S&P Global
Market Intelligence

Arch Capital Group Ltd. NasdaqGS:ACGL

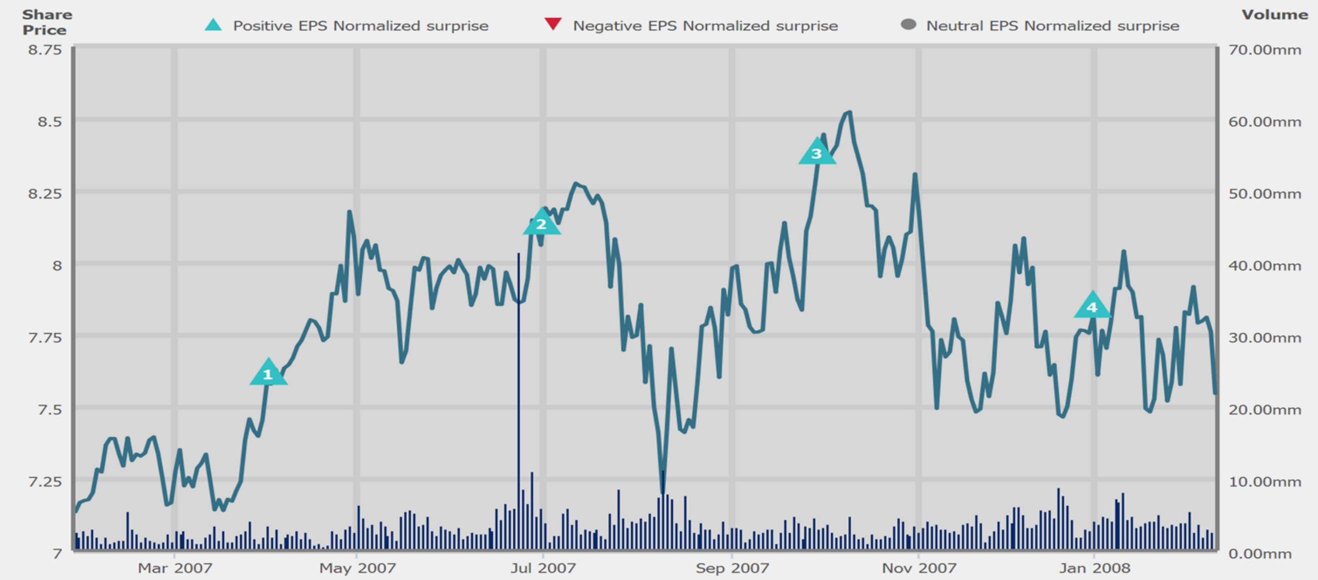
FQ1 2008 Earnings Call Transcripts

Friday, April 25, 2008 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ1 2008-			-FQ2 2008-	-FY 2008-	-FY 2009-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.30	0.31	▲3.33	0.30	1.13	1.12
Revenue	-	-	▲(4.33 %)	-	-	-
Revenue (mm)	848.10	811.34	-	746.41	2835.65	2762.68

Currency: USD
Consensus as of Apr-25-2008 2:27 PM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ1 2007	0.26	0.29	▲1 11.54 %
FQ2 2007	0.28	0.31	▲2 10.71 %
FQ3 2007	0.26	0.32	▲3 33.33 %
FQ4 2007	0.31	0.35	▲4 12.90 %

Table of Contents

Call Participants

EXECUTIVES

Constantine Iordanou

John D. Vollaro

ANALYSTS

Brian Meredith
UBS

Jay Gelb
Lehman Brothers

Joshua Shanker
Citigroup

Matthew Heimermann
J.P. Morgan

Susan Spivak
Wachovia

Thomas Cholnoky
Goldman Sachs

Vinay Misquith
Credit Suisse

Presentation

Operator

Good day ladies and gentlemen and welcome to the First Quarter 2008 Arch Capital Group Earnings Conference Call. My name is Eric, I will be your coordinator for today. And at this time, all participants are in a listen-only-mode. We will facilitate a question-and-answer session towards the end of the conference. [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 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 risk and other factors that may affect the future performance, investors should review the periodic reports that are filed by the company with the SEC from time to time.

Additionally, certain statements contained in the call 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 these forward-looking statements in the call to be subject to Safe Harbor created thereby. Management also will make reference to some non-GAAP measures of financial performance. The reconciliation of 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.

And I will now like to turn your presentation over to your host for today's call, Dinos Iordanou and John Vollaro. You may begin gentlemen.

Constantine Iordanou

Thanks, Eric, and good morning ladies and gentlemen, and welcome to our first quarter earnings call. Against the backdrop of a more challenging underwriting environment and an extremely volatile investment climate, we are really very pleased with our performance and the results we have achieved.

Our book value per share, including the effects of our share repurchases, increased to $56.92, a 21.4% increase from the end of the first quarter of 2007. Our after-tax operating income for the first quarter was $2.97 per share, which represents a 21.9% annualized return on average common equity.

Cash flow from operations continues to be strong at $335 million for the quarter. John, as usual, will give you a more detailed analysis on our financials in a few minutes. But before I turn it over to him, let me comment on our two businesses, insurance and reinsurance and also some comments on general market conditions.

On the underwriting side, the market continues to be challenging with increased competition in almost every line of business we underwrite. As underwriters of specialty lines, we have technical knowledge, expertise, and experience, a key to underwriting performance. We believe we have a competitive advantage. Over the past six [ph] years, we carefully selected a team of great underwriters in both of our businesses and we have equipped them with the best available underwriting tools. Their underwriting performance and discipline gives us the competitive advantage we seek. We are proud of our teams and the performance they have achieved so far and we are confident in their ability to navigate through this more challenging environment. On the asset side, the extreme volatility that affected the credit markets has had minimal effect on our portfolio. Our subprime exposures are relatively small and this is true both on the asset side, but also the liability side of our balance sheet.

