Group. We are extremely pleased that Dave has chosen to join our management team. His executive skills and extensive specialty knowledge will further deepen Arch's already-strong talent pool in the executive assurance and professional liability lines of business. Over the long-term, we expect to expand our participation in these lines through Dave's leadership.

Before I turn it over to John for more commentary on our financials, let me update you on our PML aggregates. As of July 1, 2009, our one in 250 PML from a single event expressed as a percentage of common equity was 22%. That was one percentage point below April levels and below our 25%

of common equity self-imposed limitation. The reduction was directly attributable to the increase in shareholders equity, not a reduction in the PML itself. We are pleased that our capital position remains excellent on the various measures, and we have enhanced our ability to benefit from opportunities in either insurance or reinsurance as they become available to us in the market. With that, I'm going to turn it over to John, and right after John, we will be ready to take your questions. John?

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

Thank you, Dinos. Let me give some more details regarding the solid quarter for both sides of the balance sheet. First of all, our shorter tail to longer tail gross written business mix moved slightly to 51.49%, from 49.51% a year ago, reflecting a gradual shift for improved rates and property CAT and a lessening focus on casualty. And the same ratio, our net premium written was 48.52% from 45.55% a year ago. The net-to-gross mix was 76%, about the same as last year.

When comparing quarter-to-quarter, gross written premium in the Reinsurance segment, please note two items: Number one, the impact of the renewal in the second quarter of 2009 of a two-year treaty of $42 million; and number two, the quarterly effect of the 2009 non-renewal of a non-standard auto treaty impacting written premium by $12 million. The combined ratio of 87.2% this quarter compares to 87.1% a year ago. Favorable reserve development improved the combined ratio by 8.8 points compared to 7.8 points a year ago.

The loss-ratio of 57% in the second quarter reflected 8.9 points or $62 million of favorable development in prior-year reserves, roughly the same as the 8.8 points or $62 million recorded a year ago. The 2009 development included the computation of a non-standard auto treaty by our Reinsurance segment that had a net favorable impact on the loss-ratio of 1.4 points, or $10 million. The net benefit to earnings was $6.1 million after consideration of the profit commission. Please note that this computation was booked in the second quarter of 2009, but would negatively impact our cash flows by $46 million in the third quarter.

Approximately 60% of the total favorable development came from medium and long-tail lines from the older accident years, while 17% of this total development was in the Reinsurance segment. The Insurance segment loss ratio of 68.9% reflects increases in expected loss ratios as well as a higher level of large loss activity in the Surety and Aviation lines than in the prior period, partially offset by the favorable development of 4.5 points, no cat activity and lower loss estimates for hurricanes Ike and Gustav of 0.8 points.

The Reinsurance segment loss ratio, a 39.6% reflects favorable development of 15.4 points, no cat activity, an increased shift in the mix of business to shorter-tail lines and increased loss estimates for hurricanes Ike and Gustav of 3.6 points. The total acquisition expense ratio of 17.6% increased by 0.8 points from the prior year due and part to the expiration of the Flatiron treaty, and a resulting lower level of profit commissions recorded in '09 under the treaty worth about 0.7 points.

Our lower level of acquisition expenses related to prior development in the quarter was offset by changes in the mix of business, with higher acquisition expense business replacing lower acquisition expense business. The total other operating expense ratio of 12.6% reflects an improvement of 0.4 points from the prior year, due in part to a non-recurring expense recovery in the period and continued cost control in the insurance operations. Such items more than offset the 0.5 points of expenses incurred related to an expansion of the Insurance segment's presence in the Executive Assurance and Professional Liability lines of business. We expect this initiative will negatively impact the operating expense ratio of the balance of 2009.

Net investment income of $100.5 million was down from a year ago at $117 million, but up from $96 million in the first quarter. As Dinos mentioned, the second quarter net investment income represents a book yield of 4.86%, down from 4.17% in the first quarter. While the duration of the portfolio remained constant at 3.02 than the first quarter, lower available yields and high-quality assets have continued to impact the portfolio. Yields on new money investments in the second quarter averaged approximately 3.5% with an average duration of three years.

More important than investment income however, is the total return of investment portfolio of $10.7 billion, which was 3.89% in the second quarter in U.S. dollars, and 3.2% in local currency. This brings the year-to-date total return to the portfolio to 5.03% in U.S. dollars and 4.46% in local currencies.

