Q1 2014 Earnings Call

Company Participants

- Alan Schnitzer, Vice Chairman
- Brian MacLean, President, COO
- Gabriella Nawi, SVP IR
- Jay Benet, Vice Chairman, CFO
- Jay Fishman, Chairman, CEO

Other Participants

- Adam Klauber, Analyst
- Amit Kumar, Analyst
- Jay Cohen, Analyst
- Jay Gelb, Analyst
- Josh Stirling, Analyst
- Larry Greenberg, Analyst
- Michael Nannizzi, Analyst
- Randy Binner, Analyst
- Vinay Misquith, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. Welcome to the First 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 on April 22, 2014.

At this time, I would like to turn the conference over to Ms. Gabriella Nawi, Senior Vice President of Investor Relations. Ms. Nawi, you may begin.

Gabriella Nawi {BIO 2211991 <GO>}

Thank you. Good morning. Welcome to Travelers' discussion of our First Quarter 2014 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 Investors 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 up for your 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 Investors 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.

We couldn't be more pleased to report an outstanding start to 2014, with net and operating income of over $1 billion and record net and operating income per diluted share of $2.95. Our operating return on equity of nearly 18% in the quarter is the highest since the Fourth Quarter of 2009 when we posted just over 18%.

These results keep us very much on track to meet our financial objective of achieving a mid-teens return on equity over time. And this is the case even if one were to exclude our favorable prior-year reserve development in the quarter, given that our accident year operating return on equity was 14.7%.

In the Fourth Quarter of last year, I shared with you that we believed we were firing on all cylinders, and that continues today. We had terrific First Quarter results in Business Insurance; their profitability improved once again.

We couldn't be more pleased with our efforts to improve returns through the continued execution of our granular pricing strategy. Given our segmentation approach of seeking appropriate returns, on an account-by-account and class-by-class basis, we have shared with you that the headline aggregate rate gain, which is the result of our active pricing strategy, will come down as we continue to execute this strategy.

Some industry observers perceive this as an indication of increasing price competitiveness. We reject that notion, because we are managing our pricing actions very thoughtfully.

And in that regard, for our individually underwritten accounts we have the ability to consider each individual account's contribution before engaging in renewal negotiations. This is where our analytical competitive advantage, based on data, really matters. Our strategy is very much proactive and much less reactive than it seems many industry observers believe.

That said, our assessment of the competitive environment as it relates to rate is that it is for the most part unchanged. This is supported by the fact that we continued to achieve historically high levels of account retention.

Another point of support is the data we are providing on slide four of the webcast, which for our middle-market business compares the renewal rate gain and number of accounts in the poorest-performing segment of this business in the First Quarter of 2014 to the First Quarter of 2013. You can see that the renewal rate gain was virtually the same in these quarters, but that the number of accounts qualifying as poorest-performing and renewed in the quarter declined from 289 to 216.

As our overall portfolio improves and the number of accounts in our poorest-performance band has declined, the change in the aggregate headline rate gain, to the extent that this band contributes to that headline number, reflects the decline in accounts in this band rather than a change in the competitive environment within the band. In summary, given that our goal was to achieve improved returns consistent with our financial objectives, there is nothing that we see happening in the competitive environment today that causes us to be less optimistic about our ability to achieve our goal.

In Financial, Professional & International Insurance, we achieved 20% growth in operating income and a 47% increase in net written premiums, both from the impact of the Dominion acquisition and strong performance in our management liability and surety businesses. Our integration efforts in Canada are very much on track, and we are really pleased with the progress we have made.

Turning to Personal Insurance, in homeowners we produced a combined ratio of 72.4%, or 86.5% excluding favorable prior-year development, even considering the meaningful winter weather we experienced in the quarter. This performance, taken in the context of our results over the last decade, continues to demonstrate industry-leading performance.

In personal auto, we experienced 1.1 points of improvement in the underlying combined ratio. More importantly, we are very excited about the deployment of our new personal auto product, Quantum Auto 2.0. We've now rolled the product out in 28 states and the District of Columbia.

It was our expectation that this product would dramatically improve our comparative rate or quoting position, and that is what we are experiencing so far. While we have achieved this improvement largely through reductions in price, it is critical to note that this lower price structure is based upon the expense actions we have committed to and meaningfully achieved, as well as a lower commission for Quantum Auto 2.0. Consequently, once fully rolled out, we believe the product is priced to produce returns that are consistent with our long-term goal.

While we are reasonably confident in our estimates of loss content, particularly because the product was built largely on the foundation of Quantum Auto 1.0, it will take a few more quarters for us to know more. We will continue to roll this product out across the country.

We are pleased that we now have a product that can successfully compete in this rapidly changing marketplace. Brian will speak more about Quantum 2.0, and we look forward to talking to you more about our strategy in personal insurance during our Investor Day on June 6.

Finally, this morning we announced an increase in our quarterly dividend per share of 10% to $0.55 per share, which is the 10th consecutive year we have increased our quarterly dividend. We note that the compound annual growth rate for our dividend over that time is 9.6%.

