Q4 2013 Earnings Call

Company Participants

- Alan Schnitzer, Vice Chairman
- Bill Heyman, Vice Chairman & CIO
- Brian MacLean, President & COO
- Gabriella Nawi, SVP of IR
- Greg Toczydlowski, President of Personal Insurance
- Jay Benet, Vice Chairman & CFO
- Jay Fishman, Chairman & CEO
- Unidentified Speaker

Other Participants

- Amit Kumar, Analyst
- Brian Meredith, Analyst
- Jay Cohen, Analyst
- Jay Gelb, Analyst
- Josh Stirling, Analyst
- Michael Nannizzi, Analyst
- Mike Zaremski, Analyst
- Randy Binner, Analyst
- Vinay Misquith, Analyst

Presentation

Operator

Ladies and gentlemen. good morning. Welcome to the Fourth Quarter Results teleconference for Travelers. We ask that you hold all questions until the completion of formal remarks at which time you will be given instructions for the question-and-answer session. As a reminder, this conference is being recorded, January 21, 2014. At this time, I would now like to turn the conference over to Ms. Gabriella Nawi, Senior Vice President of Investor Relations. Ms. Nawi, you may now begin.

Gabriella Nawi {BIO 2211991 <GO>}

Thank you, Lena. Good morning. Welcome to Travelers' discussion of our Fourth Quarter and full-year 2013 results. Hopefully all of you have seen our press release, financial supplement and webcast presentation released earlier this morning. All of these materials can be found on our website at www.Travelers.com under the Investor section.

Speaking today will be Jay Fishman, Chairman and CEO; Jay Benet, Vice Chairman and Chief Financial Officer; and Brian MacLean, President and Chief Operating Officer. Other members of senior management are also available for the question-and-answer period. They will discuss the financial results of our business and the current market environment. They will refer to the webcast presentation as they go through prepared remarks and then we will open it for questions.

Before I turn it over to Jay I would like to draw your attention to the explanatory note included at the end of the webcast. Our presentation today includes forward-looking statements. The Company cautions investors that any forward-looking statement involves risks and uncertainties and is not a guarantee of future performance.

Actual results may differ materially from those projected in the forward-looking statements due to a variety of factors. These factors are described in our earnings press release and in our most recent 10-Q and 10-K filed with the SEC. We do not undertake any obligation to update forward-looking statements.

Also, in our remarks or responses to questions we may mention some non-GAAP financial measures. Reconciliations are included in our recent earnings press release, financial supplement and other materials that are available in the Investor section on our website. And now Jay Fishman.

Jay Fishman {BIO 14011069 <GO>}

Thank you, Gabi. Good morning, everyone and thank you for joining us today. This morning we are very pleased to report a terrific Fourth Quarter to conclude a very impressive 2013. We posted full-year operating income of $3.6 billion coming from dramatic improvements in our underlying underwriting margins over the past two years, continued contributions from prior year reserve development, as well as a more modest level of catastrophe losses than we've experienced in recent years.

These operating results, combined with our strategy of returning excess capital to shareholders, led to record earnings per diluted share of $9.46 and an operating return on equity of 15.5%. For the Fourth Quarter we generated $981 million in operating income, producing operating earnings per share -- per diluted share of $2.68 and an operating return on equity of nearly 17%.

I don't think we could be more pleased than we are with these results, particularly given the challenges that our industry has been facing over the last several years including historically low interest rates and more volatile weather patterns.

These one year results should not be viewed in isolation but rather as part of the journey we have been on since 2010 when we articulated a clear strategy of thoughtfully and appropriately increasing the profitability for our products, particularly for those that were not meeting profitability thresholds. While improved rate, terms and conditions were our tactics our strategy was, is and will remain all about producing superior returns.

The returns of our products had deteriorated over a number of years from declining pricing and the return deterioration was exacerbated after the financial crisis when interest rates fell to historic lows. In addition, it was apparent that weather patterns, at least in recent periods, had become more volatile.

With a philosophy of not reaching for yield in our investment portfolio beyond where the risk/return balance is appropriate, our strategy was to improve the price and, where appropriate, the terms and conditions of the products that we sell so as to improve the returns on an account by account or class by class basis with the additional goal of not disrupting our agents business or the relationship with our insureds.

The results since then have been nothing short of remarkable. As slide number 4 indicates, underlying underwriting gain in 2013 was almost triple the amount it was in 2011 and demonstrates that we have way more than offset the decline in net investment income resulting from lower investment rates.

Second the impact on product returns, which is what drives us, has been impressive. Slide number 5 in the webcast shows a summary analysis of our expected economic product returns and demonstrates that the impact on these returns has been consequential.

On this slide we show our analysis of expected economic product returns on a written basis for two periods. The outlook for Q1 2013 as of that time and the outlook for Q1 2014. The numbers noted in red indicate the percentage of our aggregate premium from products or the expected economic return on capital allocated to those products is less than 10%. The numbers and black indicate the percentage of our aggregate premiums where expected product returns are in the range of 10% to 20% and the numbers in blue indicate the percentage of our premiums where expected product returns exceed 20%.

The progress we believe is quite remarkable. I should note that this analysis does not directly correspond to a GAAP return and I encourage you to read the important explanatory notes on slide number 6. The significance of this analysis is that the very granular data we review play an important part of our pricing strategy and tactics and it is a critical element of our senior management analysis and review. We all spend a lot of time with it and it is one of the most important tools.

We have been on an analytical journey for a long time and have worked diligently on developing this analysis and it allows us to be quite surgical in our marketplace strategy. The conclusion to be drawn from this summary analysis is that we've made tremendous progress in driving our returns closer to our long-term targets. However, closer to is not good enough, for those who will consider that this analysis suggests we are finished trying to improve returns -- that is just categorically wrong.

We will continue to take pricing actions on an account by account or class by class basis for those accounts or classes of business that continue to be in the poorer performing segments of our portfolio. While after three years of pricing actions, considerably more of the portfolio has moved from poorer performing to better performing classes, there is still enough business in the poor performing classes so that successful pricing actions should continue to result in improved returns. Even for our better performing accounts we will see great equal to or greater than loss trend when appropriate.