We saw a strong recovery in prices of the asset-backed securities in the quarter, as well as with the bank-loan funds. Credit-related impairments of $20.7 million, primarily due to continued deterioration in expected recovery rates on certain residential mortgage-backed securities. Arch's CMBS portfolio, comprised mainly of older, vintage CMBSs, has continued to perform in the quarter and we recorded no impairments. Our CMBS portfolio is AAA and we've had no downgrades in this portfolio. As a reminder, Arch adopted FAS 115-2 and FAS 157-4 in the first quarter.

Our shareholder equity increased to $4 billion at the end of June. The common shareholder's equity of $3.6 billion represents 60.76 per share. We did not buyback any shares in the quarter under our share repurchase plan. However, we will continue to monitor share price and depending upon the upcoming storm season and the development of the economy, we will consider share buybacks under our existing remaining authorization of $415 million on an opportunistic basis. We currently estimate that our excess capital is approximately $400 million to $500 million compared to what we target for the various rating agencies. S&P recently modified its ratings of Arch with a positive outlook.
Portfolio liquidity remains strong and we experienced a solid cash flow from operations of $224 million in the second quarter. Our operating ROE was 18.6% and the increase in the book value per share was 11.3% in the quarter, very solid metrics. That concludes my remarks, and we're pleased to take questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Vinay Misquith from Crédit Suisse.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

First question on the primary insurance, the accident year combined ratio ticked up by 4 points and it's now running at 104%. If you could give us a sense of whether there were any one-time items in that? And plus this quarter, you don't have any cats, so what do you expect for the full year combined, at an accident year basis in this segment?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Your question is a sequential question, quarter-over-quarter. The first quarter to second quarter, yes, we had two losses that they were, an aviation loss and a loss in surety that we booked in the second quarter, so that will have an effect on the accident quarter. But your question is even broader than that because if you look at the quarter-over-quarter movements, we have moved our accident years up based on our belief that the industry was giving quite a bit of rate in '07 and in '08, that's the premium you're earning now. Most of the premium you're earning is coming from, of course, '09 but mostly '08 at this part of the year. We want to continue to be strongly reserved, so we have moved our view of accident years up and we have booked that at a higher level than we did a year ago. So it's the combination of those two, one-time events for the quarter, if you look at it sequentially, the first to the second quarter. But if you look at the movement from a year ago to this year, it's mostly our view that you got to reflect in your accident years the reduction in rates that us in the industry have experienced in '07 and '08.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Since pricing is still not improving right now, should we expect higher accident combined ratio for the second half of this year and for next year?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Don't forget the pricing in some sectors is improving, and also our underwriting teams, they're changing mix. We tried to gravitate where we believe there is a better return. And as you saw from my commentary, there is lines of business that we're shrinking and there is some lines of businesses that we're growing. In the aggregate, we're kind of flat, no real movement either on a gross or net basis. So it's not that easy to conclude that our accident year will continue to go up because we are making adjustments based on the underwriting environment. So I don't expect the accident year to be moving significantly. It depends on the market. I mean, if the market deteriorates further, we'll recognize it. If it doesn't and it improves, we'll also recognize it.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

You mentioned that pricing is increasing. The question is, is it increasing in excess of loss cost trends?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Clearly in some lines, yes. property, property cat in the executive assurance. In some other lines, we have increases that keep us in line with trend and in areas that we're not, that's the areas that we're trying to reduce writings as much as we can. Of course, it's very difficult to go to nothing and maintain infrastructure and people, and relationships in the market. So you try to manage your volume and the mix that you have to optimize your portfolio to get the better results. In the meantime, you'll be a fool not to recognize and reserve the company appropriate by moving up the accident years.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

On the Construction business, could you just give us some details as to what sort of new business you're writing there in...

Constantine P. Iordanou
Chairman and Chief Executive Officer

This is no different than what we mentioned in the past. Most of our Construction business is made to larger accounts that they buy a lot of service from us, and the coverage they buy is their GL, auto and workers comp primary program, and then maintaining a significant portion of that as self insurance. Maybe $250,000 in each and every loss, maybe $0.5 million in each and every loss. So in essence, our underwriting is for the GAAP to get to a million, but predominantly, we're providing a lot of the services that come with the large accounts business that is loss-sensitive. The choice of some of these customers to come to us is because, first, we're a very financially-secure company, and also we have a lot of expertise, specialization, which is critical to them as to how you manage their claims, because they're paying 90% on the cost of the claims. We want to grow that business, it's our national accounts business and also in the large construction accounts, and that's where we see the growth.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Would it be fair to say that most of the risk is centered to the low risk business and most of the income comes from fee income from this source?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's a combination. You take some risk on what we call the xs. the half a million x they have, or the 750 x, the 250. Sometimes we reinsure a portion of it, sometimes we retain it depending on what kind of pricing we get. And of course, you get profit in administration for administering their loss-sensitive portion of the program which is the bottom part.