Now let's turn to our businesses, our reinsurance group net premiums declined by 7.9% in the aggregate, due predominantly to market conditions. Average rates continue to decline at a low double-digit level, with terms and conditions generally holding except for request for increased ceding commissions. In reaction to the current market conditions, we continue to adjust our book of business.

Our casualty lines, which includes professional liability and D&O, in our reinsurance sector were down 27%, and our marine and aviation lines were down 49%. On the other hand, our property cat book grew by 32%. With the termination of our Flatiron facility, we have the opportunity to choose to increase our participation on existing business. Where we believe the returns are most attractive, we have increased our participation, but always staying within our risk management limitations. We will continue to apply the same principles to the second quarter renewals based on our underwriter's evaluation of the relative attractiveness of the accounts that come up for renewals.

Our insurance operations saw a reduction in net written premium of 6%. Rates were down 8% to 12% in most lines. The exceptions were in our program business, in which rates were basically flat and in our professional liability book, which saw a 1% reduction for the quarter.

Our program and professional liability books are predominantly comprised of small accounts. The other exception was in our executive assurance unit, where financial institutions' D&O moved to a flat rate change for the quarter overall.

However, positive rate increases were achieved during the last month of the quarter. In January and February, rates decreased, while in March we achieved a 6% increase. And our April 1 renewals were up over 10%. More recently some accounts that have had claims are seeing increases in the 200% to 500% range.

It's too early to tell if this trend will continue, but the market is adjusting to subprime losses and the accounts who have caused them. From a volume point of view, we had the most significant reduction in casualty, healthcare, and surety and growth in property, marine, and aviation, travel accident, and Wexford, which is our excess workers' compensation facility.

Now, before I turn it over to John, let me update you on our PML aggregates. As of April 1st, our 1-in-250 year PML for a single event, expressed as a percentage of common equity, was approximately 22% with Tri-County, Florida, and Northeast windstorm being the largest exposed zones. This is a slight increase over the 20% we reported last quarter. We currently expect that after the 07/01 [ph] renewals that PML may increase slightly from these levels, but that will be not a significant change.

With that, let me turn it over to John to go through our financials. John?

John D. Vollaro

Thank you, Dinos. Good morning everybody. As Dinos indicated, our first quarter results are a good start to the year with a return on equity of 22% driving growth and book value per share in excess of 3% despite the extreme level of volatility in the financial markets. As usual, I will briefly walk through the key components of our financial results starting with the top line. Dinos has already commented in some detail on premium volume, but there are few additional items of note. On a trailing 12 months basis, premiums written by the insurance segment represented 66% of our gross volume and 60% of our net volume, while property and other short-tail lines now represent approximately 44% of our net premium written.

On a consolidated basis, the ratio of net to gross written premium in 2008 increased to approximately 77% from 72% in the 2007 quarter, primarily as a result of the non-renewal of the Flatiron treaty. On a reported basis, we ceded $18 million of written premium to Flatiron in the first quarter of 2008 and $109 million in the prior-year quarter. On an earned basis, premium ceded under this treaty amounted to $59 million for the first quarter of 2008 in comparison with $66 million ceded during the 2007 first quarter. The override in estimated profit commission recorded on the treaty with Flatiron are reflected as a reduction of the acquisition expenses of the reinsurance segment, which improved the expense ratio of that segment by 330 basis points in the 2008 quarter, while the impact on their expense ratio in the comparable 2007 period was 280 basis points.

The increase in ceding commission was due to a higher level of profit sharing, driven by low cat activity in 2008 and reserve releases on business written in prior periods. The unearned premium on the business ceded to Flatiron was approximately $105 million at March 31st, 2008. We expect that an additional $10 million to $15 million of written premium on existing contracts will be ceded to Flatiron. Most of the ceded premium yet to be earned and the related fees, including profit sharing if there is any, will be reflected in earnings during the balance of 2008.

Turning to underwriting results. Underwriting income per share for the first quarter of 2008 was $1.45 in comparison with $1.63 per share recorded in the first quarter of last year. On a consolidated basis, the combined ratio was 86.2% in the 2008 quarterly period, which is slightly higher than the comparable 2007 quarter. These outstanding underwriting results were due in part to the continuation of excellent underwriting results in the property and marine business of the reinsurance segment, as well as to favorable development of prior year's reserves. The difference in combined ratio on a quarter-over-quarter basis resulted from increases in both the loss and expense ratios. The increase in the loss ratio primarily was attributable to an increase in catastrophe and large individual risk losses in short-tail lines, as well as to an increase in our loss fixed for intermediate and long-tail business over the past 12 months. These effects were partially offset by the shift in the overall mix of business towards short-tail business, which generally has lower loss ratios relative to longer tail lines and also by an increase in the amount of favorable development.

On a consolidated basis, favorable development, net of related adjustments to acquisition expenses, totaled $57 million in the 2008 quarter compared to $43 million recorded in the first quarter of 2007. A significant portion of the net favorable development in the 2008 quarter was attributable to short and medium-tail lines. In general, reported and paid claim activity across most lines of business remained at favorable levels, and IBNR and ACRs combined remained at approximately 75% of total loss reserves.

The consolidated expense ratio was also higher on a quarter-over-quarter basis. About one-fourth of the increase in the ratio was due to the addition of our facultative operations, as we continue to expense the cost of the start-up operation. The balance is attributable to the lag between lower premium volume and steps that are underway to reduce operating costs.

