S&P Capital IQ

CONTENTS

W. R. Berkley Corporation NYSE:WRB

FQ1 2013 Earnings Call Transcripts

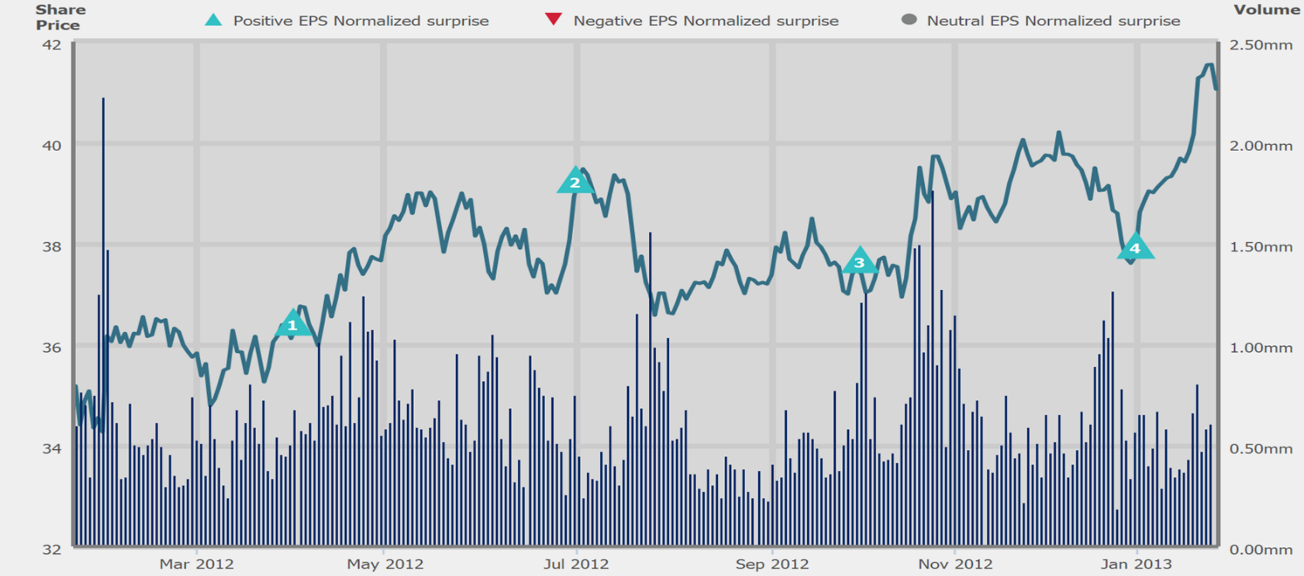
Wednesday, April 24, 2013 12:30 PM GMT

S&P Capital IQ Estimates

	-FQ1 2013-			-FQ2 2013-	-FY 2013-	-FY 2014-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.74	0.74	0.00	0.69	3.01	3.21
Revenue (mm)	1431.93	1506.77	5.23	1477.63	5915.02	6384.13

Currency: USD

Consensus as of Apr-24-2013 1:29 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2012	0.67	0.73	8.96 %
FQ2 2012	0.61	0.65	6.56 %
FQ3 2012	0.54	0.61	12.96 %
FQ4 2012	0.49	0.64	30.61 %

Call Participants

EXECUTIVES

Eugene G. Ballard
Executive Vice President of Finance

William Robert Berkley
Chief Executive Officer, President and Director

William Robert Berkley
Founder and Executive Chairman

ANALYSTS

Amit Kumar
Macquarie Research

Gregory Locraft
Morgan Stanley, Research Division

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

Lawrence David Greenberg
Langen McAlenney

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Robert Edward Farnam
Keefe, Bruyette, & Woods, Inc., Research Division

Ronald David Bobman
Capital Returns Management, LLC

Vinay Gerard Misquith
Evercore ISI, Research Division

Presentation

Operator

Good day, and welcome to the W.R. Berkley Corporation First Quarter 2013 Earnings Conference Call. Today's conference is being recorded.

The speakers' remarks may contain forward-looking statements. Some of the forward-looking statements can be identified by use of forward-looking words, including, without limitation, believes, expects or estimates. We caution you that such forward-looking statement should not be regarded as a representation by us as future plans, estimates or expectations complemented by us will in fact be achieved. Please refer to our annual report on Form 10-K for the year ended December 31, 2012, and our other filings made with the SEC for a description of our business environment in which we operate and the important factors that may materially affect our results. W.R. Berkley Corporation is not under any obligation and expressly disclaims any such obligation to update or alter its forward-looking statements, whether as a result of new information, future events or otherwise.

I would now like to turn the call over to Mr. William R. Berkley. Please go ahead, sir.

William Robert Berkley
Founder and Executive Chairman

Thank you very much. We were really pleased with our quarter. I think that -- a number of things I'd like to just comment on, and then I'll turn it over to Rob. First of all, you'll see our change in format as we try to address what we think is a better presentation as an ongoing basis of how to look at our company. That's an evolutionary process, and we think this gives people a better picture, in part because our various segments seem to move around and overlap and no longer gave a good picture of our ongoing business.

Second of all, I think that the growth that we're showing, an increase in prices, is coming into our financial statement, as we've tried to in fact explain on a slower basis, and one what might have expected. But we're really enthusiastic about it continuing to build over the balance of the year. And we're very optimistic as to how things are going.