Operator

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

Jay H. Gelb
Barclays PLC, Research Division

Dinos, can you talk about the new teams you've brought on board and what the opportunity is?

Constantine P. Iordanou
Chairman and Chief Executive Officer

You call it a new team. We hired Dave. I've known Dave for a lot of years as a competitor. In my view, one of the best executives in this professional liabilities D&O lines of business and we're always looking to improve talent. My goal is to be hiring guys that are better than me and I've been lucky over the last 10 years, I hire a lot of them that are better than me. So we hired Dave and he's building a bigger team. Don't forget, we were in that business, and we have great guys already and you've seen seven, eight years of great performance for March on our D&O professional liability. This is an opportunity for us to expand further. I'll leave it up to him. He is a senior executive. The size and scope of how big it's going to be is going to be, of course, with holding company approval, but it's up to him and Mark Lyons, and the rest of the senior executives in the Insurance Group. Every time we get an opportunity to get what we call world-class talent, we will go out and do it, independent if the premium revenue will come immediately over a long period of time. This is an investment in the future. And we saw the opportunity, we took advantage of it.

Jay H. Gelb
Barclays PLC, Research Division

Separately, can you talk about the opportunity to take profitable market share from some of the stressed competitors out there? Is it accelerating? Is it stabilizing? Is it decelerating?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Clearly, when you look at it from a submission activity flow of business, it has been significant to us both on the Insurance and Reinsurance sector. Probably, in the range of, depending by product line, 15% to 20% more flow of opportunities. We haven't translated that into a lot of premium revenue. That has a lot to do with the market where it is. I mean, the market is not horrible, but it's not robust that you can say, hey, this is the time that I want grow 10%, 15% and 20%. The opportunities are there, we're seeing them, selectively, we're picking our spots, But as I said, we've seen a lot on the reinsurance side and we chose to pass. We just didn't like the rating environment in some of the opportunities, and likewise, on the Insurance Group. I like to grow my program business, but we look at 100 a year and maybe we do one or two. We're working our guys hard, but they know the benefit of, if they work hard but we make good decisions, at some point in time, we're going to benefit from the right revenue coming through. We're not a top line-focused company. We're focused mostly on the bottom line.

Operator

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

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

Could you quantify the aviation and surety loss, just so we can see what the stripped-down number is?

Constantine P. Iordanou
Chairman and Chief Executive Officer

The surety loss, it was, I think a high-single digit, and the aviation a little less than that on a net basis.

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

So maybe $10 million to $15 million in total?

Constantine P. Iordanou
Chairman and Chief Executive Officer

A little more than that.

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

Can you talk a little bit about the structural changes to the reinsurance program that impacted property, marine and aviation in the quarter?

Constantine P. Iordanou
Chairman and Chief Executive Officer

In the Insurance Group, you mean?

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

Yes, in the Insurance segment. Just some of the changes to your Howard reinsurance.

Constantine P. Iordanou
Chairman and Chief Executive Officer

We switched some quota share to excess of loss, so that will play with your net-to-gross relationships. On how much we buy for protection, that hasn't changed significantly. We like to have somewhere around $100 million of net retention per event on the Insurance Group, and we buy protection all the way up to the 250 year event so we don't have the potential of cycling all there between. But the structure, we changed a bit.

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

You've mentioned that were some slight changes to Ike and Gustav estimates. Can just give us where the total loss estimates stands today and how that contrasts with year end?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It was minor. I'll have John look it up and he will give you the numbers. I think it was down a little bit on the Insurance Group and it was up on the Reinsurance. We have the numbers. John?