Turning to investment results, you may have noted that we have broken out separately the results of certain funds that invest in fixed maturity securities. We moved to this disclosure because the legal structure of these investments requires us to equity account for them, which means that unrealized gains or losses are reflected in the income statement rather than directly in the balance sheet. This is contrary to the way we account for our other fixed maturity securities.

Most of the securities underlying these funds are secured bank loans, a sector in which we have recently increased our participation given the attractiveness of current market conditions in that area. Pre-tax net investment income per share in the 2008 quarter increased by approximately 25% on a quarter-over-quarter basis to $1.80. The growth in investment income per share on a quarter-over-quarter basis is primarily due to a level of higher average investable assets. This increase was generated by cash flow from operations, which amounted to approximately $335 million for the 2008 quarter and $1.4 billion on a trailing 12 months basis.

After reflecting share repurchases, which I'll comment on detail in a moment, investable assets rose to approximately $10.2 billion at March 31 and the portfolio is healthy and well positioned. Taking into account yields, realized and unrealized gains, and investments accounted for under the equity method, the total pre-tax return on the portfolio was approximately 1% for the first quarter of 2008, an acceptable result considering the market dislocations encountered in the quarter. The pre-tax yield of the fixed-income portfolio in the quarter was 4.88%. This represented an increase of 4 basis points over the comparable 2007 yield, while it was 16 basis points lower on a sequential basis. The increase in investment income yield on a quarter-over-quarter basis primarily resulted from higher interest rates embedded in the portfolio, as the portfolio's average credit quality remain near the AAA level.

In addition, the 2008 quarter included $3.4 million of interest income resulting from a favorable arbitration decision, which had no impact on the reported yield I just gave you. During the quarter, the reported duration of the portfolio increased slightly to 3.5 years. The change in duration is not the effect of an increase in the level of interest rate risk in the portfolio. It was primarily attributable to the manner in which duration is calculated for the municipal component of the portfolio. Portfolio continues to be comprised primarily of high-quality, fixed-income securities with essentially no investment in hedge of private equity funds. As we did last quarter, we have included additional data on the mortgage-backed securities in the portfolio on page 12 of the release. In addition on page 11, we have included information on our asset-backed securities. I encourage you to review the information on both of these sectors.

Our balance sheet remains in excellent shape and our financial flexibility remains strong with total capital amounting to $4.3 billion at quarter-end and with debt in the hybrids representing less than 15% of total capital. With respect to capital management, during the first quarter of '08, we repurchased approximately 2.7 million common shares for a consideration of $190 million, which represents an average price per share of roughly $69 or 1.21 times book value per share at quarter-end. At March 31st, we had approximately 273 million remaining available under the current share repurchase authorization.

On a weighted average basis, the share repurchase were accretive to earnings per share by approximately $0.26 for the 2008 quarter. The effect would have been 28% of full weight given to them in the quarter. Moreover, the repurchases enhanced ROE for the 2008 quarter by approximately 250 basis points. For the quarter, share repurchases, net of accretion, reduced book value per share by approximately $0.25, while since the inception of the program share repurchases, net of accretion, again have reduced book value per share by approximately $1.70.

In summary for 2008 operating results and our capital management initiatives produced an ROE of about 22%, and book value per share despite the short-term effect of the share repurchases and the extraordinary volatility in the financial markets grew by more than 3%.

Eric, with that, that concludes our prepared remarks, we are ready to take questions.
Question and Answer

Question and Answer

Operator

[Operator instruction]. Your first question comes from the line of Joshua Shanker with Citi. Please proceed.

Joshua Shanker
Citigroup

Good morning. I have a number of small tedious questions about these investment fund bank loans.

John D. Vollaro

Sure.

Joshua Shanker
Citigroup

What kind of yields are you getting in comparison to the stuff via the general portfolio yield on these investments?

John D. Vollaro

Well, there is nothing included on the yield in the portfolio yield I gave you. So I want to be clear about that. The yields we are getting here are superior over the yield. The reason we went and we put you… we had a call hold in this a year ago and it was very insignificant. We built it towards... significantly towards the end of the year and into the first quarter for the following reasons. One spreads on these assets widened very, very dramatically that... that widening obviously occurred all through the rest of the first quarter, but spreads went to a very, very wide level and remember these are secured assets, it's the diversified portfolios among a number of credit managers. Secondly, while treasury or risk-free rates were falling in this environment to levels that make them relatively unattractive, these notes predominantly are floating rates notes. So they protect what you wind up with is essentially no or little interest rate risk but capturing the credit spreads on them. So that's what made this attractive to us. We continue to like the area and we think that over time it's going to add to our total return of the portfolio which is what we are worried about primarily and to book value per share.

Joshua Shanker
Citigroup

Okay. In terms of the accounting change, why this quarter?

John D. Vollaro

The reason for it this quarter, with hindsight, we probably should have been doing this the whole time. It has been insignificant up to this point. With the significant increase we put in there when you considered a fact that their fixed income securities just like the rest of the portfolio but the accounting on them is completely contrary. We don't believe, it makes any sense to account for them in that manner. And Josh, I would note that this is not an accounting change, it's a presentation change. We laid it out for people and you're obviously everyone is welcome to interpret it anyway they want it and place it where they want. But we feel pretty strongly that this is the right place for it, and this is where you see it in the future. So it's not a case of, it's going to be in and out quarter-to-quarter.

Joshua Shanker
Citigroup

And about the reduction in the value or the unrealized loss from that during this quarter.

John D. Vollaro

That's a result of wider spreads over the course of the quarter. We believe these securities are money good and that the total returns on them is going to be very attractive. We bought them at discounts to the original spreads, so timing was reasonable but spreads did continue to increase during the quarter and that's the reason for the difference in value.