We remain optimistic that we will be able to continue to execute this strategy successfully. Brian will speak more about rate and will provide some perspective on looking at the data on a segmented basis. And while we can't predict the future, the recent data as well as the most recent anecdotal observations from the field give us confidence that we will be able to continue to execute successfully.

We've also been helped in pursuing higher returns by somewhat increased interest rates and Jay Benet will speak more to that. While we are not explicitly contemplating further meaningful increases in the near-term, in interest rates that is, we do believe that interest rates will eventually rise from here and will provide further lift to returns.

We have commented before that we believe that many industry observers are putting inappropriate significance on the absolute number of rate gain, particularly the headline number that is so often quoted. While the number is interesting, it is not nearly as revealing as many believe as the rate and retention on a much more granular basis holds the real key to success.

It is also worth noting again that we are return focused and as long as our risk profile is appropriate, whether an underwriting risk selection or investment selection, we are agnostic about where product returns come from. Our goal remains a simple one, top-tier profitability, and if we generate more capital than is necessary to support our business, returning that capital to our shareholders so as to right size our capital base.

To that point, since we started buying back our shares in the middle of 2006 we have returned almost $27 billion to shareholders through share repurchases and dividends, an amount which is now approaching the market capitalization of the Company when we embarked on our active capital management program. This strategy has worked elegantly by producing superior returns and we remain committed to it. With that let me turn it over to Jay.

Jay Benet {BIO 2456473 <GO>}

Thanks, Jay. By any measure, our Fourth Quarter results; record net income per diluted share of $2.70, record operating income per diluted share of $2.68, operating ROE of 16.8% and a GAAP combined ratio of 87.7% were very strong. As has been the case all year, these strong results were built upon very solid investment and underwriting performance.

Within the investment world the recent rise in interest rates has lessened the headwinds that we and our industry have been facing due to historically low interest rates. Slide 10 shows how average after-tax yields have increased for the long-term fixed income securities that we actually purchased during each quarter of 2013. For taxable that increase was approximately 45 basis points from the Fourth Quarter of last year while for tax exempts the increase was 105 basis points.

As we've done periodically, we've included in the appendix to this webcast a schedule showing our current expectations for maturities and calls of our long-term fixed income investments projected over the next three years along with the expected impact on net investment income if reinvestment rates generally remain where they are today. All things being equal, while we still expect that fixed income net investment income will decrease in the next three years, that decrease will be smaller than what we previously expected.

Turning to underwriting, we continue to earn rate increase in excess of loss trends in each of our business segments. This drove a 130 basis point improvement in our underlying combined ratio in BI as compared to the prior year quarter, although in PI and in FP&II the benefits from earned rate increases exceeding lost cost trends were more than offset by normal quarterly fluctuations in non-cat weather, fire-related losses and what we define as large loss activity.

Pretax cat losses were $53 million in the quarter, down dramatically from last year's Fourth Quarter, which included storm Sandy and pretax net favorable prior-year reserve development remain strong at $259 million.

As has been the case throughout the year, each of our business segments contributed to the favorable reserve development which was driven by BI's general liability product line for accident years 2006 through 2012. FP&II's surety business for accident years 2006 through 2010 and by PI's home owners and other business for both Cat losses related to accident year 2012 and liability losses for accident years 2009 through 2012.

As I have done in the past, I would also like to share with you a preliminary view of what our combined 2013 Schedule P is expected to look like when it is filed on May 1. On a combined product basis all accident years other than accident year 2012 developed favorably and the unfavorable development for 2012 is truly de minimis.

Looking at the data on the product line rather than on an accident your basis, our major product lines developed favorably across all accident years except for relatively small unfavorable development in auto liability and CMP. Commercial and personal auto liability developed unfavorably by a little over $30 million and $20 million pretax respectively each having a reserve based on approximately $2 billion driven mostly by the 2012 accident year, while CMP developed unfavorably by about $60 million pretax on a reserve base of approximately $3 billion and that was spread out over several recent accident years.

Of note, workers comp developed favorably by approximately $85 million pretax on a reserve base of approximately $14 billion even after the $42 million pretax charge precipitated by legislation in New York related to the New York fund for reopened cases for workers comp that we disclosed in the First Quarter and some very minor strengthening of about $60 million pretax for a few recent accident years.

We continue to generate capital well in excess of what is needed to support our business and consistent with our strategy we've continued to return very significant amounts of capital to our shareholders. Operating cash flows were in excess of $900 million this quarter bringing total operating cash flows to over $3.8 billion for the year.

We ended the quarter with holding Company liquidity of almost $1.6 billion after returning almost $1.2 billion of excess capital to our shareholders this quarter through dividends of $182 million and common share repurchases of $1 billion. And for the full year we returned over $3.1 billion of excess capital to our shareholders through dividends of $734 million and common share repurchases of $2.4 billion.

All of our capital ratios remain at or better than their target levels, our debt to total cap ratio of 21.3% was well within its target range. During the quarter book value per share increased 3% and adjusted book value per share, which excludes net unrealized investment gains and losses, increased 4%. For the full year book value per share increased 4% and adjusted book value per share increased 12%.

The difference between unadjusted and adjusted growth rates was driven by the impact that the recent rise in interest rates had on net unrealized investment gains. Net unrealized investment gains were approximately $1.3 billion after-tax at the end of the year as compared to $3.1 billion at the beginning of the year. So with that Brian is now going to provide some further insight into our operating results.

Brian MacLean {BIO 4679150 <GO>}

Thanks, Jay. I will begin with Business Insurance which had a very strong Fourth Quarter with operating income of $634 million and a combined ratio of 88.9%. The underlying combined ratio, which excludes the impact of Cats in prior year development, was 91.5% for the quarter, an improvement of more than a point year over year and 92.2% for the full year, an improvement of about 2.5 points over full year 2012.

As always there were a lot of moving pieces in the combined ratios -- in 2013 large losses were slightly higher, expense items were a net positive and mix changes were a net negative. Excluding these items the pure margin expansion, that is the impact of rate increases in excess of loss trends, was 2.5 points in the quarter and 2.7 points for the full year.