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

With respect to general expenses overall and obviously, you've had a number of things you've been using to help manage costs as the business volumes, obviously, for the whole industry have dissipated the last couple of years. Have most of those gains come from just office relocation and things like that, or I guess what I'm really curios is how significant staffing level is really? Any changes have been there, because I know you've been adding people in places, but I'd just be curious of what's happening.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Net net, we haven't really -- we added people recently, probably around 60, 65 people. But we have taken out about 50 people a year ago. And also, as we spoke in prior calls, we did make movements into lower-cost jurisdictions. We made a major move with a lot of people from Manhattan going to Jersey City. We've put a claims center in Nebraska. We've put a processing underwriting center in the Twin Cities, Minneapolis-St. Paul, so we have looked around to make the Insurance Group more efficient both from an infrastructure, but also personnel. And we will continue to manage the company in that fashion. If we have volume opportunities, we'll grow staff and if there is no volume opportunities, we'll manage. And we try to do it by managing quietly through attrition. A good run company, you don't have to go through layoffs to manage your personnel needs. A turn on the ratio on the Insurance Group is a little below the industry. The industry average, I think, is about 15%, ours is about 12%. But 12% on a thousand people is 120 people a year, and basically if you selectively -- it's not going to -- all of your attrition is not going to come in the right places, but selectively, maybe half of it, you might not have to replenish and you can make reassignments. So you can manage effectively, and we hold our managers responsible in managing revenue and expense, and we have an expectation for them to manage that.

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

I got the numbers here. The total we've got up to the end of June now was $306 million for Gustav and Ike. Split $212 million in reinsurance and $94 million insurance.

Operator

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

Brian Robert Meredith
UBS Investment Bank, Research Division

On the Reinsurance sector, Dinos. I'm kind of curious why we haven't seen the axing of loss ratio as cat are to trend down or just move more into property, property cat more volatile line of business where you historically see a lower run rate loss ratios?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We book what we believe are -- it's a proper accident year. And don't forget our cat load and attritional, you might be different than some other companies. As you've seen over the years, probably the last four or five years, the early on all of our reserve, positive reserve development came from the cat lines. And it continues to come from the cat lines. It's how we believe the Cat business should be booked. What we believe, the attritional loss ratio should be. We re-evaluate that. We do studies once a year to make sure that we get that right and also we factor-in based on the latest models and all that, what's an expected cat load should be, and that's the way we book it and if we are -- the good thing about the Cat business, you don't need a lot of actuaries eventual to tell what your numbers are within a year or two you know. If we got it wrong, we adjust it. So far, we'll be adjusting it downwards consistently and I like that, the taste of that, instead of having to adjust it upwards consistently.

Brian Robert Meredith
UBS Investment Bank, Research Division

Is part of it possibly that the casualty loss ratios are heading up so it's kind of offsetting the...

Constantine P. Iordanou
Chairman and Chief Executive Officer

There is quite a bit of that. I think, we have moved depending on the line accident year, loss ratios between the Insurance and Reinsurance Group of some lines anywhere from five to seven points. This is quarter-over-quarter, not sequential but year-over-year. And that's what we're factoring in. Rare reductions that we see in the marketplace.

Brian Robert Meredith
UBS Investment Bank, Research Division

On the investment portfolio. I noticed a big slug of RMBS securities, non-agency RMBS securities at this quarter. Is that the TALF program?

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

No. It's more RMBS's.

Brian Robert Meredith
UBS Investment Bank, Research Division

Yes. I believe there was non-agency RMBS some '09 vintage? I thought that's the supplement.

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

We have increased a slight bit there but it's not -- prices have recovered a lot, too.

Constantine P. Iordanou
Chairman and Chief Executive Officer

It might be more the price recovery but...

Brian Robert Meredith
UBS Investment Bank, Research Division

There wasn't any in the first quarter supplement that's why I'm asking if there was '09 vintage, non-agency? I guess it says, MBS which I assumed is your RMBS and you got $45.5 million of this. There wasn't any in the first quarter supplement.

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

$45 million, right. But they're all AAA and there sure a duration pieces we're picking up that we saw as a good value. TALF, we're hoping to participate if our flow through this quarter has a pretty small to date.

Constantine P. Iordanou
Chairman and Chief Executive Officer

We're on TALF, we've done I think four deals so far, roughly a little over $5 million of equity and the leverage was a little less than eight to one on average. We've done a -- I think we've got a CMBS deal. We did a credit card deal. We did an auto-motorcycle and a credit card deal.