Constantine Iordanou

Yes, especially and towards the end of the quarter.

John D. Vollaro

Yes, especially the last two weeks in March.

Joshua Shanker
Citigroup

And where do these valuations come from?

John D. Vollaro

The valuations are provided by the managers but we have a whole elaborate procedure in place to make sure, under the new accounting rules, to make sure that these are tradable securities. So they're based on market observations, they are not Level 3 assets. We have next to or the amount of Level 3 assets we have is negligible.

Constantine Iordanou

It's less than 0.5% on a $10.2 billion portfolio?

Joshua Shanker
Citigroup

Okay. Well, very good. I have more questions, so I'll get back in the queue because I don't want to dominate. Thank you very much.

John D. Vollaro

Thank you.

Operator

Your next question comes from the line of Jay Gelb with Lehman Brothers.

Jay Gelb
Lehman Brothers

Thanks and good morning. Given the... a lot of moving parts with regard to Flatiron, I thought it might be helpful if you can give us a sense of gross and net written premium and home premium trends may be for the balance of 2007?

Constantine Iordanou

Go ahead, John.

John D. Vollaro

Well, on that Jay, as you know, as we've said many times we don't provide guidance. So it's very hard for us to give you any specifics on that. Clearly, as you saw in the first quarter we did increase our participation and we did grow on the reinsurance side which is where Flatiron was being for those who are not familiar was business written basically cat-exposed business written by our Bermuda reinsurance operations and ceded to Flatiron. So we did step up our participation more on the pure property cat XOL side than we did on the property pro-rata side but that's an underwriter’s decision based on where they see the relative attractiveness of the business. It’s hard to know for sure that we had a 6.1, 7.1 renewals which will come up shortly, those are two major renewal periods. We have the existing portfolio, as Dino has pointed out in his remarks its... we have the right to decide whether we want to keep the same size line, cut the line back, or withdraw it totally or write new business. So, we still like the property business. We think that the cat exposed property reinsurance particularly in the US exposed areas is still very attractive from a risk-adjusted return standpoint. So we expect to be active at that period. Where the numbers come out will depend on what pricing across the time and what we believe... what part of that the spectrum we think is attractive enough to want a ride in and step up on.

Constantine Iordanou

And to add to what John said, as you saw our 1-in-250 year PML moved significantly, moved by a couple of points. And the reason being is that it allows us since we have this renewable our underwriters not only look at the relative pricing and return expectation of the specific deal but also we have this business is adding to the PML. So, they have the ability to optimize the portfolio. If we have zones, our PML is at low in relation to other parts of the country then that's the kind of deals that they get priority and that's the kind of deals that we increase our participation. So it's pretty attractive for us to be in that situation.

Jay Gelb
Lehman Brothers

I see. Okay. And then on a separate issue we've heard some of the largest carriers in the D&O space essentially saying they don't see that much of a change on the impact from the credit crunch on D&O and E&O, would you agree with that?

Constantine Iordanou

Well, like I said in my prepared remarks, it's too early to tell. I can give you... listen we’re a [inaudible] of that because we don't have significant exposure in the sector. In the last call if you go back to our prepared remarks in the notes you'll see we gave all that information. So I don't want to repeat it. Having said that, our rate monitoring systems gave us kind of flattish first quarter numbers for D&O and financial institutions. When you analyze it further it was negative in January and February, positive in March to average to zero and then April 1 renewals they were even further up with the little over the 10% and also we've seen accounts, not particularly accounts we were on, but accounts that they gave losses to the market coming to the market for renewals and we've seen 200% to 500% increases in a few isolated instances. Is that a trend? I don't know. I'm just reporting the facts to you guys, you can make your judgments. What we told our underwriters is we always wanted to be smart underwriters and react to the market conditions and make underwriting decisions by what is presented to us today, not yesterday or tomorrow.

John D. Vollaro

Jay let me just say one thing, may be the source of confusion is we are talking specifically about the Financial Institution segment of the D&O business. The rest of the business we would probably agree, we haven't seen much change. It's still double digit down on the commercial D&O. So, but on the Financial Institutions I do think... I don't recall what was that, but I do think on another call, another one of the major players indicated they also were seeing improvement in the Financial Institution section.

Jay Gelb
Lehman Brothers

Right. Okay. And then final, there was a big frequency of large loss events that I think hit the reinsurance sector globally. Do you think that's enough to tighten things out for mid-year renewals or see a reversal or at least a flattening of the downward trend in pricing?

Constantine Iordanou

Well, other than the specific accounts that some that are coming to renewals and this is more from the primary side, not the reinsurance side. And don't forget these large loss, you are talking about the $5.5 billion or so in large risk losses that it’s been the worst first quarter in the last 20 years from a risk loss point of view. We haven't really seen the market react across the board. On the few accounts that they're up for renewals and there were subject to losses, as any account would subject to losses, there is some sort of an adjustment but right now based on what we're seeing in the market we don't see those losses changing the trends, or still downward pressure on the property business. If you have a couple of quarters like that, I don't know what's going to happen, but it's only one quarter and like I said if you go back for the last 20 years, this is the worst quarter in 20 years. It doesn't mean that second quarter or third quarter or fourth quarter is going to be the same. Large losses happen randomly and sometimes there is averages quarter-to-quarter, it’s the long-term averages that we more worry about.

John D. Vollaro

Jay, it might be similar to what's going on in D&O although we haven't seen any evidence of this yet and that is there were sectors within the various lines which were hit harder than others, we'll see whether or not it has a similar impact where those losses if they continue it might have effect on may be improving sectors. But we certainly don't think it's going to turn the whole market.

Jay Gelb
Lehman Brothers

Okay. Thank you.