So with that, I'll let Rob talk about our operations and we'll turn it over to Gene, and I'll come back and make a few more comments and answer questions. Rob?

William Robert Berkley
Chief Executive Officer, President and Director

Good morning. Through the first quarter of the commercialized market continued to experience further gradual tightening. This ongoing trend seems to be primarily fueled by concerns stemming from prior year reserve development. However, the low interest rate environment is also beginning to have a real impact on investment income and consequently, overall profitability for the industry, and people are beginning to recognize the issue and react. There has been a lot of talk about this over the past couple years, but we're now beginning to see it translate into action in the form of greater discipline on the underwriting side.

We believe these factors will sustain the market improvement. While on the surface, market conditions during the first quarter appeared consistent with the second half of 2012, there were a number of signs that a sense of urgency is on the rise. The combination of continued strong growth in the assigned risk plan and less competition for certain large accounts with a noticeable spike in submissions coming into the specialty market from the standard market is evidence that we are likely to see further tightening as the year progresses.

The overall casualty market continues to firm, as companies are looking to raise rates, as well as reduce capacity or line [ph] size. While the professional market lagged the broader market, it is also now showing signs of improvement. Although in general, the excess lines continue to be more resistant to such changes.

The workers' compensation market was also somewhat of an anomaly, with discipline returning to the primary market, while the excess space remains surprisingly competitive. One can only assume the explanation is the difference in the duration of tail and that companies are not yet recognizing that their excess business was underpriced.

The commercial auto market, aviation and marine market all continue to remain quite competitive. However, given the industry results, we are anticipating a noticeable shift over the balance of the year.

Finally, the property market. While improvement rates are available, they are less robust than one might expect, given the global cat activity over the past 2 years.

We continue to emphasize the importance of rate adequacy and underwriting margins throughout our organization. The company's rate monitoring of renewal business for the first quarter indicated an improvement of 7.3% over the corresponding period in 2012. Our new business relativity metric indicated that we charge roughly 2% more for our new versus renewal business.

All 3 business segments contributed to this improvement in rate, for both new and renewal business, though not equally. More specifically, about 4 of our operations did not contribute to balance contributed. This is the ninth quarter in a row the group achieved additional rate and consequently, the fifth quarter that rate on rate was achieved.

Cumulatively, our written rates are up 15% in 2010 and our prices are on level with where they were at the beginning of 2005. Of course, loss cost have risen since then and interest rates are lower, so there is still more work to be done.

As in the past, we continue to believe we are obtaining this improved rate without jeopardizing the quality of our books, which is demonstrated in part by our renewal retention ratio continuing to remain at approximately 80%. We continue to believe these 2 meaningful data points demonstrate that the group's underwriting margin is improving.

Gross written premium for the quarter was $1.63 billion. This is an increase of 16.4% when compared with the first quarter of 2012. When you take a closer look at the breakdown of this growth, 7.3 points came from rate, 8.5 came from exposure growth and audit premiums added 0.6 points.

Our international insurance and global reinsurance segments grew by 25% and 23%, respectively. While our new businesses are contributing to the growth, they are not the sole driver. 37 of our 47 underwriting operations reported increases in earned premiums during the period.

For the quarter of the company's calendar year, loss ratio was at 60.4%, an improvement of almost 2 points compared with the first quarter last year. The improvement in the x cat accident year loss ratio was about the same, as cat losses and reserve releases were comparable to the same quarter a year ago.

Perhaps more importantly, the company's paid loss ratio was 53.8%, which is the lowest it's been in several years. Our expense ratio for the quarter was at 34.3%, a reduction of approximately 0.5 point. This is gradually improving as our earned premium continues to build momentum. We expect this trend will continue. However, it is impacted from time to time by costs associated with the development in new operation.

When you put it all together, the company produced a combined ratio of 94.7%, which represents an improvement of approximately 2 points. As the year progresses, we expect this trend to continue, primarily due to the benefits that both the expense ratio and the loss ratio will gain from higher earned premium, as well as improved rates.

We continue to be comfortable with our balance sheet due to the strength of our investment portfolio, as well as the health of our loss reserves, as evidenced by 25 consecutive quarters of positive reserve development.

The company continues to subscribe to a general philosophy that in the aggregate, it is better to err on the side of caution when selecting initial loss ratios and adjust accordingly as more information becomes available.

The market continues to tighten, evidenced not just by higher rates and the power of compounding of these higher rates, but is additionally supported by the narrowing appetite of the standard market, once again demonstrated by growth in assigned risk plans, as well as increased submissions into the specialty market.

Our company remains well poised to take advantage of this improving market.

William Robert Berkley
Founder and Executive Chairman

Thanks, Rob. All right, Gene, do you want to take us through the financials, please?

Eugene G. Ballard
Executive Vice President of Finance

Okay, thank you. Before I go through the numbers, let me just take another minute to describe the change that Bill referred to and the way we define our business segments.

First, the new domestic insurance segment is really just an aggregation of former specialty regional and alternative market segment. And over the time, the distinction between these segments has become a little less relevant from a financial reporting perspective. As Bill said, that's because many of our profit centers, especially the newer ones, don't just write one type of business. It falls within one category or another. Therefore, they don't specifically fit in a subsegment, and we felt it was better to combine them.

The other 2 segments, international insurance and global reinsurance are the same as we've previously reported, except that we moved 2 companies, Berkley Re Australia and Berkley Re UK, from the international segment to the reinsurance segment. You'll find -- you can find an exhibit on our website that presents our historical financial results under the new segment alignment.