Operator

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

Jay Adam Cohen
BofA Merrill Lynch, Research Division

You talked about the large accounts business on the construction side and some of these having a high self-insured retention. I guess I assumed to do that business you need to have sort of a big claimed infrastructure to manage that business through, and my assumption for you guys is you don't have a big claims infrastructure that you had outsourced the fair amount of this, whether it's Gallagher Bassett or others. And I'm wondering is that wrong and what's changed and why this business is attractive to you?

Constantine P. Iordanou
Chairman and Chief Executive Officer

You're absolutely, you're actually correct. A business model was not to build a huge feel adjusting staff and rent pack. For this particular sector, we used Gallagher Bassett almost exclusively because we worked together as to organizations, our underwriting folks with a lot of expertise and Gallagher Bassett's claims services that they do have a lot of expertise in the Construction segment. And basically, it's that combination that gives the comfort to join customers that they will get a good claim service from very knowledgeable claim examiners. All of our business, in national accounts and construction, is done on what we call unbundle basis. When we sit down with a customer, we agree on the claim service and the provider and also we agree on the risk management services and the provider, because sometimes we go outside to get to provide risk engineering services. And it gives both us comfort because we're working with partners that we have a long-standing relationship and it gives comfort to the customers because they're comfortable with the service and the activity. And they have a say in it, because they're paying for that provider. We pass through the cost so they have a say as to, do they want to ratchet up the Gallagher Bassett services or they want to ratchet it down and they pay for it.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

So then I assume you wouldn't make a lot of money on sort of the claims services. That's just sort of a -- you just pass along the costs. They don't have extra margin there.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Right. The margin is on our profit and administration for and utilizing our admitted paper so they don't have to go and qualify themselves as self-insurers and have to do all the posting notices for worker's comp or register all their trucks and their transportation vehicles, etc.

Jay Adam Cohen

BofA Merrill Lynch, Research Division

Secondly, I think on the reinsurance side, you talked about reducing premiums in a Non-Standard Auto business. I thought that business was doing pretty well industrywide. I'm wondering what about that business is less attractive to you?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's nothing less attractive. We didn't say we're going to do it permanently. I'll take you back a little bit in history. You remember, we owned a company called American Independent where it was self-stand auto-company. I sold that company about five years ago because it was not cored to what we do. We had maintained a reinsurance arrangement with them that contractually, they have to buy reinsurance. They have to buy it from us assuming that we agree on terms. We have the right of first refusal and we continued to provide a lot of support through that reinsurance treaty and it was significant to us. It was $80 million annually and it came down to 60 and a little less in the last year. As terms and conditions deteriorated, we chose not to renew about -- and it doesn't mean that the underlying business is not performing well. The reinsurance terms that they were willing to give us the premium were not acceptable to us. So it was not a partnership that if they made, we made dollar, and if they lose a dollar, we'll lose a dollar. It was a little bit skew to their favor and we just didn't like that arrangement and we ended it. If we find other opportunities in the marketplace that economics work for us, we will be in that line of business.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

On the capital standpoint, you obviously slowed the buyback program as many did. It seems hard to imagine you guys not buyback some stock. In our view, we're not going to see a dramatic cycle turn here. I can't see top line growth accelerating too dramatically. It sounded as if you could just generated a fair amount of excess capital in addition to what you already have.

Constantine P. Iordanou
Chairman and Chief Executive Officer

We got the season coming, right? My authorization is perpetual and why be ahead of myself? Listen, if there is an opportunity because some it going to happen all the traders go on and they get drunk one night and share prices collapsed significantly, as John said, we'll buy very opportunistically. But we're going to re-evaluate that based on how we're going to see the market. What we're going to -- as we get closer, right after the hurricane season, you get closer to year-end, you got a better view of what you anticipate to happen in January 1. We'll re-evaluate what our capital position is and we can make those decisions. I don't anticipate a lot of activity in the third quarter but stay tuned for the fourth quarter.

Operator

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

Ian Gutterman
Adage Capital

First question on McElroy's team. Can you tell me a little bit more, I guess when I look at the numbers here, professional liability and executive assurance combined is a better quarter of your insurance book, and I assume you don't hire a whole big group of people to just draw it a little bit. Is that going to 35%, 40%, 50% of your insurance book over time? If so, where is it growing? Is this just the same types of business you're doing today and just more share within those arenas? Or are you looking to get into different parts of professional liability that you maybe didn't even touched before. Can you just tell me a little bit more about the strategy because it seems pretty...