Turning to the top line, we posted record high net written premium volume for the full year of $12.2 billion. Looking at the production trends underlying the premium volume on page 13, retention was up slightly from recent periods at 80%, while renewal premium change was in line with recent periods at about 8%.

The 8% included pure rate increases of about 6% down about a point from the last few quarters. The rate increases continue to be broad-based and were led by commercial auto. New business volume in the quarter was $435 million and for the full year new business was over $1.8 billion. Loss trends continue to run at about 4% for the segment so on a written basis rate gains continue to be significantly above our current view of loss trends.

The aggregate production results were strong but, as Jay emphasized in his opening, our focus has always been on returns and to understand the impact of rate and retention on returns you have to examine the detail behind how we got to the aggregate results. We talked before about how we measure our business returns on a very granular basis, by business, by line, by territory, in smaller accounts by class and in middle and large accounts down to the individual account level.

Looking at this data for full-year 2013 and the Fourth Quarter we are very pleased with our execution, specifically retention in our better performing business was very strong with reasonable rate increases. But our real opportunity is to get significant improvement on our poorer performing accounts, for example, think of the below 10% ROE section on the chart Jay showed on page 5. Obviously we are not going to share with the public the full granular detail at all the levels that we manage the business. But we did want to give some insight into our performance specifically for those poorer performing businesses.

Slide 17 shows the renewal rate change over the last eight quarters for the poorer performing segmentation bands in our middle-market business. About 20% of our total middle-market premium. And middle-market here includes commercial accounts, construction, technology and our public sector business. Intentionally we didn't give you specific rate numbers but they are all well into the double digits.

So you can see clearly from this slide that over the last two years we've been able to consistently get meaningful rate increases on the portfolio of poor performing accounts. Although the rate changes move slightly quarter to quarter, in our view there doesn't appear to be a clear trend which would signal any real movement in the marketplace.

For example, we believe that the Fourth Quarter 2013 decline in rate and increase in retention is more a function of our execution than a change in the marketplace. And accordingly, we see an opportunity to improve pricing in this book of business in the coming quarters.

So the main thing that this data tells us is that at least through the end of 2013 for the lower returning businesses in our portfolio, our ability to take appropriate pricing and underwriting actions to improve performance in those accounts has not changed significantly in the last two years. Not all the segmentation bands have this level of consistency and rate change, but in each band pricing gains continue to exceed the expected increase in loss cost and we continue to make progress in the accounts with the greatest opportunity to improve returns.

The data underneath this graph, along with the other granular analytics we use to manage the business, gives us confidence that throughout 2013 our underwriters continue to execute well on our strategy, making the right targeted decisions class by class, account by account.

As we continue to execute on our strategy of improving returns, if we are successful the aggregate headline rate will come down over time. The key for us, however, is not the headline number but instead will always be why our rate and retention numbers are changing regardless of direction and whether these changes are consistent with our goal of generating mid-teens return on equity over time.

Turning to our Financial, Professional & International business, operating income of $171 million for the quarter was up 31% over the prior year quarter. This increase was driven by a lower level of Cat activity in the current quarter as well as higher levels of favorable prior year reserve development.

The underlying GAAP combined ratio of 94.7% deteriorated 3.2 points over the prior year quarter due to a higher underlying loss ratio reflecting a higher level of large losses and non-cat weather-related losses for international as well as the Dominion acquisition. Partially offset by earned rate increases that exceeded loss cost trends. The increase in the underlying loss ratio was partially offset by a lower expense ratio reflecting the inclusion of the Dominion.

Net written premiums were up 29% in the Fourth Quarter of 2013 driven primarily by the inclusion of the Dominion for two months. Management Liability premium increased as a result of our decision to discontinue the excess of loss reinsurance treaty for this business. In our personal insurance business operating income was $237 million for the quarter and $838 million for the full year an almost fourfold increase over full year 2012, a very strong result driven in part by lower catastrophe losses but also reflective of improvement in our underlying auto and homeowner results.

The underlying combined ratio for the quarter was 88.8%, up about 2 points over 2012 due to unusually favorable fire and non-Cat weather losses in 2012. On a full-year basis the underlying combined ratio of 88.3% improved 2.5 points over 2012 due to pure margin expansion.

Looking specifically at auto production, retention was strong at 81%, renewal premium change was 7%, and new business volume was up versus recent periods, while net written premium was down year over year. The increase in new business volume was primarily the result of the rollout of our new product, Quantum 2.0.

By the end of 2013 we had launched the product in 18 states and, while we are still in the early days of the rollout, we are pleased with our execution so far. To date in these states we are achieving the competitive position that we had modeled both broadly in the marketplace and specifically in the comparative raters [ph]. In addition, in these states area agents have embraced the benefits of the new cost structure and product features.

Turning to auto profitability, the underlying combined ratio was 102.2% for the quarter, an improvement of 3.5 points, and 97.6% for the full year, an improvement of 1.6 points. Earned rate in excess of loss trends contributed about 2 points of improvement for the quarter and about 2.5 points for the full year. Our current view of auto loss cost trend is about 4%, mix adjusted frequency continued to be benign while severity trend remained stable at a slightly elevated level. Specifically, bodily injury severity trends this quarter remained in line with what we have seen over the past few quarters.

Turning to homeowners, production was strong in the quarter with renewal premium change of 10% while retention ticked up to 84% and new business volume was up from the prior year quarter. From a profitability perspective our full-year agency homeowner's combined ratio was 77% both on a reported an underlying basis.

This outstanding result reflects the long-term strength of this franchise and the impact of the rate and underwriting actions we've taken in the marketplace over the last two years. We feel very good about our homeowner's results and the marketplace position of this business. With that let me turn it over to Gabi.

Gabriella Nawi {BIO 2211991 <GO>}

Lena, we will now like to open up for question-and-answer. If I can ask the participants to please limit yourself to one question and one follow-up so we can get through as many people as possible. Lena?

Questions And Answers

Operator

(Operator Instructions) Randy Binner, FBR.