By the way, we also recently completed a significant change in our statutory financial structure. Effective January 1, 2013, all of our U.S. insurance business is being reinsured to our lead company, Berkley Insurance Company, under a 100% intercompany pooling agreement. This will significantly reduce our administrative and regulatory costs. And we also think having all the business in one annual report will provide more useful statutory financial information.

Now with regard to the financial results, it was another strong quarter, underwriting quarter with an overall increase in underwriting income of 70% from a year ago. The improvement was driven by a 12% increase in earned premium and by lower loss and expense ratios for each of our 3 business segments.

As Rob said, gross premiums were up 16% to $1.6 billion. Ceded premiums were up more than that. It's 30% due to 2 things: higher reinsurance limits, as well as strong growth in some of our newer companies. We tend to buy more reinsurance for companies in their early years, while they are developing a sufficient spread of risk. You should also note that approximately 1/3 of our ceded premium is business ceded to state-assigned risk plans and related self-insured entities that we administer.

Net premiums were up 14% to $1.4 billion, with increases of 12% for the domestic insurance segment and 22% each for international and reinsurance.

For the domestic insurance, the growth was led by our E&S companies and our monoline workers' comp business. The international growth was mostly from our businesses in the U.K. and Europe and the increase in reinsurance was driven by growth in Asia Pacific region and the U.K. Changes in foreign exchange rates had minimal impact on the international growth rate.

In terms of our combined ratio. Just to add a few comments to what Rob had to say, the combined ratio declined by 1.8 percentage points to 94.7%. Underlying loss ratio before cats and reserves declined by 2.62%. Prior year reserves developed favorably by $24 million, almost unchanged from $25 million a year ago. All 3 business segments reported favorable reserve development this quarter, with the majority of that coming from the reinsurance segment. Cat losses were light again, at 0.4 loss ratio points, unchanged from a year ago. And the expense ratio improved by 4/10 of a point to 34.3%.

Because we're growing so significantly, we've talked about this before, we also look at our direct written expense ratio, that's before ceded premiums and DAC, because we think it's a more current measurement of our expense trend. And on that basis, the expense ratio declined a full point to 30.6%.

Investment income from our core portfolio was down $2 million to $121 million, with annualized yield of 3.6%. Income from investment funds was $11 million, with an annualized return of 5.7%. Although the investment fund income was in line with our expectations, it's well below the 18% returned -- return that was earned in the first quarter of 2012. The difference is mainly due to energy funds that had a especially strong earnings in the first half of 2012.

Realized gains from investment sales were $20 million during the quarter and pretax unrealized gains were $804 million at March 31. At the end of the quarter, 81% of our portfolio was invested in cash and fixed income securities, with a duration of 3.3 years and an average credit rating of AA-.

Unrealized gains were up slightly in the quarter, but a 6% decline in the British pound exchange rate resulted in an unrealized currency translation loss of $46 million. About 1/3 of that decline has reversed so far in the month of April.

So that gives us net income of $117 million and annualized return on equity of 10.8% and book value per share of $32.19. And if you adjust for the special dividend we paid in December, our book value per share is up over 11% for the last 12 months.

William Robert Berkley
Founder and Executive Chairman

Thanks, Gene. So we are pretty pleased with how we're going and where things are going. There were some things that were unusual, as the volatility. We're well hedged on the euro. We are investing in sterling still. That decline in sterling at the end of the quarter did cost us in book value. Although as Gene said, between 1/3 and 1/2 of that is back already, and we think that sterling is a better alternative for us than the euro at the moment.

We do have a number of investment alternatives that we think will protect us over the long run from inflation. But in the short run, we're less concerned with inflation because we think the dollar is still the place to go and we think that foreign flows into the U.S. will really keep inflation under control, certainly, in the next 12 to 18 months. So we're feeling a little less pressure for inflation being around the corner, which is causing us not to be in such a rush to shorten the duration of our portfolio.

As far as our own opportunities, we're seeing growth in almost all of our operating units. And there's a lot of volatility as people leave segments of the business that they entered without properly positioning themselves, and we're finding good opportunities with people and relationships where we're able to step in and gain market position. It's clearly becoming a marketplace of the haves and have nots. And for the haves, it's going to be an excellent next few years.
So with that, Kevin, we're happy to take questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Amit Kumar with Macquarie Capital.

Amit Kumar
Macquarie Research

Just 2 questions. First of all, just going back to your pricing comment and the shift to -- from standard to specialty markets. Do you get the sense that perhaps we will be able to hit double-digit rates by end of 2013? Or do we stay in the 7% to 8% range for the remainder of the year?

William Robert Berkley
Chief Executive Officer, President and Director

Amit, this is Rob. I think that it would just be speculation. Certainly, there are lots of data points that would suggest that pricing leverage in favor of the carriers could potentially build from here. At the same time, I'm not sure if it's such a perfect science that we can call it with any -- within any 90- or 180-day period. So are the fundamentals there? Does the pressure continue to build that would drive further change in behavior and looking to achieve as far as rate? Absolutely, that is the case. But our ability to answer your question with a level of precision that you're looking for, I think is a stretch. Having said that, it certainly is a distinct possibility.