Operator

Your next question comes from the line of Susan Spivak with Wachovia. Please proceed.

Susan Spivak
Wachovia

Good morning, Dinos and John. Dinos, I was hoping that you could just clarify for me the comment that you made about PML. You talked about the fact that they're going to increase or could increase slightly as at 7:1. Is that both on the insurance and reinsurance side? Are you buying less reinsurance… reinsurance on your insurance book or selling more reinsurance? I'm not really understanding like what's going on with your retentions on the insurance side?

Constantine Iordanou

Right. There is no change in our retentions on the insurance side. Usually most of our PML comes from the reinsurance side of our business because we... usually our net underwriters on the reinsurance side, I would say you roughly out of every $5 of PML, $4 comes from the reinsurance side and one from the insurance. On the insurance side, we always buy reinsurance although you have to… the 250 year event and that's strategy hasn't changed and we continue to buy and usually we like to keep about $100 million of retention within the insurance group anyone event. So the moment if we're going up or down is going to happen on our reinsurance side and as you saw I mean our increase, it was slight, you saw a lot more movement on that portfolio from a premium point of view, but PML increase wasn't that significant from last quarter to this quarter and we always do projections. Our systems they have these ability to dynamically making some assumptions as to which accounts we are going to renew and which accounts might not renew to even have a forward look before we are going to start the season as to what our PML is because we got to manage those PMLs tightly and we do it as a matter of risk management practices and as a matter of conscience to make sure that our balance sheet remains always strong. So the slight increase is what I believe is kind of forward-looking anticipation what rates are going to be in the second quarter and what success we're going to have in writing that business and filling buckets that we might not have as much as we would like to have without really significantly changing the peak zone PMLs which right now is the Northeast and they would... Miami, Broward County.

Susan Spivak
Wachovia

Okay. If I could follow up, could you also comment on your views of when we'll start to see some Bermuda market consolidations?

John D. Vollaro

Well, I don't know, I'm not an investment banker, I'm not in that business. There is people who would like to dance but we would like to underwrite.

Susan Spivak
Wachovia

Okay. So okay, well, thank you.

John D. Vollaro

You're welcome.

Operator

Your next question comes from the line of Tom Cholnoky with Goldman Sachs. Please proceed.

Thomas Cholnoky
Goldman Sachs

Good morning. I have got three questions. Number one, I just want to go back to this net to gross a little bit, John. As you... on the reinsurance side, as you looked at how this year was going to unfold, is a 94% net to gross, does that kind of fit into where you thought that would come out or is there something unusual driving that high. I understand that you'll… as high as it is, and I understand that you have options to change what you ceded to Flatiron. What we are just trying to grasp is, is that kind of a reasonable rate for the quarter or is there something influencing that perhaps that would be a bit higher than what you would have expected?

John D. Vollaro

Well, actually the opposite because what you got... as Dino said before, we are typically a net lines underwriter on the reinsurance side.

Thomas Cholnoky
Goldman Sachs

Right.

John D. Vollaro

Flatiron was essentially all of the outgoing, there is some common account that works in there. So…

Thomas Cholnoky
Goldman Sachs

Okay. So... go ahead.

John D. Vollaro

94 will probably tend to creep up over the course of the year.

Thomas Cholnoky
Goldman Sachs

And it will probably approach 100.

John D. Vollaro

Yes, it won't get quite to 100 because on some quota shares, we buy the common account but it will probably move towards the 97, 98 area.

Thomas Cholnoky
Goldman Sachs

Okay. That's fine, that's great. Now secondly, just in your comments, Dinos, about the overall market and based on what other people are saying about the outlook for pricing and opportunities as the year unfolds, is there anything that you could do to change or to provide some growth opportunities beyond what we saw… I mean your premiums are shrinking, is there anything in the horizon that would change that trend or…? And what I'm probably trying to get out is when you think about your premium volume down 7% for the quarter, is that a trend that given the market conditions is going to be hard for you to change in any meaningful way?

Constantine Iordanou

Well, I mean you can never predict the future, Tom, but what… we're making assumptions on the basis that the market is not going to improve in the next couple of years, '08, '09 and maybe even '10, will probably be tough years where you've got to bunk it down and underwrite.

John D. Vollaro

Right. And that's when…

Constantine Iordanou

Having said that, there is usually unusual events that happen. For us, one, we have fac re guys, they're getting more traction and getting… we're very pleased with their performance so far, and we're hoping that performance will continue and we have no reason not to believe it will. It's a long-term opportunity we had with Gulf Re to make an investment in a part of the world, in a region that is growing very fast and we have the capabilities to underwrite specialty lines, which is basically where the need is. Now, the one-off unusual events is that we're hearing of transactions in the market that might or might not require significant reinsurance support in order for companies to see their balance sheet improve, so they can get more ability to either issue debt or other hybrid securities in order for them to make these transactions. Those... and we've been getting calls on those, in Europe, and in some cases, in the US, those are going to be one-off for reinsurers that they might want to participate in getting some business off companies' balance sheets in order for them to be able to move forward with those transactions. But, I can't predict that.

So if your question is about what we believe is going to happen, it's steady as we go. We're going to underwrite on a daily basis if that requires us to be shrinking by 5% to 10%, so be it. I think the winners in this game over the next two to three years is the ones that they… they have the most disciplined underwriting performance in the marketplace and as a matter of fact, I'm spending most of my time working with our troops around the country to understand the message, but more importantly, practice the message because underwriters don't like to lose. They… there is market pressure, they want to write business, that's what makes them successful and management has to continue to re-emphasize that. Top line is not what's important to us. Profitability and bottom line is what's important to us, and we keep reinforcing that message as loud and as clear as we can. You can never over-communicate in a market like this.