Q - Randy Binner {BIO 15145081 <GO>}

I had one on investment income. It ran higher in our model even counting the real estate and private equity partnerships. And you made an illustration of kind of higher investment yield you have been getting. So I guess the question is, were there any other one timers in the net investment income line this quarter like prepayments, etc.? Or was this a reflection of what -- the kind of underlying higher rate environment is helping this?

A - Bill Heyman {BIO 3429455 <GO>}

Hi, it's Bill Heyman. There were no one timers in the fixed income portfolio.

Q - Randy Binner {BIO 15145081 <GO>}

And where are you seeing -- I guess where is the sweet spot of where you are investing now I guess from a rating and new money yield perspective?

A - Bill Heyman {BIO 3429455 <GO>}

I think probably the municipal market. If you look at the differential spreads between book yield expiring and new money, it is closest in municipal. In, fact for a time in the Fourth Quarter we were investing even yield with what was expiring, that has fallen off a bit. Generalizing in order of attractiveness, municipals, corporates, mortgages.

Q - Randy Binner {BIO 15145081 <GO>}

And a quick follow-up there is that -- was that attractiveness in the muni market a function of people's expectations of a potential Puerto Rican sovereign default? And is that something that is affecting how you look at the market and do you guys have exposure there?

A - Bill Heyman {BIO 3429455 <GO>}

Well in order, it is not really affecting how we look at the market. As far as our exposure, I could to go through it in some detail. I wouldn't say it is material, we haven't purchased a Puerto Rican obligation in 12 years and of the legacy portfolio most is short term and short or both. But I think Puerto Rico probably did affect the market as a whole. And frankly to the -- speaking selfishly, anything that cheapens the market is good news for us.

Q - Randy Binner {BIO 15145081 <GO>}

All right, that is great. Thanks.

Operator

Mike Zaremski, Credit Suisse.

Q - Mike Zaremski {BIO 20606248 <GO>}

Question on the capital management outlook for 2014. If I do the quick map on 2013, add up the dividends, share repurchase and then I guess M&A funded with cash, it equals about 105% of operating earnings. Should we think about that payout ratio level continuing in 2014 or maybe we should expect a slow down. I see that exposure growth does seem to be -- to grow -- picking up a little bit.

A - Jay Benet {BIO 2456473 <GO>}

Yes, this is Jay Benet. I think in terms of looking forward as it relates to capital management, the absolute level of capital that is needed to fund the growth in the business is relatively small. So what we have said in the past is to look at operating earnings as a rough basis to what might be available for capital management activities like share repurchases, subject to what needs to take place with regard to, as we just said, funding the growth of the business, possibly making a contribution to the pension plan.

Although I will say our pension plan at the end of the year was overfunded at this point in time. So that doesn't require in our view much in the way of funding next year. But it is always subject to all the things that might take place in terms of how the world will change next year. But operating earnings would be the base to look at.

Q - Mike Zaremski {BIO 20606248 <GO>}

Okay, that is helpful. And lastly, follow up. So higher levels of non-Cat Large and non-CAT weather losses appear to have materially impacted two of the main segments. I know this is tough to do but can you help us think about the dynamics like, for example, were the losses a couple points above historic levels or were they just much higher than prior year levels which were very benign?

A - Brian MacLean {BIO 4679150 <GO>}

So, Mike, this is Brian. For starters, in PI, which I think had the biggest swing, the real driver there was how low the Fourth Quarter was in non-cat whether in 2012. And so, this year was more consistent with kind of a normal run rate level of non-Cat weather. In BI it was relatively consistent. And in FP&II, Alan, if you --.

A - Alan Schnitzer {BIO 3529437 <GO>}

Mike, it is Alan Schnitzer. In FP&II the small weather and the large losses compared to a very favorable result in the prior year. So that is really driving the difference.

Q - Mike Zaremski {BIO 20606248 <GO>}

Thank you.

Operator

Amit Kumar, Macquarie Capital USA.

Q - Amit Kumar {BIO 15025799 <GO>}

My first question relates to the new slide -- slide number 5. And again, this is extremely helpful, the slide five and slide 17. What I was wondering is using that slide five as a backdrop, could you help us understand what might to be the range of earned rates in those different buckets.

A - Jay Fishman {BIO 14011069 <GO>}

The range of earned rates in those --.

A - Unidentified Speaker

In the ROE buckets.

A - Jay Fishman {BIO 14011069 <GO>}

Yes, no, I understand. I am trying to -- I wouldn't know how to answer that actually because it is aggregated by product by business.

A - Gabriella Nawi {BIO 2211991 <GO>}

And, Amit, those are returns on capital, so obviously it is underlying margin and the investments component on those cash flows.

Q - Amit Kumar {BIO 15025799 <GO>}

Yes but what I was trying to understand is --.

A - Jay Benet {BIO 2456473 <GO>}

This is Jay Benet. It is weighted by the premium volumes associated with each one of the businesses. So I think as a proxy you can probably look at those weightings as rough justice approximately what the earned premiums are. But keep in mind what Jay said earlier, this is an economic product view going forward of what the returns are going to look like. This is not a GAAP view. That is why we are having trouble answering the question. As a proxy you can kind of divide the unearned premium.

A - Brian MacLean {BIO 4679150 <GO>}

Amit, this is Brian. Let me go back to I think -- go back to my comments in the Webcast and if you can kind of translate the ROE slide roughly into the poorer performing businesses obviously the bottom of the ROE Chart and vice versa. And as I said, for the poorer performing accounts, obviously we've got some that are still well into the 20s but think solid double-digit rate increases.

Now I am talking written and you mentioned earned. So I would have to think through how everything is getting earned in. And although there over the last couple years there hasn't been a great volatility. In the better performing businesses, as I said in the comments we are still getting rate increases on a written basis that exceed our loss cost growth. So you can kind of approximate what that would be about -- the 4%-ish, 3%-ish range. But we -- and then there are other things in between.

A - Jay Fishman {BIO 14011069 <GO>}

I think this will be our last comment on it because it is an unusual question. The analysis is our best estimate of the economic capital returns of the products being sold. I will say today, but think it about it over the next quarter. And so, there really isn't much of a rate assumption in terms of change in written rate; it is largely an earned rate embedded in what has already been written and will be earned in the quarter.