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it's getting bigger in what we already do. Maybe with a couple of new products that there is expertise that is coming with Dave and some of the people he's hiring. This is a long-term play. Let me give you the macro view here, the big players in D&O were, and they still are AIG, Chubb, Xcel and then after that, Travelers and Hartford. Some of these companies, they had issues. So in essence, there might be an opportunity for a new player to emerge as one of the top five over time. We're not saying it's going to happen tomorrow or next week or next month or the next quarter, so we saw that opportunity. Likewise, I can give the same speech on the Professional Liability line. In this business, you don't get talent when you want it. Only my wife finds all the clothes she wants because she goes into Bloomingdale's with my checkbook and then she gets anything she wants. In this business, you have to get the talent when it's available. Not often enough, you're going to find the talent at the most opportune time. But like I said before, we liked to always focus on getting very good people to be part of our team. Independent if it might cost us in the short run, a couple may be of point of expenses, et cetera because these kind of initiatives for us, we view with a 10-year lengths, not a quarter, or annual or two-year lengths. If they told me who was interested to come and work for us for a year, or two or three, I wouldn't have any conversations. When they said, "I want to be part of your management team," And I said, "This is not quite like the old AIG that you have got to be permanent forever," but I said, "You've got to be at least 10 years." And he said "Yes." then we have the right guy.

Ian Gutterman
Adage Capital

I'm just trying to understand longer-term where you're going with this business and my sense was you were kind of writing more niche-type stuff in professional liability and not the sort of business that the AIG, Chubb and Xcel were targeting. So I was wondering if this meant you're broadening your appetite to compete in those areas?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, it will broaden our appetite, but also the market got to give us the proper rates. Broadening our appetite doesn't mean we're going to lose our underwriting discipline.

Ian Gutterman
Adage Capital

I understand what you're saying about being patient, but on the other hand, professional liability does not seem like an area lacking for capacity right now, where I mean pricing arguably isn't going up as much as it should because it seems everyone is hiring a team to go write more professional liability. I'm just wondering, do you agree with that? I mean, as Dave's team is going to be sitting on their hands for a year because the opportunity is not there? Or do you disagree with that and think that maybe there's more opportunity that were more lack of capacity than I have perceive?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We see more opportunity on the D&O area than in the professional liability area. If Dave was on this call, we'd tell you exactly the same. We are patient. At the end of the day, I don't know how many -- I say that to my board all the way to every person who follows this company and somehow, even though we have demonstrated that's what we are for seven years, a lot of times people just don't believe it but I'm willing to warehouse talent for a year or two or three, because I agree with your premise. Some of the larger accounts, Professional Liability business today is not attractive and we're not going to be aggressively going after it. Having said that, we still are going to be looking for niche business. And once you have talent, you're going to find things to do. Maybe not to decide that you will like to, but you're going to find profitable things to do in the marketplace. And that combination of patience and willingness to take a little bit more of an expense hit for a year or two, I think, work to our advantage over a long period of time. Our growth will be better than the industry over a 10 year period of time but it's going to come very lumpy. You've heard my speech before. Some years we're going to be shrinking, some years we're going to be flat and when we believe the market is extremely good, that's when you're going to see hyper growth out of us. But in order to do that, you got to have -- and I don't want to embarrass my people, but I'm going to use the expression anyway, you got to have horses in the barn to do it. You can't run the race unless you have the horses.

Operator

And the next question comes from the line of David Semra [ph] (1:08:42) from OTI Sun Partners.

Analyst

Currency loss through the P&L, is that mainly due to depreciation of the pound? Is that what caused that big loss?

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

Yes, it's been in the pound.

Constantine P. Iordanou
Chairman and Chief Executive Officer

And it beat the euro, but not --mostly the pound, yes.

Analyst

Just getting back to capital question that was asked earlier. If I go back in history over the last couple of years and I look at your shareholder's equity, you're basically back up to peak levels that you hit sort of at the end of 2007. And in the meantime, obviously premiums sort of trailed off over that time period. When you look at your capital positions sort of putting aside, any estimates that you may or may not have regarding your reserve position, but when you look at the capital position today and the excess capital that you have, are we at this point in the strongest position in terms of capital than we have been in the past?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I think we're reaching that point that we might be at the highest. But don't forget, we have an aspiration for our rating to improve. We believe we already deserve it and we're starting to get indications that we're moving in that direction. We always maintained excess capital even above what the rating agencies will require us for the ratings that they give us, because we like to be conservative from a capital point of view. And then on top of it, we might have a bit excess. The numbers that John shared with you is above even the cushion that we have. If we don't believe, we can deploy that capital in the business either insurance or reinsurance. At some point in time, it has to go back to shareholders and we'll find the way to get it back. Share repurchases, extraordinary dividend, whatever is the appropriate way to do it, because we have that strong belief that excess capital belongs to shareholders not to management to warehouse.