William Robert Berkley
Founder and Executive Chairman

I think, Amit, the one external factor that's here today that wasn't here in the last cycle is we have an economy that's not as robust. And that's going to keep a little more pressure on the marketplace. So I think that it's not as much as an insurance question as an economic question. There is plenty of pressure for improving rate as needs for returns. On the other hand, you do have that economy that is improving, getting better but not at a robust rate.

Amit Kumar
Macquarie Research

Got it. And secondly, I guess related to that is the discussion on loss-cost trends. And I know you spend a lot of time talking about, I guess, using a 3% number on the past calls and why maybe that's what your views, but trends might be even better than that. Has anything changed on the loss-cost trend front? Or is it still pretty much the same what we discussed about on the last call?

William Robert Berkley
Founder and Executive Chairman

I think that we would generally -- based on what our actuaries see, with medical costs and everything else, we would say it's generally steady. I think because of less pressure on inflation overall, we would have expected a little more pressure, and there's definitely less pressure. But I think that to be more optimistic at this moment would probably be foolhardy. So I think that we would still sort of stick at that 3% level. And be happy if it came out to be 2%, that will be great. But I think we're going to still stick at the 3% level.

Amit Kumar
Macquarie Research

Got it. Final question, and I know you've given us the chicken today, feathers tomorrow analogy in the past. There's a lot of discussion on third-party capital entering the reinsurance marketplace and providing additional capacity to the market, which already has a lot of capital. Do you have any thoughts on third-party capital, and even perhaps utilizing third-party capital back to reinsurance to write some lines which you might not have written in the past?

William Robert Berkley
Founder and Executive Chairman

Third-party capital or, if you will, capital provided by various pieces of the capital markets, ranging from private equity funds and hedge funds to banks have been available for a while. I think it's an interesting avenue. We've used it on occasion to provide us with reinsurance. However, our own view at this point is we're not really interested in the uncertainty or the volatility that those kinds of returns offer us. We have looked and considered providing services to some of those people, and for the moment, don't think it's where we want to go. We believe that when we do that for someone, we're still putting our name on that risk variant fees business, and it's just not -- it's not something that we're going to do tomorrow. If we think that we can do it in a way that provides a return for them and fees for us and they're willing to accept the volatility, we might well go there as these markets develop more, but we're not ready to do it tomorrow.

Operator

Our next question comes from Mike Nannizzi with Goldman Sachs.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

So one question I had, I guess, is in growing now. I mean, are you able to find areas where margins on business you pick up is consistent with or are consistent with the margins that you're seeing on your retained book?

William Robert Berkley
Founder and Executive Chairman

The pricing on our new business is in general 2% higher than on our renewal book [ph]. So in fact, the answer is yes. In fact it's a little bit better. But you think it needed to be a little better because you don't have the same experience, you don't have the same knowledge, so the certainty of your underwriting skills is not as good.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Right. I mean, it makes sense -- I guess, and this may be a really basic question, but who is giving that -- who is not writing that business? So if the business is at good margins, maybe better margins, what is causing that business to be available?

William Robert Berkley
Founder and Executive Chairman

I think in general, what's happening is you've got lots of people who are more concerned with the quality of their insurers and are saying, "We need to be sure that people are here." So you have people going for stability, going to people who they know knew will be there. I think you've got several larger companies that are trying to sell themselves, trying to get out of business that's bringing up business and people are saying, "We don't want this. We'll pay a little more to have stability." And like everything, there's turmoil in the marketplace in some segment or another always. So I think that's going on, people aren't reunderwriting their books of business. So it's not like there's 1 company, but there's probably 2 or 3 medium-sized companies that are currently going out of business. And so I think that what we will do is look at the list of the companies that people like Goldman Sachs are selling. And that those customers are the ones who are creating opportunities.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it, okay. And then could you give a little bit more color, you mentioned primary versus excess. I thought that was really interesting, just kind of the competitive dynamics between those 2 different distribution-placed businesses?

William Robert Berkley
Founder and Executive Chairman

Rob?

William Robert Berkley
Chief Executive Officer, President and Director

Yes. I think that obviously, we can't specifically pinpoint what is driving others' behavior, but we are noticing a great difference as to the tone and the attitude when it comes to pricing of primary versus excess in a couple of parts of the overall marketplace. Our hypothesis or theory is that the excess tends to take a little more time for the results to come through and for people to recognize the issues that they may be facing, as opposed to a primary where the consequent has come through in a more timely manner, which is why you're seeing people respond to the primary more quickly.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Do you think part of it might be -- I'm just curious, if have to do with the fact that to write this traditional business, you need more infrastructure, you need fully built-out claim system. And then maybe if you're writing higher mid-layer excess, maybe you need less than that. Is that a possibility? Or is that not likely?

William Robert Berkley
Chief Executive Officer, President and Director

I guess it's a possibility. But based on what we see, it has less to do with expense ratio and more to do with perhaps a lack of underwriting discipline and how long it takes for, when you're in the excess layers for that to become apparent, the excess comp probably being a great example of that.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it, great. And then just one last one, if I could. What are the attributes that you look at when you're -- you mentioned new startups, and I would imagine a lot of that is still taking place outside of the U.S. What are the attributes that you look at in terms of deciding where you want to grow? I'm guessing and we've heard from other folks that pricing is still better in the U.S. than outside of the U.S, I'm guessing, you just have a longer lens in terms of what you want your profile to look like, but any color there would be helpful.

William Robert Berkley
Founder and Executive Chairman

I think that we'll let Rob give you the answer, the specifics. But I think that our strategy, as opposed to the specifics to your question, is always an opportunistic one. It's not here's what we're going to do. It's finding the opportunity that presents itself. So you want to...