But it is looking at the returns on a fully discounted basis. And so, we are discounting that projected investment income, it is an economic -- an economic return concept based on allocated capital. But it is, as of today, as of the next three months, that is why we say for the quarter.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. No, actually that color is extremely helpful. But the only other question I have is sort of a quick follow-up on the opening comments. Regarding the modest adverse development and workers compensation. I am trying to sort of reconcile the $85 million modest unit development with the growth in that line, if I look at page 11 of the supplement, and then the loss cost trends, can you sort of talk about how do you think about the returns in workers' compensation line and maybe address that development a bit more? Thanks.

A - Jay Benet {BIO 2456473 <GO>}

This is Jay Benet. Let me talk about the development for a second. First of all, I do want to correct one thing, workers' comp developed favorably this year. It didn't develop unfavorably. And what you have heard us talk about before is we have a very, very granular by business line approach to calculating and evaluating our reserves.

So when one of our business units, and these can be relatively small business units says they are seeing a trend and maybe the trend is they have a few losses that went tabular that were more than what they expect and therefore they feel they should be strengthening their reserves and that business line. That will bubble up through the reserve setting process.

So I can't stress enough that when we are talking about a modest increase it is against a reserve base or, I'm sorry, a premium base of $3.5 billion in any given year. So I think it is more a function of our businesses looking at things that are taking place, not putting news in a drawer hoping that it goes away, but just reacting to whatever they currently see. It is not an indication that if you have a negative development in one quarter you are going to get more development of the negative type in the next quarter.

It is just the normal variations that we see going forward in the quarterly reserve setting process. And as I said, overall worker's comp developed favorably and we can see the same thing in all of our lines, the same kind of variation.

A - Brian MacLean {BIO 4679150 <GO>}

just -- and so I will give a couple of comments, this is Brian, from a business perspective how we are feeling about comp. And first of all I would say if you are looking at net written premium, the growth in net written premium is because of pricing primarily rate. So that has been driving the growth there not necessarily account growth.

I would also say we understand comp very well, we understand its challenges and its volatility. For the last two plus years it has gotten the strongest rate increases across our portfolio. And I think we've got real competitive advantages there. So it is a state-by-state industry, class by class game and there are clearly some states and some classes that still need rate improvements. But in the aggregate we feel very good about the returns.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it, okay, that is -- thanks for all of the answers. Appreciate it.

A - Jay Fishman {BIO 14011069 <GO>}

Hi, it is Jay Fishman. I misspoke on a comment about that slide 5, let me just correct it. I am told I said it is earned rate. It is not, that is a written rate analysis, it is the price, the rate at which the product is being written today. And so again just to correct the record on that.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it, thanks.

Operator

Michael Nannizzi, Goldman Sachs.

Q - Michael Nannizzi {BIO 15198493 <GO>}

So I do have a question on Dominion, I don't know if it would be possible to know kind of what the underlying was for Dominion in the Fourth Quarter and maybe what FP&II would have looked like ex that? And if you could just talk about the actions you are taking in that book and whether there are any constraints from a regulatory or other perspective that could impact your ability or that will allow you to push for rates that you need to improve that business? Thanks.

A - Alan Schnitzer {BIO 3529437 <GO>}

Sure, it's Alan Schnitzer; let me try to take that. In the quarter actually the Dominion was all in neutral it was adverse to the loss ratio but favorable to the expense ratio so that sort of netted out, but that was really the result of a couple of I will say unusual things related to the transaction, and just as an example, purchase accounting.

So I think the way to think about that going forward is for next year we expect Dominion to have about a 2 point adverse impact on the overall FP&II combined ratio. Now I'll also say that we expect that to be offset by some other things going on in the segment. So the way to think about the segment for next year is for 2013 we had an underlying combined of about 92 and we are expecting that to be broadly consistent in 2014.

So just to put the Dominion and perspective. Certainly there are -- we are harder at work on that business in trying to bring all the Travelers sophistication and know-how and working with our PI and BI colleagues here in our US based business to try and bring all of the Travelers benefits to that business.

When you talk about regulatory constraints you are probably referring to Ontario auto, that is a fluid situation and obviously the regulators from Ontario are looking for some significant rate cuts. But we are also hopeful that that will be combined with some commencement reductions in loss cost.

So it remains to be seen what the impact will be on the overall margin. But we are quite confident that even though we will have that 2 point impact in 2014 that all the work that we will bring to that book over time will improve that result and clearly we will evaluate the transaction as it impacts our ROEs -- for our international business over time and we remain as optimistic about that today as we did when we announced the transaction.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Great. Thanks. And then I guess on that front, I mean do you expect -- anything we can glean from what you expect for on a top-line perspective in terms of how much of the book you expect to keep versus part of the business that may go as a result of the rate gain or the rate action that you take?

A - Alan Schnitzer {BIO 3529437 <GO>}

Sure, I understand the question. I think given the size of the transaction and its significance to the segment and the overall business, we are not going to -- we're going to try to stay away from that level of detail. That is why we tried to give you the combined ratio impacts to help you with your modeling as you think about it for next year. But I think going forward; we are going to try to stay away from that level of detail on that side of the business.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Great. And then just wonder if I could on BI, I know that non-cat weather has created some noise in terms of evaluating the year-over-year over the last couple of quarters. How should we think about the starting point for margins next year more comparing to this year, either Fourth Quarter or for the full year, as we think about the rate actions on a written basis earning through? Thanks.

A - Brian MacLean {BIO 4679150 <GO>}

So, first of all, you meant Business Insurance there, right?

Q - Michael Nannizzi {BIO 15198493 <GO>}

I'm sorry, Business Insurance.

A - Brian MacLean {BIO 4679150 <GO>}

Well, because in Business Insurance there really wasn't much of an impact of non-cat weather. The last couple years were very comparable. It wasn't exactly the same number, but rounding. There wasn't -- when you look at the full-year 2013 in Business Insurance, there was a little bit of movement in large losses and mix change, but nothing really material. So that is probably a pretty decent benchmark of run rate, combined ratio or loss ratio.

And then you can see our written rate numbers and how they are going to earn in over time. So I think you can -- and as we said, loss trend is holding at about 4%. So I think you can kind of do that arithmetic. There isn't a lot of unusual stuff that is really distorting that number this quarter.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Great. Thank you.