With that, let me turn it over to Jay.

Jay Benet {BIO 2456473 <GO>}

Thanks, Jay. By any measure, our First Quarter results -- record net and operating income per diluted share of $2.95, operating ROE of 17.8%, and a GAAP combined ratio of 85.7% -- were exceptional. As was the case in recent quarters, these strong results were built upon very solid investment results, primarily driven by private equity and real estate returns, along with very strong underwriting performance.

Within underwriting, earned rate increases continued to exceed loss cost trends in each of our business segments, although this benefit to our loss ratio was mostly offset by the severe cat and non-cat winter weather that gripped the country this quarter. Our loss ratio also benefited from net favorable prior-year reserve development of $294 million pretax, which was up $63 million from the prior-year quarter and was adversely impacted by catastrophe losses of $149 million pretax, which were up $50 million.

In addition, our expense ratio benefited from a $76 million pretax reduction in an estimated liability for state assessments that we are required to pay in relation to our workers compensation premiums. This reduction in our estimated liability resulted from a change in state law that took effect in the First Quarter of 2014 that clarified our payment obligations.

Each of our business segments once again produced net favorable prior-year reserve development. In BI, net favorable development of $93 million was driven by better than expected loss experience for general liability excess coverages that resulted from a more favorable legal and judicial environment than we had expected, as well as favorable cat and non-cat property loss development partially offset by higher than expected loss experience for liability coverages within CMP.

Net favorable development of $69 million in FP&II primarily resulted from better than expected results in contract surety and bond and financial products, while in PI a net favorable reserve development of $132 million was primarily driven by better than expected loss experience in homeowners and other, cat and non-cat weather-related losses.

On a combined stat basis for all of our US subsidiaries, accident year 2004 and prior developed unfavorably by a de minimis amount, approximately $11 million, while each accident year in the period 2005 through 2013 developed favorably in this quarter.

Operating cash flows were very strong, a little over $700 million, and up from $530 million in the prior-year quarter. We ended the quarter with over $1.6 billion of Holding Company liquidity, and all of our capital ratios were at or better than their target levels.

Net unrealized investment gains were approximately $2.6 billion pretax, or $1.7 billion after tax, up from $2 billion and $1.3 billion, respectively, at the beginning of the year, mostly due to reductions in spreads. Book value per share was $73.06, or 7% higher than a year ago and 4% higher than at the beginning of this year.

Turning to capital management, we continue to generate much more capital than we need to support our businesses, allowing us to return $882 million of excess capital to our shareholders this quarter. We paid dividends of $177 million and repurchased $705 million of our common shares, including $650 million under our publicly announced share repurchase program, consistent with our ongoing capital management strategy, and $55 million to partially offset shares issued under employee incentive plans, mostly to cover employee withholding taxes due upon the vesting and payout of performance and restricted stock awards.

Finally, we announced an increase in our quarterly dividend from $0.50 per share to $0.55 per share, a 10% increase on top of last year's 9% increase. So with that, let me turn the microphone over to Brian.

Brian MacLean {BIO 4679150 <GO>}

Thanks, Jay. In Business Insurance, we had a very strong quarter with operating income of $653 million and a combined ratio of 87.7%. The underlying combined ratio, which excludes the impact of cats and prior-year development, was 88.1% for the quarter, an improvement of 4 points year-over-year.

As always, there were some moving pieces in the combined ratio this quarter, including a favorable nonrecurring expense item and unfavorable non-cat weather losses. Excluding these items, margin expansion driven by the impact of earned rate in excess of loss trend was about 2 points.

Turning to production trends, beginning on page 10, retention was up in the quarter to 81%, while renewal premium change was down somewhat from recent periods at about 7%. The 7% included pure rate increases of about 5%, down about 1 point from last quarter. The rate increases continued to be broad-based and were led by commercial auto.

New business volume in the quarter of $443 million was similar to recent periods. Loss trend continued to run at about 4% for the segment. So on a written basis, rate gains continued to be about our current view of loss trends.

The production results for the quarter within the segment tell somewhat different stories this quarter, so I would like to spend a moment discussing each of them individually. Beginning on page 11 with select accounts, our small commercial business, the production metrics reflect the impact of our active strategy to improve the profitability on portions of this business.

For some time, we've been taking the necessary actions to improve our returns, and those actions have been successful. Consequently, we are shifting focus and rate expectations to retaining more of our business and are pleased with the 4-point improvement in retention this quarter. We also feel very good about the 9.2% renewal premium change we achieved for the quarter.

Turning to commercial accounts on slide 12, both the aggregate rate and retention were unchanged from the Fourth Quarter of 2013. But as we have commented before, it is not the aggregate number that we focus on.

As we have successfully executed our strategy of improving the returns of this business over time, the headline aggregate rate increase number has moderated, while retention has improved. We continue to execute a very granular strategy to retain our best-performing accounts and to get significant rate increases on our poorer-performing business.