William Robert Berkley
Chief Executive Officer, President and Director

Yes. I mean, our general approach when we're looking for opportunities is on a macro level the same domestically, as well as outside the United States. We're looking for market opportunities which we think is a sustainable opportunity. We want to differentiate based on intellectual capital and expertise as opposed to purely just capacity because that makes you write for becoming even more of a commodity. As far as your comment about the U.S. versus the non-U.S., I think to paint with such a broad brush to say that price increases in the U.S. are better than outside of the U.S., I think that is a bit of a broadbrush. Certainly, there are markets outside of the U.S. that remain more competitive than our domestic market here, perhaps Europe being an example of that or parts of Asia. But ultimately, when we look at opportunities, whether they'd be in the U.S. or outside of the U.S., we're looking at it from a risk-adjusted return perspective. Obviously, when you're doing business outside of the U.S. in some jurisdictions, you need to take into account the environment or the country risks, which we factor into the analysis. We don't have the luxury of investing in operations that hopefully a decade from now will start to generate a return. That's not our approach or philosophy. At the same time, we're prepared to, both domestically and outside of the U.S., invest in opportunities that we think, over the foreseeable future, will help build value for the organization and the shareholders.

William Robert Berkley
Founder and Executive Chairman

To try and be a little bit more specific as to what our general process would be, somehow or another through referral or someone we know, we would find a group of people who we think are talented. We've examined their expertise, the market they do business in, country, specialty, whatever. We'll evaluate what we think is the risk adjusted return, the volatility, the exposures, the size, if it's fit within the group, what does it take to do it, and then try and move forward. It would be possible but not usual that we would say we want to be in this business. It has happened, some of our units got started because we said we want to be in this business.

Michael Steven Nannizzi
Goldman Sachs Group Inc., Research Division

Got it. And then would you -- lastly, did you evaluate those opportunities based on local interest rates, local country and equity risk premiums? Or do you kind of centralize that?

William Robert Berkley
Founder and Executive Chairman

It's all based on our risk-adjusted return. But understand, the risk is related to wherever it is, whatever lines of business it is. So obviously, the risk of doing business in some places is much different than the risk of doing business in others, either because of the line of business, the nature of the country, its legal system, whatever.

Operator

Our next question comes from Ron Bobman with Capital Returns.

Ronald David Bobman
Capital Returns Management, LLC

Last year in your -- in the excess worker's comp market, your main competitor was bought by one of the giant Japanese companies. And then at year end, that same main competitor took a massive reserve addition. I'm wondering, it's a big seasonal renewal in that line of business, January and I think the summertime. So I'm curious if at 1/1 or of late, whether you're seeing some behavioral change from that competitor.

William Robert Berkley
Chief Executive Officer, President and Director

I'm not going to speak specifically about the one competitor, but we'll speak about the market in general or competitors as a group. Certainly, we are observing a somewhat change in appetite and attitude. Quite frankly, I don't think we're seeing the same level of competition that we saw 12 months ago. It's not to suggest at all that -- that rates are dramatically going up and that there's been a sea change in behavior. But certainly, the blind leading the blind doesn't seem to be the case any longer.

Ronald David Bobman
Capital Returns Management, LLC

I think you should say the blind leading Berkley, not leading -- they were the blind ones I thought, But according to your -- to Bill's commentary...

William Robert Berkley
Chief Executive Officer, President and Director

No I think that they are the blind ones, but I can assure you we are not following them. Having -- so long story short, as far as excess comp goes, it's not the free-fall that it was in maybe last year and prior. At the same time, certainly, we are not seeing the excess comp market react the way we have seen the primary comp market over the past quarter or 2.

William Robert Berkley
Founder and Executive Chairman

Understand, the excess comp market is the epitome of risk in this environment. And that is because it's such a long tail line, inflation is inevitable to impact their cost of claims because you have -- the average duration of about 17 or 18 years and you know you'll have inflation long before we get to that point in time of a substantial degree. And you have the discount based on current interest rates, if you're cautious. And if you're not cautious, you choose an optimistic interest rate. And that optimistic interest rate could cause you to have a huge difference in your pricing. So the combination of optimism as to low inflation forever and higher interest rates than we currently have can create differentials in price of 50%, and you can justify it. And just you have to worry about retiring before you have to pay the piper.

Ronald David Bobman
Capital Returns Management, LLC

So are you -- just to follow up, so are you -- so I would think that the rational [indiscernible] would pull -- you'd pull back your writings dramatically in the line like that, sure of getting rate increases...

William Robert Berkley
Founder and Executive Chairman

No, it just means you have to adequately price and make rational decisions. And in fact, our writings are down substantially. How much are they down now roughly?

Eugene G. Ballard
Executive Vice President of Finance

They're down probably about 40% from where they were at the peak.

Operator

Our next question comes from Vinay Misquith with Evercore Partners.

Vinay Gerard Misquith
Evercore ISI, Research Division

The first question is on the pace of growth, and it's been pretty healthy the past few quarters. Just curious on what the outlook is going forward. I mean you seeing higher pricing, I guess more business is now becoming attractive to you. Do you see the pace continuing? Or do you see the pace slowing down from these levels?

William Robert Berkley
Founder and Executive Chairman

Rob?

William Robert Berkley
Chief Executive Officer, President and Director

As far as -- I'd like to make sure I understand the question, as to whether we see rates continuing to progress at this level, is that what you're...