Operator

Vinay Misquith, Evercore.

Q - Vinay Misquith {BIO 6989856 <GO>}

So the first question was just a clarification on the Dominion acquisition. I believe it was mentioned that the acquisition would have a 2 point negative impact on 2014 combined ratio, but I still thought that he said that the combined ratio will be flat 2014 versus 2013?

A - Alan Schnitzer {BIO 3529437 <GO>}

Yes, that is right, and that is because while the Dominion transaction on itself has about a 2 point adverse impact, there will be other things that we expect to offset that. For example, a change in the reinsurance program in our Management Liability business and as earn rates continues -- as written rate from the prior year and this year continues to earn in at a higher level than loss cost. So that margin improvement together with the reinsurance program on a segment basis, we're talking about, should be about flat. On an underlying basis, ex-Cats and PYD.

Q - Vinay Misquith {BIO 6989856 <GO>}

Sure, that is helpful. Okay, and then just looking at the Business Insurance segment, and looking for this quarter -- that is the Fourth Quarter. I am looking at it on an accident year loss ratio ex-Cat. It seems that that number is relatively flat at about 61.2% this quarter versus the year ago quarter. Just curious, given the rate increases I would have expected a 3 point improvement year over year.

A - Brian MacLean {BIO 4679150 <GO>}

Yes, so in the quarter, there were some moving pieces and there is always a little bit of weather and a little bit of large losses and a little bit of mix and you are talking just loss ratio so expenses aren't impacting it. We saw about a 2.5 point -- when we net through all of that stuff what we think of as kind of pure margin the rate -- earned rate in excess of the loss cost trend was about 2.5 points in the quarter, down a little bit -- it was about 2.7 points for the full year.

A - Jay Benet {BIO 2456473 <GO>}

One of the other things that is always going to impact the year-over-year quarter-over-quarter look at the loss ratios in particular would be mix changes in the business, what products are a higher percentage one year versus the next, how much loss sensitive business there is relative to guaranteed cost. So I think that is also impacting some of the quarterly variations that you are seeing.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay, that is helpful. And just one last question on pricing. I just wanted to get a clarification. You mentioned that the slowdown in rate is not because of market conditions but more the actions that Travelers has taken and more of your business is adequately price. I just want to get the clarification on that.

A - Brian MacLean {BIO 4679150 <GO>}

So several comments there. I mean clearly in the poorer performing business we feel very good that our ability to get price improvements, terms and conditions, whatever we need to improve the account, is pretty consistent with where it has been the last couple years. So there we don't see a lot of market movement.

A - Jay Fishman {BIO 14011069 <GO>}

And this is Jay. To the point that Brian made in his comments, what you will see in the Fourth Quarter on that graph is a slight deterioration in rate and an increase in retention in those poor performing classes. So the comments about our own actions is that we would look back on that and say we didn't execute to allow retention to go up and rate to go a tiny bit down, a little bit down, and the poor performing cost is not perfect, not perfect. It would have been better if we had achieved flat retention and rate had moved differently.

That -- so Brian's comment was more specific to the management of those poorer performing classes. The question that I always ask when we are talking about marketplace competitiveness is do our field underwriters think that if an account in a particular class came up for renewal today versus a year ago or two years ago would the opportunity for rate improvement be viewed differently by a field underwriter today than it would have then?

And I have asked the question many times in a lot of ways and the answer that I get routinely is in the poorer performing classes no, no difference at all. In the best performing classes perhaps a little more difficult -- perhaps a little more difficult is quite literally the words that we hear.

As we looked at the numbers our rate gains even in the best performing classes more than offset loss costs. And so, that continues to be pretty good. The point about the headline number is that as business moves from poor performing classes to the better performing classes, by definition the headline number is going to go down. And it would be I think inappropriate to make a direct conclusion that that number going down therefore means that rate opportunity has peaked. What you are seeing much more is a change of mix within the classes than the ability to get a rate improvement in a particular class.

And lastly, Brian mentioned that the poorer performing classes, that graph that is in the materials, still represents about 20% of our middle-market business. So there is not -- it still represents a meaningful portion on which to improve rate. Now I wish the answer for rate peaking or not peaking was a lot easier to say than that. It is just not, it is a complicated business with a lot of moving parts, different business, different lines and after three years different levels of profitability. But that is the most fulsome response I think that we can provide.

Q - Vinay Misquith {BIO 6989856 <GO>}

Sure, very helpful, thank you.

Operator

Greg Locraft, Morgan Stanley.

A - Gabriella Nawi {BIO 2211991 <GO>}

Next question then.

Operator

Josh Stirling, Sanford Bernstein.

Q - Josh Stirling {BIO 17463087 <GO>}

Thank you for the -- thanks for taking the call. And two good new slides this quarter. I guess just trying to synthesize them. The point you seem to be making is that the mix of accounts, sort of how much you need is you are taking as stable, but as accounts naturally improve there are sort of fewer on which you need to take rate.

I guess if we could, just to belabor the point then, just to set expectations for headline run rates though, should we as investors expect them to continue sort of this slow downward trajectory into 2014? Or 2013 was reasonably stable for most of the year after you guys sort of set a trajectory in the end of 2012. And I am wondering if you think it is going to look more like last year or if the recent trend for the next -- for the past quarter or two is likely to persist with pricing slowing as we work our way through the year?

A - Jay Fishman {BIO 14011069 <GO>}

I think it is very difficult for us to project in the short term because it is a function of which accounts in particular come up for renewal in a given quarter. So it is difficult to compare a Third Quarter to a fourth or a Fourth Quarter to a first, they are not the same counts, it is a different batch.

So in the short-term I -- we would struggle to answer that. We just don't have the insight that I think you all think that we do. In the longer-term if we continue to be successful I would say with certainty the headline number will continue to go down. As accounts move into our best performing business our goal changes to the highest retention possible consistent with maintaining margin.

That is very, very different than the philosophy in the poorer performing accounts where lower retention if we are unable to achieve meaningful rate gains is just fine. Our goal is always to improve product returns. And once accounts get into a range that are consistent with the highest levels of profitability in our industry, we begin to move much more to retention.