Analyst

I've been as you know following the company for a long time. And aside from a few extreme points in time where the share price relative to book value has been a little bit cheaper than where it is today. But today presumably, with a lot of information out there, the price to book without any sort of extreme impact of the market is relatively low at a point in time where you've got probably your best capital position. I just noted sort of an interesting juxtaposition because if we're really going to wait through the hurricane season, we might not have the luxury of what we have today. Just a note.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Well, maybe you can predict the future but then we can't. I don't know where the market is going to go. We run the company focusing 98% of our activities on the underwriting, underwriting risk we take in the balance sheet to make sure that it's secure. What if scenarios from the risk management perspective. I don't watch the stock price on a daily basis. I'm not focused on that then maybe I should, but at the end of the day if we move book value per share consistently over the years, eventually we're going to get the proper valuation. I don't know where that is. And for patient investors and we like to believe that most of our investors, they're patient with us. They're not trading in and out of the stock. That's what they would like us to do and that's where we're focusing our energies to do.

Analyst

It's just interesting that the premium that the company deserves and has for most time period, this is where I am trying to point For most time period, the company's always had their premium and today it looks like for whatever reason maybe the underwriting cycle, is my guess, that the premium has sort to come off a share price.

Operator

And the next question comes from the line of Steve Tabb from Tocqueville.

Stephen Tabb

I see that the book value went up quite a bit more in the net earnings. The book value in the quarter went up $6.15, the net earnings were $2.43, at least $3.72. And is that primarily in the value of the assets owned by the company, the bonds, et cetera?

Constantine P. Iordanou
Chairman and Chief Executive Officer

That is correct. It was a recovery on the asset side.

Stephen Tabb

That was quite a good recovery there. You took quite a hit on the foreign exchange as a lot other companies have in various industries. How was it working out, do you see it this year and compared to what you're going to have from a year ago or quarter?

Constantine P. Iordanou
Chairman and Chief Executive Officer

You've got to understand our strategy on -- we don't make any bets on foreign exchange. What we like to do as an insurance company is to make sure that our assets and liabilities that we have, they match and they match the currency that we're exposed to it. So for euro denominated liabilities, we maintain euro denominated assets and for British pound liabilities, we have British pounds. And basically, that's almost kind of a natural hedge as long as you're maintaining your assets to your outstanding reserves and those reserves that -- they are accurate, you have a natural hedge. And when it goes to the balance sheet, some of it you get the benefit on the asset side and other one goes to the income statement, but at the end of the day when you look at it in totality one offsets the other.

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

In the P&L, the liabilities moved through the income statement whereas on the asset side, with a 3.89% return in the quarter in local in the U.S. dollars but 3.2 in local currencies. So you can see how it's impacting both sides of the balance sheet.

Stephen Tabb

My question was how does that look with this coming quarter?

Constantine P. Iordanou
Chairman and Chief Executive Officer

The quarter just started. We don't know. We don't focus to try to see currency movements.

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

Because eventually we matched.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Right, what we focus on is to make sure that we are properly matched. Our liabilities and the assets we carry, they're on the same currency.

Stephen Tabb

I am an investment advisor and own the stocks along with my clients, so my accent on dividends might be a little different but I was wondering what the company's added to these towards dividend and dividend increases?

Constantine P. Iordanou
Chairman and Chief Executive Officer

We have not paid dividends because our belief is that ordinary dividends -- it's not a capital management tube on a capital intensive business like the Insurance business. If you want to manage your capital, I think you can manage it if you have access by using other tools to return it either share buybacks depending where you would share price trade, or if you believe you're getting intrinsic value on the shares as they are trading then you can do an extraordinary dividend. Having said that, we do get calls that is a lot of investors that they would like us introduce an ordinary dividend. That question comes up in board discussions but so far, we haven't decided to introduce that, because at the end of the day it's not really an effective capital management tool for an insurance company.