Vinay Gerard Misquith
Evercore ISI, Research Division

No, it's really about the top line growth.

William Robert Berkley
Chief Executive Officer, President and Director

The top line growth. Certainly, it really depends in part as to how we see the market harden from here. We would expect that the -- many of our businesses have quite a bit of runway in front of them and the opportunity to grow, as we've suggested to you and others in the past, we feel like we have the fundamental platform in place for our business to be able to grow dramatically beyond what it is. It's hard to know with certainty what market conditions will be tomorrow, which will play a big role in defining how big we can get and how quickly we can get there. There's nothing that is in front of us right now that leads us to believe that we are not going to be able to continue to grow at a healthy pace since -- once again, as we mentioned earlier, there are signs that the market may continue to tighten even from here, which will give us more opportunity to grow the business.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, that's helpful. Second question was on the accident year loss ratio improvement. That was about, say, roughly 200 basis points. Your rate increases are about 600 to 700 basis points and loss-cost trends of 300 basis points. So I would have expected maybe slightly more margin improvement. So is that just a normal lag between...

William Robert Berkley
Founder and Executive Chairman

So I'm going to let Gene explain, and don't expect it to make sense but Gene will explain.

Eugene G. Ballard
Executive Vice President of Finance

I'll try. So really what happens is for every 1% change in net trend, and by net trend I mean price increases less loss-cost trend, equals a 1% change in our loss ratio. But a 1% change in our loss ratio is 6/10 of 1 point, not a full point. So we would expect for every point change in that net trend, 6/10 of 1 point change in our loss ratio. So 3 -- we're estimating round a 3-point improvement in net trend, 3.5 maybe. That equates to about 2 points in the loss ratio.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, I'd have to follow up on the math later.

Eugene G. Ballard
Executive Vice President of Finance

Yes.

William Robert Berkley
Founder and Executive Chairman

And why don't you -- he'll go through it with you.

Eugene G. Ballard
Executive Vice President of Finance

Be happy to.

Vinay Gerard Misquith
Evercore ISI, Research Division

Okay, great. And then the last question, if I may. On the arbitrage account, I noticed that you put a significant amount into the arbitrage account this quarter. So 2 questions on that. So do you expect that to remain at these levels for the future? And what's your normalized expectation for that?

William Robert Berkley
Founder and Executive Chairman

The arbitrage account goes up and down almost daily, okay? It was -- that was what it was the end of the quarter. But if you go up or down pretty dramatically based on opportunities that are available at that point in time, it's just the user of cash. And it's -- from our point of view, we can convert 90% of that to cash within a day or 2. So for us, we actually got into the arbitrage business 25 years ago because it was just a short-term way to use cash and a lot better return than cash. So historically, it's given us a return of probably 300 or 400 basis points net of all expenses and so forth above cash returns, and we would expect to continue to do that. In fact, it's probably, in the long run, probably it could be more like 500 basis points better than cash. But at the moment, it just -- it went up because there were opportunities to do things at the end of the quarter. That's all. And I think that could come -- it wouldn't be surprising for that to be down by a few hundred million dollars at the end of the second quarter.

Operator

Our next question comes from Ken Billingsley with Compass Point.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

Question I have is on the rate increases -- I'm sorry, the growth that's occurred in the quarter. After backing out rate increases, where is the growth coming from? Is it from recent startups? Or is it grabbing market share with existing lines of business? Where is that mix of growth coming from?

William Robert Berkley
Chief Executive Officer, President and Director

It's really a combination. And as we had suggested, much of the growth was in our reinsurance segment in our non-U.S. business percentage-wise at least. And as far as the reinsurance goes, the lion's share of that was coming from non-U.S. reinsurance activities. And as far as the international insurance business, that's really coming from, at this stage, all over, ranging from South America to our Lloyd's operation to some of our activities that are in our European business, as well as our insurance activities in Australia.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

I would imagine the comments that you made aren't necessarily domestically related. So for some of the international business, is that -- is the competition less there? Or is it just organic growth?

William Robert Berkley
Founder and Executive Chairman

I'm sorry, could you repeat that? You didn't come through.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

Sorry, about that. The -- just repeating the question is I would imagine your comments about competition backing away and creating opportunity does not just mean domestically related. So in the international business, is that organic growth? Or are you seeing the same trends both domestically and internationally?

William Robert Berkley
Chief Executive Officer, President and Director

The answer is that the change in appetite is perhaps a little bit more or behavior is a little bit visible domestically, but we certainly are seeing that in some places outside of the United States as well. I think also some of the growth that we have is where we participate in markets or economies where they have been just going through a great boom. And as a result of that, we've been benefiting as well. So whether that be a place like Brazil or Australia, as far as our European business goes, certainly Germany has fared reasonably well and Norway has done quite well also. So I would suggest to you the -- while it does apply across the board, the market dislocation, if you will, is more the case domestically. And outside of the United States, while there is a bit of market dislocation, the growth has more been as a result of the economies that we operate in and benefiting from the momentum they're enjoying.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

All right. But there's been some comments recently that maybe regional competitors and especially renewal business -- I'm sorry, new business is being more aggressively priced than renewal business. Obviously, you guys commented that you're getting about 2% more. Not asking you to comment on, obviously, other people's events. But maybe why are you able to -- maybe your trend seems to be counter to at least what comments are coming out this quarter?