And so, if we are successful my expectation is that our retention will slowly tick up over time. Again, I am not speaking about quarter to quarter because the mix will change and that the headline rate number will continue to come down over time. If it doesn't there's really something that we are executing that is not quite right. Now, again, quarter to quarter because the accounts themselves are different not nearly as predictable. But as an overall trend that is the way that we look to the business.

Q - Josh Stirling {BIO 17463087 <GO>}

Great. See if I can ask one final question, growth, you guys are starting to get some results from Quantum, separately it looks like in the commercial lines business you might be ticking up your growth in the targeted risk section a bit.

I'm interested in your thoughts both in sort of the success of Quantum, and maybe more qualitatively what agents -- what agents are really sort of what feedback you are really getting from agents, as well as if there's anything that we should be inferring from rising growth in a couple of your smaller business insurance lines? Thanks.

A - Jay Fishman {BIO 14011069 <GO>}

It's Jay Fishman. I will start with Quantum and I will ask Greg Toczydlowski to chime in and provide perspective and then I think we will look to Brian for comments and Bill Cunningham is here as well on Business Insurance.

Our goal in Quantum, remember we shared with you that we had back tested it and had a view of how the product would be positioned in the comparative rating engines. Our goal was to achieve a meaningful improvement in its positioning in most comparative raters.

That doesn't mean a reduction in profitability because of cutting price. You've got to absolutely remember that Quantum's premise is a lower cost, lower commission product and therefore could support the same returns at a lower price, that is entire philosophy of it. As of yearend we were in 18 states.

We do know where it is positioned in the comparative rater, we get the data. And its positioning so far is consistent with our back testing modeling. It is doing from a comparative rating positioning just what we had hoped it would.

Now no idea what competitive reaction will be prospectively or what will happen, our goal initially was to do the analysis thoughtfully and see that we had the product positioned in the comparative rating engine correctly and the price was what we had contemplated it would be. In that regard, so far so good.

Obviously we don't get -- we have an analysis and assumption of loss content, we will find out as losses begin to develop how good that is. We don't have a point of view or a view on that yet other than the analytics that we did when we developed Quantum 2.0. So we are not yet declaring victory that the underwriting margins coming from it will be consistent with what we modeled.

We are hopeful, we will know more of that relatively soon I suspect over the next I don't know, Greg, couple of three quarters we will begin to have a view on the loss content. In terms of agent -- why don't you take it? Why don't we go through the agent reaction? Anything else you want to add about (multiple speakers)?

A - Greg Toczydlowski {BIO 16615940 <GO>}

Yes, I think just as you said, the agent reaction has been very positive, we're three months into the big wave that went out in October. And we are actually not surprised on that. We had a lot of co-development with the agents, they were right here in Hartford in helping us design the structure, the features of it and so we got a lot of feedback from them in helping build the product.

And the two key metrics we are watching right now are we have seen an increase in flow, the amount of at-bats or quotes, and we are seeing that. And then the actual success of our competitive position of those quotes and we are seeing a meaningful uptick there. So when we put both of those together we are very encouraged. And as Jay said, the loss expense will be the third leg of the stool.

But we are not waiting for a full loss ratio to develop, we are spending a lot of time looking at surrogates or leading indicators including the profile of the business and again we are encouraged on that. So across the board we are going to continue rolling it out with the same level of discipline and are very enthusiastic as we do that.

A - Brian MacLean {BIO 4679150 <GO>}

On the BI front, as Jay mentioned, we are about returns. And as returns improve we are going to be more interested in retaining more business. And we feel good that we had record net written premium in BI. It is clearly being driven primarily by pricing actions.

Independent of price there are a lot of things that we are doing to leverage competitive advantages and various strategic initiatives to grow and we have got a lot of that. The thing that we won't be doing is trying to grow through playing the price game. So we are not going to run a sale in the hopes of increasing our market share at the expense of returns.

A - Jay Fishman {BIO 14011069 <GO>}

I think that's important, the questions that we get on many of these calls seem to center on the impact of pricing and growth. We do have a series of initiatives in our business insurance segment that are designed to produce growth including in one case more salespeople, hopefully it actually turns around and has an impact. But we will find out.

Because we have a disciplined view of price doesn't mean that we refuse to think of or abdicate responsibility for finding growth opportunities that are there by product, by people, by expertise, by underwriting skill, and we remain committed to that. As a business that generates $20- billion-odd-plus of premium a year it is a challenge to generate numbers that are consequential in the total. But it doesn't mean that we don't have serious effort and work to try and find those opportunities, we do.

Q - Josh Stirling {BIO 17463087 <GO>}

That's helpful. Thanks for the color. Good luck.

Operator

Jay Cohen, Bank of America-Merrill Lynch.

Q - Jay Cohen {BIO 1498813 <GO>}

On the explanatory notes on the expected economic return table, you talk about $2.5 billion of statutory surplus that was not allocated in this analysis. Should we think of that as excess surplus? Or if not, why it wasn't it allocated?

A - Jay Benet {BIO 2456473 <GO>}

Yes, Jay, this is Jay Benet. First of all, there is some fluidity in what the statutory surplus balance is going to look like each quarter because we have earnings and those earnings will get dividended up to the holding company. So that is part of it. But we also have, as you know, asbestos and environmental reserves and some other run off businesses. So there is capital that supports that as well.

So what we have done in this model is we have allocated all of the capital that supports what we have referred to as the business to those -- to the products associated with the business. So we think it is a -- and that regard a full allocation of the capital that we had for the businesses.

A - Jay Fishman {BIO 14011069 <GO>}

And the majority that is not allocated is attributable to what we also would call these run off businesses, meaning specifically asbestos, environmental and such.

Q - Jay Cohen {BIO 1498813 <GO>}

That makes a lot of sense, thank you.

Operator

Brian Meredith, UBS.

Q - Brian Meredith {BIO 3108204 <GO>}

A couple quick ones here. First, can we chat a little bit about the homeowner's insurance business? It looks like your underlying combineds are in pretty good shape there. And I guess my question is, at what point do think you are going to pull back on some of the rate that you are getting on homeowners and maybe could potentially look to grow that line of business? And could that help at all with some of the auto insurance growth?