Thomas Cholnoky
Goldman Sachs

Yes. And my last question just has to do with capital management and how we should think about that because clearly, you were quite aggressive in the first quarter, noting that you bought back stock at 1.2 times book, given that you've grown your book, presumably, the stock is still very attractive at these levels. Yet, you only have $270 million left in your authorization. If you continue to go at the rate that you're going at, you're going to quickly run out of anymore buyback capacity, and what is your… what are your views in terms of balancing the lack of growth with perhaps continuing to be very aggressive in buying back the shares?

Constantine Iordanou

Well, our view has not changed. In our capital management, we have… number one principle is, we will always maintain a very strong balance sheet. We like to… the ratings we have, we would like to be a strong rated company. We always have discussions with the rating agencies and because that is fundamental to our business and our customers and it's important. Having said that, we accumulate excess capital and we can't put it to work, the best way to do it is to return it to shareholders. And at 1.2 times book or 1.3 times book is a no-brainer but the proper way to return it is by share repurchases. So where we are today is where we are today. We get Board meetings once a quarter and this is always a standing discussion with our Board, where is the capital account of the company, what are the prospects of using that capital in our business and based on that, we make decisions and but I can’t... if you take my last comment that there might be unusual large opportunities that might come out because of M&A activity that it will allow reinsurers to write big reinsurance transactions, that might change what we do, but I can't predict the future, I wish I was that smart. If I was that smart, I’d be a lot wealthier, but I'm not that smart, I can't predict the future.

Thomas Cholnoky
Goldman Sachs

You have done it right, Dinos. Thank you.

Operator

Your next question comes from the line of Matthew Heimermann with J.P. Morgan. Please proceed.

Matthew Heimermann
J.P. Morgan

Hi, good morning, everyone. I just had a couple of quick questions, I guess, and I don't mean to harp… this isn’t meant to harp and I'm probably thinking… over-thinking this, but in your insurance business, there were a lot of comparing growth rates last year to what we saw in the first quarter of this year, particularly like property, marine, aviation, the construction business, professional liability that we basically had kind of the inverted trends that we did in the second half of last year and I wondered if there was anything... any trend worth highlighting there or just don't… that we’re focused on a quarter?

Constantine Iordanou

Matt, it’s a great observation. Two things, if you noticed, we pointed out in the footnote that we broke certain lines out differently. So surety, for instance, which we were including in construction and national accounts is now broken separately and we moved the classification of another one. We...

Matthew Heimermann
J.P. Morgan

I generally had those... I added those back so even there I got…

John D. Vollaro

Yes, but you can't... trend wise, you don't have the other quarters. So it's hard for you to note they were... we are going to put that information in our 10-Q.

Matthew Heimermann
J.P. Morgan

Okay.

John D. Vollaro

So you will get it. With respect… what you see... what you see though is the only area where the trend did look different. Your comment is right on, it is the property, marine, and aviation and that's driven mostly by seasonal factors and the way the business is written. So there is definitely seasonality within that group between sort of the second half of the year and the beginning of the next year. So if you look quarter-over-quarter, for instance, you see a different trend than if you look from the third and fourth quarters into the first quarter of this year.

Matthew Heimermann
J.P. Morgan

Okay. That is helpful. And then the other... Dinos, this is for you and again, I don't know from… I am over-thinking this, but you are starting to see the professional liability market respond to some of these losses and obviously, you are seeing dramatic increases in FI and it's having enough impact with things, the whole market looks like it’s stabilizing, but most folks continue to kind of say, we think this is not going to be enough to really impact results. So I guess, is there a disconnect between the market firming and people saying, this isn’t a big deal or are we in store for perhaps more bad news than people realize?

Constantine Iordanou

No, I think the market is being consistent. We looked at this, 42 is the Sunday, and when... and don't forget, we are not a big participant, but we are in the matter and we know what's going on. When you add up all the limits for the companies that they are in trouble, you hear people throwing numbers at $5 billion and $6 billion and $10 billion, we don't agree with that. We see this to be somewhere in the $3 billion, $3.5 billion in short losses, and this is on the D&O side, I am not talking about E&O and with that, based on the size of the management liability business, the executive assurance business, I don't think it’s significant to change the trend. Having said that, I don't think it is inconsistent to see the market react specifically to a particular sector. The banks, the mortgage brokers, some of the homebuilders, etcetera. So, that's why my remarks that we’re trying to be more specific that it was only in the financial institutions D&O, and the real big adjustments there were on companies that they had some issues that caused losses to the market. Now, I can't predict if that's a trend that is going to continue, and I said so. It's early indication that there is a cause and effect in the marketplace and underwriters are not totally stupid. They do react to situations and they make adjustments and I was pleased to see it because it was a market adjustment, it wasn't just one company or two, it was across-the-board for that narrow segment.

And let me just add on it because some of the noise you might be getting with what you would call… what you termed disconnect might be the fact that, we... the losses on this will not be distributed symmetrically across the marketplace. So primary… it's our view, the primary writers will absorb more than excess writers and then after that, it's a function of whether people are underweight, overweight, the financial institution sections going in. We happen to be underweight. So for us, it's an opportunity where if rates go up a lot, we can add a lot of rate and we are not looking at that much coming at us from the past. So you may get different views from different people because the losses are going to be distributed unevenly in the market.

Matthew Heimermann
J.P. Morgan

Okay, that's fair. And then just one other question, it's my understanding that the reinsurance that folks would purchase for a lot of the D&O is predominately proportional. So I don't know if this is an easy question to answer or not. But are you seeing the same reaction by... I guess are you seeing a similar reaction by reinsurers in the D&O space? I mean, obviously they’ll benefit from the primary increases but are they reacting even more or less, I would say, with respect to terms and conditions, ceding commissions, or other things with respect to economics to what you are seeing in the primary market?