William Robert Berkley
Chief Executive Officer, President and Director

Well, I think -- well, not using names, we're happy to comment on what other people are doing and explain to you how that's different from our philosophy. There seems to be others that are interested in what we would define as buying market share or buying accounts with the approach or philosophy that when it becomes a renewal, they will make up for that, raise the rates and they look at it somewhat prospective of the total value of account. We struggle with that a little bit because to the extent you can finally get your rates where they need to be and it's a hard market historically, when it is a hard market, you do not have to have bought business, you can write as much business as you want at good prices. So the idea buying it upfront doesn't really resonate with us. We have a philosophy that you should charge more for risk and that applies to the organization on multiple levels. Presumably, you know more about an account that you are renewing than business that is new to you. As a result, there is more risk with a new account than a renewal account. So you would think that you should have some type of surcharge for that additional risk. So again, I guess, on 2 fronts, it really just -- the difference is philosophy as it relates to buying market share with the attitude that you'll make up for it in the future with your rate increases and also how you fundamentally view the risk that comes along with new business versus renewal business.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

Yes. Last question I have is on the excess workers' comp business, you talked a bit about that. Could you explain what is the typical reporting time lag between losses from the primary side as it actually impact the excess carrier in the case of workers' comp?

William Robert Berkley
Chief Executive Officer, President and Director

It's certainly north of 3 years and probably north of 5 years. It really depends on attachment point and how the deal is structured, if you will. But it -- certainly, it takes longer to figure out your issues in the excess comp world than it does in the primary. There is no doubt about that and probably the difference would be at least 2 years.

William Robert Berkley
Founder and Executive Chairman

So in part, you have to remember that excess comp is in fact very similar to comp reinsurance. And again, you have to see how the claim develops, see how the underlying risk develops. There -- a small percentage of the claims you know right away. But the vast majority of the claims, even disability claim takes time to know whether people will get back to work, whether they're going to be permanently disabled, whatever, and that's the place where it really runs into big amounts of money. So it takes time. And then the question is when you find out about it, do you set up the adequate reserves to start with? Or are you a newbie in the business and you think that this is more like primary comp and you don't recognize the nature of how large a reserve to set up?

Kenneth G. Billingsley

Compass Point Research & Trading, LLC, Research Division

So in these issues, it's not necessarily the fact that -- historically looking at the loss ratio for the last few years have been kind of poor in that space. And though it's improving, it's still pretty bad. It's more of a case of the medical inflation trends that they're not capturing?

William Robert Berkley
Founder and Executive Chairman

Well, it's not just the medical inflation trends because lots of it is just rehab cost, what's going on with drugs, what's going on with -- I mean, it's a very complex business and it's the discount rate you're going to use on claims payments. You want to be optimistic or pessimistic on the discount rate. And the discount rate can double the amount of reserve or cut it in half. So there's a lot of variables that have to do with judgment.

Operator

Our next question comes from Bob Farnam with KBW.

Robert Edward Farnam
Keefe, Bruyette, & Woods, Inc., Research Division

Not to keep hammering at the excess workers' comp piece, but obviously, you said that you think competitors have issues if they're not looking at the discount rate correctly. But -- so have you changed your assumptions in the -- basically your inflation assumptions in the long-term reserves there? And what are you looking at?

William Robert Berkley
Founder and Executive Chairman

Well, we always use the current discount rate of current treasury market. And each year is -- a piece of the market. So reserves that were set up in 2006 will have, let's just make up the number, 5%, then the reserves we set up in 2012 might have 2%. So it's average of the historical discount rate and we buy long-term bonds to try and match that for that piece of our portfolio.

Robert Edward Farnam
Keefe, Bruyette, & Woods, Inc., Research Division

All right. So basically the business you put your -- the reserves you're setting up now are sets with the expectations over the current rates in...

William Robert Berkley
Founder and Executive Chairman

Yes, and then what you really have is a composite rate of all those years that gives you hopefully the average.

Operator

Our next question comes from Larry Greenberg with Langen McAlenney.

Lawrence David Greenberg
Langen McAlenney

I think we probably all agree that this is a fairly unique period in the pricing environment and the industry and some...

William Robert Berkley
Founder and Executive Chairman

I assume you mean that the prices aren't going up as fast as they should.

Lawrence David Greenberg

Langen McAlenney

Yes, yes, yes. That would be one explanation. But you've got some saying it's not a hard market, some saying it's not a classic hard market, some wondering that we're now going into round 3 of price increases and could it continue. So I'm just curious, you've got your antenna up, obviously. And if anything is out there that might truncate the momentum that we have in pricing right now, what do you think it is? Or where might it come from? What would be the characteristics of that segment of the market that could get in the way of this momentum?

William Robert Berkley
Founder and Executive Chairman

There's really nothing that I see, but we're in a strange world. And you never know what can come out there. I think that we have more sophisticated managers for what I'd call the haves in the insurance business. And they understand that they can't continue running a business pretending there's underwriting results and there's investment income, and they're separate. The reality is with investment income down so dramatically and older portfolios coming off, you need more underwriting profitability. So if anything, there's more and more pressure to gain underwriting profits because we've had a longer and longer time where those old bond yields are going off. And we have a longer duration on average than most of our competitors. There are lots of people who had 2.5 years and their duration is down to 1.8 years, and that's a lot of pressure. You've got to make it up. And some people are making it up because they're going more to do more speculative things, some people are extending the duration on what they're buying now. There's a lot of strategies people are following. But the reality is with investment returns down a lot, you've got to get underwriting profit. So there's nothing I see that's going to change that trend for certainly through next year. I think there will be continued price increase pressure through this year and through at least next year, with increasing pressure, honestly, as we get towards the end of this year and into next year.