A - Brian MacLean {BIO 4679150 <GO>}

So, Brian, this is Brian MacLean. Clearly the homeowners combined on any basis you look at it we feel very good. There has obviously been a huge a story of whether volatility that we are still -- so there are still a decent number of places around the country that we are still taking some underwriting actions and looking at managing that.

Broadly speaking you can look at our rate filings and see that our rate there is tempering a bit. But in the aggregate still have a need. We do expect that we will get some lift through the Quantum product. We are very much an account focused personal lines company. So we sell more combined auto and home than any of the other major competitors. And so, we should be getting a lift as our auto product moves out into the marketplace and get some of the traction that we were talking about before.

A - Jay Fishman {BIO 14011069 <GO>}

And I would love Greg to comment on it -- I'd just make an observation, we take it for granted. Our pricing, terms and conditions profile in homeowners is not anecdotally driven, right. It is not as if it is instinctive, we are basing it on the data and the information that we have.

A - Greg Toczydlowski {BIO 16615940 <GO>}

And Brian said, that really does have a local story underneath it. When you are following the perils across that product line. So as Brian said based on some of the weather trends and the perils we have got various strategies across the country right now.

Q - Brian Meredith {BIO 3108204 <GO>}

Great. And then my second question just quickly here, on Business Insurance and FP&II, are you seeing any loosening at all in terms of conditions and from a competitive landscape out there, anything that we should be concerned about as investors?

A - Brian MacLean {BIO 4679150 <GO>}

In the aggregate no, and that is something we are pretty encourage with. So we feel good about that.

Q - Brian Meredith {BIO 3108204 <GO>}

Great, thank you.

A - Gabriella Nawi {BIO 2211991 <GO>}

And this will be our last question for today.

Operator

Jay Gelb, Barclays.

Q - Jay Gelb {BIO 21247396 <GO>}

I have two questions. The first is so far in the First Quarter there has been some pretty severe freezing temperatures. And I'm just wondering if that could lead to elevated non-Cat weather for things like burst pipes in the First Quarter?

A - Brian MacLean {BIO 4679150 <GO>}

Yes I think, Jay, the honest answer it is too soon to tell. But no question, when you get the severe temperature changes that you get we get claim activity from that and we have seen some of that, we can't really assess the magnitude of it and the forecast for the Northeast is another round the next couple of days. So we will watch it.

And it is actually maybe less about the Northeast and more about when you get those severe temperatures in the mid-Atlantic and down south where you really start having some challenges. But there will be claim activity coming -- there is claim activity coming out of it but we haven't scoped it.

Q - Jay Gelb {BIO 21247396 <GO>}

Okay. And the second one on a broader issue as the economy recovers we're seeing the benefit of increased exposure growth. But I think there is also the looming issue of potential increase loss cost inflation both on frequency and severity. So when you talk about as 4% for baseline loss cost inflation in Business Insurance, to what extent could we see that move up as the economy recovers?

A - Brian MacLean {BIO 4679150 <GO>}

So I think, again, this is Brian, Jay, things we worry about all the time -- we are seeing a little bit of exposure movement from a positive kind of GL and comp driven, which are good things, nothing dramatic but there is a little bit of movement there.

A - Jay Fishman {BIO 14011069 <GO>}

Good news.

A - Brian MacLean {BIO 4679150 <GO>}

Positive news, right. And on the -- so supporting your comment about signs of some economic growth. We -- all I can tell you is we obsess over looking at every metric we can about what is going on in loss trend and we continue to be encouraged that we are not seeing anything out of pattern. Probably the biggest thing that we look at that we've been talking about for years now is the auto BI trends, bodily injury trends and across all of our businesses. And that continues to run at an elevated level, but it hasn't been getting worse in the last several quarters. But we look at it closely.

A - Jay Fishman {BIO 14011069 <GO>}

And I think that it's, at least so far, fair to say broadly speaking, I am not speaking about the insurance industry (inaudible) or us, but broadly speaking there remains not yet a meaningful change. In fact I could argue there isn't any change in actual inflation at least by the traditional measures by which it is reported. We pay a lot of attention, we read everything we can. But it is very much kind of an outlook question and who the heck knows I think is the answer there.

Q - Jay Gelb {BIO 21247396 <GO>}

As long as over economic inflation remains benign should that be a pretty decent indicator on loss cost inflation if you boil it down?

A - Jay Fishman {BIO 14011069 <GO>}

I think we have -- I think the Property Casualty industry has some specific areas where we have a little bit of what I will call inflation concentration dynamics. So wage inflation as it relates to worker's comp. Medical inflation as it relates to worker's comp. Tort inflation as it relates to general liability. Building products as it relates to homeowners and to some extent select, right.

We are not about food, we are not about energy really, there are some pockets that are more relevant to our loss cost trends than the basket kind of dynamics that you pick up from traditional economics. So we rely pretty heavily on our own look, our own ability to look at the data, the actual data, the emerging data on those areas that affect us. And look you can speculate on a lot of things. You can speculate that perhaps medical inflation will actually continue to decline. I don't know.

You could also speculate that it will go up. There are certainly more than enough economists who share an equal number of views on that. The Tort environment takes a long time to change, things don't change so quickly in that regard. So while it is always on our minds because it is important for us, it is not something that is going -- we don't think -- I don't think personally (inaudible) that it will be something that will occur quickly or be a great surprise when it occurs.

It will begin to evidence itself slowly and I hope that we will see it and be able to react from a pricing standpoint with respect to it. Now I could always be wrong, it might not be (inaudible) assessment. But that is how we think about it.

Q - Jay Gelb {BIO 21247396 <GO>}

Thank you.

A - Gabriella Nawi {BIO 2211991 <GO>}

Thank you all for joining us today. As usual, myself and Andrew Hersom in the Investor Relations department will be available for any follow-up questions. Thank you, and have a great day.

Operator

Thank you. Ladies and gentlemen, that does conclude today's conference call. We thank you for your participation and ask that you please disconnect your lines. Have a great day.