Constantine Iordanou

Well, I mean we’ve been on a... we’ve been a supporter of these lines from a reinsurance point of view. But we have... as we reported in prior quarters, we’ve been cutting our participation significantly over the last almost three years, two-and-a-half, three years. And it was different factors causing at first. We were seeing... even before the subprime, we were seeing the rate erosion and with a little more caution reinsurance wise [inaudible] pro rata because you are committing yourself to a 12-month forward look as to what the ceding company is going to do with rates. Also, some of our decisions to get off some of the business. In the last two years, more and more companies tried to switch to buy excessive loss and we feel in a business that it has severity characteristic to it, excessive loss is not the preferred way for us to support reinsurance. Having said that, yes, the reaction to the financial institutions, issues, that kind of measure on both sides of insurance and reinsurance.

John D. Vollaro

The other thing there is, it might be interesting and we haven't seen this yet, but whether people will take another look at their own risk management guidelines and decide whether primary writers want to buy more reinsurance than they were buying because of this kind of horizontal accumulation they can get out of this.

Matthew Heimermann
J.P. Morgan

It makes sense. Thank you so much. Have a great day, guys.

Constantine Iordanou

Thank you.

Operator

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

Vinay Misquith
Credit Suisse

Hi, good morning. A few questions. First is, if you could update us on your exposure to contractors' liability, especially in California, please?

Constantine Iordanou

Vinay, would you just speak a little louder. We have a difficult time hearing you.

Vinay Misquith
Credit Suisse

Sorry. Could you update us on your exposure to contractors' liability, especially in California?

Constantine Iordanou

Well, in that book of business, which we've been a participant since '02 is being… coming down significantly and we have reported that for the past year-and-a-half or so and in spite of what's happening with that activity. There are less projects, a lot of these are project policies. So, in essence, you don't have a lot of renewals. You are doing a project policy. If the project is not going to be funded and start to be built, you don't have the opportunity. So... but I don't have the specific numbers in front of me. I don't have a chit sheet to tell you that, but if it's important to know what we are, we can't get that information.

John D. Vollaro

But the book itself and again, as Dinos mentioned, we were writing it in '02 and '03 when no one was writing it. The performance of that book so far and we've been very, very cautious in how we've reserved it, it's been extremely good.

Constantine Iordanou

Yes. It's been extremely good.

Vinay Misquith
Credit Suisse

Have you been producing your business since '05?

Constantine Iordanou

Yes. We produced business in '05 and '06 and even in '07, but the current line is coming down. That's… we wish it didn't, because we still believe in the way we approach the business and the kind of pricing we are getting, it is attractive business, is not just as much of it as it used to be.

Vinay Misquith
Credit Suisse

Right. And you are not seeing any adverse loss trends as yet on the business?

Constantine Iordanou

No, no. Everything looks extremely good.

Vinay Misquith
Credit Suisse

Okay. The second question was on your… your European premium seem to have been higher this quarter. Was it purely a function of ForEx or was there some other growth there?

Constantine Iordanou

Don't forget, first quarter is always a strong quarter. So, I think it's a combination of both.

Vinay Misquith
Credit Suisse

Okay, fair enough. And the last question was on the operating expense ratio. There seem to have been movement in the reinsurance and the primary insurance segment. On the reinsurance segment, you had a slightly lower run rate this quarter than the past three quarters, but on the primary insurance that picked up. If you could just give us some clarity on that and where you see your expense ratio going, given the fact that you are already using premiums quite dramatically and how do you still manage to maintain the morale of your troops given the fact that the top line is down?

Constantine Iordanou

Well, it's questions. Let me start with the expense question. We adjust to the expenses based on what we believe the opportunities are in the marketplace. We already have in place to... on the insurance side, plans to make sure that we'll look at every unnecessary expense and deal with it, nothing that we do is not going to be taken a look at. Having said that, you've got to understand, the strength of this company, its underwriting talent, and I am not going to mess with underwriting talent. When we have underwriting talent, we are going to maintain it because in a cyclical business you need those underwriters when the opportunities will come back. Yes, you manage around that, but I will tell you both in insurance and reinsurance, our core underwriting capability is going to be maintained. And I'd rather have one point or two points of additional expense rather than lose my ability to really do wonderful things when the opportunities arrive there. So, we have this balance in our thinking. Yes, we do try to match revenue with expense and we will do the best, but we are not going to do it at the expense of destroying what we believe is the strength of this organization, which is its underwriting talent.

John D. Vollaro

And, Vinay, on the reinsurance question, bear in mind there it's not all of it, there was a slight pick up in the treaty, but a large portion of it is because in the first quarter '07, we did not have facultative operations, we began them in the second quarter. And as you know all of their expenses, because it's a direct operation, show up in the operating line, they have no acquisition cost. They don't pay any brokerage for the business. So, a good chunk as I mentioned, it had an impact on our entire ratio quarter-over-quarter and it accounts for a good part of the tick in the reinsurance side.

Vinay Misquith
Credit Suisse

Sure. But it was less than that in the second, third, and the fourth quarter, correct?

John D. Vollaro

Yes, it is. Because they have been ramping up and as I mentioned, we've been expensing all the costs that come along with it. So, especially in a start-up operation when you gap [ph] it, you don't defer a lot of the expenses. And so, the reason it came down in this quarter is they are beginning to get more and more success, so their volume is starting to build. And quarter-over-quarter, however, you're dealing with a relatively high expense ratio for that segment against zero expense ratio in the prior quarter.