Lawrence David Greenberg
Langen McAlenney

Great. And then I'm pretty sure I misheard this and -- from Gene, and I...

William Robert Berkley
Founder and Executive Chairman

He does these things.

Lawrence David Greenberg
Langen McAlenney

And listening to the conversation, I'm almost certain I misheard this. But I thought he said that a lot of the growth in the domestic insurance piece was from monoline, and I thought he said your monoline excess workers' comp company.

William Robert Berkley
Founder and Executive Chairman

No, no, monoline workers' -- our monoline workers' comp. We have monoline workers' comp company that's been able to grow. It's -- well, actually, we have several that has been able to take advantage of the market. Not our excess comp. That business, unfortunately, has still not grown at all. He has a lisp.

William Robert Berkley
Chief Executive Officer, President and Director

I think he's slow down.

Lawrence David Greenberg
Langen McAlenney

It might be my hearing.

Operator

Our next question comes from Jay Cohen with Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

So I do have 3 questions, and they're relatively short. The expense ratio, well, down from a year ago, did pick up from the past several quarters. I'm not sure if there's any seasonality in that number.

Eugene G. Ballard
Executive Vice President of Finance

Not really, but we've talked about this before, the more growth we get, the more of a drag this DAC has on our numbers. And also I mentioned in my comments, the reinsurance, so we're playing a little bit more reinsurance. We have a lower net premium base, and so that also impacts the ratio.

William Robert Berkley
Founder and Executive Chairman

I think that the change in the DAC accounting probably cost us 0.5 point or something close to it on expense ratio. And the buying of more reassurance, as we have a disproportionate number of new startups where we don't have a real spread of risk, probably cost us something like a similar amount. So I think as we go through this year and into next, I would expect -- unless our growth accelerates, which of course is possible. But if it doesn't accelerate, I would think that, that spread should start to diminish.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Great. The second one also, numbers question. The paid loss ratio, you had mentioned, Bill, there was a -- it looks like it's the lowest number in almost 5 years. Is there anything to read into that? Or is that just normal variability in paid claims quarter-to-quarter?

William Robert Berkley
Founder and Executive Chairman

So I'm going to answer before the lawyer could wave to me. And the answer is yes, you should read into that. You should read into it the fact that we think we're continuing to be cautious because we're using a higher trend than some of our competitors and we're being cautious in establishing our reserves. But as you and I have talked over many years, Jay, paid loss ratios are the one thing you can never hide behind. You can't avoid that. And I think it's a very good sign as to directionally where things are going. And while one quarter doesn't make the difference, I think it's a number that people should probably pay more attention to.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Got it. And the last question on the debt. I guess, you retired, I think it was a couple hundred million dollars of debt in a quarter that was maturing, where is the debt to capital now post that retirement?

Eugene G. Ballard
Executive Vice President of Finance

31%.

Operator

Our next question comes from Gregory Locraft from Morgan Stanley.

Gregory Locraft
Morgan Stanley, Research Division

Most of mine have been answered. Just one I'm wrestling with is just your ROE versus your peers. Those that have already reported, all of them are at much higher levels. And yet, you guys run with higher balance sheet leverage in the underwriting and investment side. So can you help us think about why the business engine is running with a lower return than peers in the current environment? I don't know what part of the P&L is lagging the others.

William Robert Berkley
Chief Executive Officer, President and Director

Greg, it's Rob. I think one of the things that's difficult to do, but I think is relevant, is the mix of business or portfolio -- the fact is many of those that have reported had benefited in a very large way from what their property results were. We, as an organization, have a bit more of a casualty vent [ph] to us. So when the wind blows and the earth shakes, we don't have the same issues that others face. Having said that, when it is a benign quarter, they certainly benefit from that. So we don't have the same level of volatility. And again, if you look at the results of those that have reported, certainly, they benefited greatly from the significant amount of property exposure that they write whether that be on the commercial line side or certainly on many cases, on the personal line side as well.

William Robert Berkley
Founder and Executive Chairman

One of the things that we have always tried to do is try to have a certain level of consistency and not have the volatility that property tax exposure has meant. It seems today that lots of people in the marketplace, when the wind blows say, "If it weren't for the cats." And they don't count it. And when the cats don't blow, they say "what great returns." We just -- I think if you looked at those differences over an extended period of time, it would probably equalize the differences. And rest assured, we ask that question every day and every quarter.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Yes, okay. I guess, yes, fourth quarter certainly showed that with Sandy and the results for everyone.

Operator

And I'm not showing any further questions at this time. I like to turn the conference back to our host for closing remarks.

William Robert Berkley
Founder and Executive Chairman

Okay. Well, thank you, all, very much. We're quite pleased, as I said, with the quarter and we're expecting a continuation of that. No one asked the question, but I didn't want it to be a special comment to any analysts that we do expect our funds to be back on track with -- between $17.5 million and $22.5 million for the second quarter. And we do have most of those back in. So that's not a guess. That's an estimate based on most of the reporting in. So thank you, all, very much. Have a great day. Bye-bye.

Operator
Ladies and gentlemen, this does conclude today's presentation. You may now disconnect, and have a wonderful day.