Stephen Tabb

I voice the disagreement with it, especially with the new income tax rate on dividends in couple of years, but I think some dividends should be paid.

Operator

And the next question comes from the line of Marc Serafin from Citadel.

Dan Johnson
Citadel Investment Group

It's Dan Johnson and Marc. On the Non-Standard business that was wrapped up, what should we be thinking about that in terms of top line implications going forward for the next couple of quarters? And then I've got a follow-up to that.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Basically, I think John gave you the numbers. It affects the year-over-year is about $12 million a quarter.

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

And then it's going to grind down about $15 million or so over the next couple of quarters and then it's gone at the end of this year.

Constantine P. Iordanou
Chairman and Chief Executive Officer

We got two more quarters and it's done. It's not totaled on you because we got some APRP adjustments, but it's going to be minuscule. It's bread crumbs off the table. Think about it third and fourth quarter and it's done.

Dan Johnson
Citadel Investment Group

With who is just commuted now, why doesn't it have an impact for the next four quarters, I must be missing something?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Don't forget, we didn't renew this treaty on January. So it's only the comparisons from a year ago to now. So the premiums that were in last year's numbers and they are not here this year and they weren't in the first quarter. They weren't in the second and they will not be in the third and fourth. The computation doesn't affect the year-over-year comparison. Commutation was, here is the reserves we carry. We'll give you a discount at net cash and then you relieve us of all future liabilities. And that's what the commutation is and we achieved that and we will carrying more reserves than we commuted that's why we had a reserve take down.

Dan Johnson
Citadel Investment Group

Second question is on your outlook for the duration of the portfolio which you, I believe, brought down at the end of last year. What's your crystal ball say about what you want to do with that going forward?

Constantine P. Iordanou
Chairman and Chief Executive Officer

I don't think we're moving the duration. It's been around three years, for less than seven quarter, worth 3.6 years on the fourth quarter and we make that adjustment and we've brought it down and I think we're comfortable where we are now. You know our philosophy, Dan. We match liability duration, the reserves and then we move up and down on shareholders equity and our shareholders equity is close to maybe six month duration or thereabouts.

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

What we bought, Dan in the quarter had an average duration of about three years.

Dan Johnson
Citadel Investment Group

What sort of yield is the market offering with your desire, sort of AA credit quality in a three-year duration?

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

We got about 3.5% in the second quarter. I don't think that's month there is that significantly different. It seems spreads up and down, here and there, but on average, particularly what we're buying is still about the same.

Dan Johnson
Citadel Investment Group

We kind of need the reference rate and/or maybe you can spread to open a bit to get the certain new money rate up to the average. I guess, would be another way to put it?

Constantine P. Iordanou
Chairman and Chief Executive Officer

Right.

Dan Johnson

Citadel Investment Group

And in order to actually grow the yield we got the reference rate... You make reference to the excise taxes paid, I'm sorry I didn't have a chance to see if you had that in the prior quarter but what was the thought in putting that into press release because it's reasonably a small amount of money and not much of a change year-over-year?

Constantine P. Iordanou
Chairman and Chief Executive Officer

It's more disclosure. In prior quarters, it's not -- I think we had a few people who asked how much was it and we just decided to disclose it. It's not material.

Dan Johnson
Citadel Investment Group

Finally, the expense discussion, I just want to try to flush that out and touch more, you said the expense ratio will be going up in the near future. I forgot the exact verbiage in the press release but can you try to give us a better sense as to what you're thinking about in terms of dollar uplift there because obviously it kind of depend somewhat on what happens to the top line since you gave us a over ratio comment than a dollar...

Constantine P. Iordanou
Chairman and Chief Executive Officer

That's why it's difficult to estimate that, but an easy calculation is if you have 60 people and they're costing you approximately, all in, a couple 100,000 on an annual basis each, you know what the number is. Between salary benefits, rent, equipment and all that, our average cost about 200,000 a person and you can do the calculations.

Operator

We have no further questions at this time. I will now like to turn the call back over to management for closing remarks.

Constantine P. Iordanou
Chairman and Chief Executive Officer

Thank you, everybody for being patient with us. We went a little overtime today. We're not going to get paid overtime. But we're looking forward to seeing you and talking to you next quarter. Have a good day.

Operator
This concludes the presentation for today, ladies and gentlemen. You may now disconnect. Have a wonderful day.