Constantine Iordanou

Yes. And the economics of that business is different, I mean the fac business operates like you are running on insurance property business. And since it's direct, all the expense is going to go on the expense side. There is no commission that gets paid out?

Vinay Misquith
Credit Suisse

But on the primary insurance business also you saw some pick up in expenses, was it something specific in this quarter?

Constantine Iordanou

No, it’s reduced volume and basically the units will adjust to it as we go into the year.

John D. Vollaro

As Dinos said, there are moves underway that are looking at all the expenses from a zero base standpoint just to make sure that, if we spend a dollar, we are getting an appropriate return on that dollar in some form and whatever is it, there is no sacred cows, whatever is it, it will be eliminated.

Vinay Misquith
Credit Suisse

Fair enough. One last question if I may. Your rate reduction that you mentioned at the start of the call seems to be slightly higher than maybe some of the larger players mentioned on their calls. Would that be a few more conservative than them or do you think that your business is more E&S and therefore your rate declines may be higher than maybe the larger players? Thank you.

John D. Vollaro

No, I don't think… I don't know what others because I have listened to some calls, but not all. I don't know what others are reporting, but don't forget I said, it’s 8% to 12% with two segments at zero. So, when you average, you got to do the average for the entire book of business. So, our book of business will be mid-to-high single digits when you do the averaging, which is no different than what others. Or when you look at the [inaudible] rate, increase, decrease reports or CIAB studies etcetera, they are not that much different form that.

Vinay Misquith
Credit Suisse

All right, fair enough. Thank you.

Constantine Iordanou

You are welcome.

Operator

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

Brian Meredith
UBS

Thanks. Just one or two real quick questions, it's almost lunchtime. The first one, could you tell me what impact did the lower interest rate environment have on you appetite for casualty business this quarter? Did it contribute to the decline at all?

John D. Vollaro

We look at rates all the time on a total return basis and it certainly has affected our appetite in certain areas, because you have hit on a very good point. Certain of the longer tail lines of business, the real rate decline, if you will, is greater than the nominal rate decline. So, yes, the answer is yes, it has had an impact on our view.

Constantine Iordanou

Yes. We price the business based on the risk-free rate of return. So, in essence, when our pricing actuaries look at that, he has an effect as to if a deal makes the cut or not from a total return characteristic, what the ROE on that business is going to be.

Brian Meredith
UBS

And since we saw an increase in interest rates, it may actually increase your appetite for business?

Constantine Iordanou

Well, you see a significant… and it depends how the competition reacts to it, too. I mean it’s all inter-related.

John D. Vollaro

All things being equal. You never know, Brian.

Brian Meredith
UBS

Right, understood. Last question is, Dinos, can you talk a little bit about appetite actually for either starting an operation or buying something on that voids [ph]?

Constantine Iordanou

Well, our preference will be to be starting something than buying. Everything that we’ve seen that has been bought, it didn't meet our characteristics of being fair value. The sellers got a better price than what the buyers got. So, from that perspective, I think… and believe me we said it before, I think a Lloyd's license [ph] will be very valuable to us. It opens the world for opportunities and… but our preferred way is for us to probably create something rather than buy something.

Brian Meredith
UBS

Great, thank you.

Constantine Iordanou

You are welcome.

Operator

Your next question is a follow-over question from the line of Joshua Shanker with Citi. Please proceed.

Joshua Shanker
Citigroup

You said you are looking at some of the conference call this morning, one of your friends said that he thought that rates would be breakeven for 2008, the industry would likely produce an underwriting loss for '09. I am wondering how you feel about that, a view of the market in general?

Constantine Iordanou

Can you define breakeven?

Joshua Shanker
Citigroup

I assume you are talking about just underwriting profits.

Constantine Iordanou

On a combined?

Joshua Shanker
Citigroup

On a combined.

Constantine Iordanou

No, I don't agree with that, I think that's a bit too pessimistic. I think the industry… and at least in the lines of business we are in and the way we are pricing the business, we still believe that on a policy basis, we are getting a 15% ROE on that business. And that view has not changed. It might in a year or two as rate reductions continue to come down, but right now I think there is still margin in that business beyond the break-even point.

John D. Vollaro

And mix of business is important variable in that equation, so it’s hard to generalize, of course you would have to look it as mix of business versus ours. If you are all long tail, you might be moving a lot close into that line than if you got a more diversified book.

Joshua Shanker
Citigroup

I think he was referring to his... not to his book of business, but the industry in general.

Constantine Iordanou

Well, I mean if your mix is… like we are 40% short tail... and 40% short tail would tell you it's going to come with lower loss ratios, expected lower loss ratios, excluding cats or just normalized cat. So, in essence, your combine ratio, it better be under 100, otherwise you are not going a good underwriting job.

Joshua Shanker
Citigroup

Fair enough.

Constantine Iordanou

If you book a business 100% casualty and all long tail, you might be doing just the opposite, you might be getting closer to 100 combined.

Joshua Shanker
Citigroup

Very good, very good. Well, thank you very much.

Constantine Iordanou

You are welcome.

Operator

Your next question is a follow-up question from the line of Tom Cholnoky with Goldman Sachs. Please proceed.

Thomas Cholnoky
Goldman Sachs

I think I'll pass, it's lunchtime. Thank you.

Constantine Iordanou

All right. Thanks, Tom.

Operator

We are currently showing no more audio questions in queue. I would like to turn the call over to Mr. Iordanou and Mr. Vollaro for closing remarks.

Constantine Iordanou

Well, thanks everybody. We are looking forward to talking to you next quarter. Have a good day.

Operator
Thank you for your participation. This concludes our presentation. You may now disconnect and have a good day.