As we enter the fourth year of implementing this strategy, our ability to execute is largely unchanged. So in summary, we continue to see a pretty stable commercial accounts market, with rate and retention dynamics consistent with improving product margins.

Looking at Other Business Insurance on slide 13, the environment is largely the same as for commercial accounts with the exception of the larger end of our national property business, specifically large layered property risks where we have seen rate pressure intensify. For perspective, our entire national property book represents about 5% of our total Business Insurance net written premiums, and the large layered programs are a subset of this.

In the Financial, Professional & International segment, operating income of $195 million is very strong and up 20% over the prior-year quarter. The increase was driven by the inclusion of The Dominion, higher levels of underlying underwriting margins, and our decision to exit a management liability excess of loss reinsurance treaty in 2014.

The underlying combined ratio for the quarter was 90%, a slight improvement from the prior year. The improvement was due to earned rate in excess of loss trend across the segment, along with the exit from the management liability reinsurance treaty I just mentioned, largely offset by the impact of The Dominion.

The Dominion had a negative impact of 2.2 points on the segment underlying combined ratio. This is the First Quarter that reflects the full impact of the Dominion acquisition, and I am pleased to say that the integration is proceeding in line with our expectations.

Of course, we expect that The Dominion results will improve over time. However, given its relative size, we don't intend to spike it out going forward.

Turning to production results, surety gross written premium of $216 million was up from $195 million in the prior-year quarter, reflecting gains in contract surety. In management liability, retention and renewal premium change remained strong at 85% and 8%, respectively, while new business was down a little bit from recent periods.

In International, retention continued to improve and came in at 83% for the quarter. Renewal premium change rose to nearly 3%, and new business was up significantly year-over-year due to the impact of Dominion. So overall, a great quarter for the segment.

In our Personal Insurance business, operating income of $268 million for the quarter was up 36% versus the First Quarter of 2013, driven by higher net favorable reserve development in homeowners along with improved underlying underwriting results in both auto and home. The underlying combined ratio for the quarter was 87.4%, an improvement of about 2 points versus the First Quarter of 2013, due to lower expenses along with rate increases in excess of loss trends, partially offset by higher non-cat weather-related losses.

Looking specifically at auto production, retention remained strong at 81%. Renewal premium change was about 6%, while new business volume was up significantly versus recent periods due to the rollout of our new product, Quantum Auto 2.0. Jay spoke about how pleased we are with the early production results for Quantum 2, and I would like to take a moment to give you some additional color on our progress on the expense initiatives that are fundamental to our ability to make our auto product more price-competitive.

As you recall, in addition to a 2-point commission reduction for the new product, we are taking actions on our operating expenses, which will result in savings of about $140 million pretax. To date, we have executed on initiatives responsible for about two-thirds of the $140 million run-rate savings, and we remain on target to achieve the full run-rate saves by the end of this year, in line with our original expectations.

As we mentioned last year, the operating expense reductions are primarily intended to benefit auto, but will also benefit the homeowners results. In terms of impact on the combined ratio, the benefit from the operating expense reductions will be split roughly equally between the loss ratio due to claim expense reductions and the expense ratio due to other insurance expense reductions.

We believe that the initial success of Quantum 2 is due not only to the delivery of a product with competitive price and a structure that better responds to consumer buying preferences, but also to the strength of our long-term relationships to the independent agent channel and the fact that we are a recognized brand in the marketplace.

Turning to auto profitability, the underlying combined ratio was 92.3% for the quarter, an improvement of over 1 point versus the First Quarter of 2013, and was driven by earned rate increases in excess of loss trend. Our current view of auto loss trend remains at about 4%, with no significant change in the underlying texture from previous quarters.

Looking at homeowners, production was strong in the quarter, with renewal premium change of about 8.5% while retention remained at 84%, and new business volume was up from the prior-year quarter, due in part to a lift from the improved auto new business. From a profitability perspective, the underlying combined ratio was approximately 80%, an improvement of close to 1.5 point versus the First Quarter of 2013, and was driven by lower expenses, earned rate increases in excess of loss trends, partially offset by non-cat weather-related losses.

With that, let me turn it over to Gabi.

Gabriella Nawi {BIO 2211991 <GO>}

Thank you. Before we open it up for question and answer, may I ask you to please limit yourself to one question and one follow-up, please? Thank you. We can now open it up for question-and-answer period.

Questions And Answers

Operator

(Operator Instructions) Michael Nannizzi, Goldman Sachs.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Thank you. I had a question actually, Jay. Has anything changed in terms of your philosophy around cat or non-cat weather, reserving philosophy? Just because it looks like this year, and we have seen a little bit recently, non-cat weather creates difficult comps on the underlying, but provides for favorable reserve development for prior year.

So is that coincidence of those guys? I am just curious. Has that changed in the last year or two? Thanks.

A - Jay Benet {BIO 2456473 <GO>}

This is Jay Benet. There is no change in the way we go about reserving. Reserving is based on the actual storms that take place and then the assumptions that surround that.

And one of the things that we have had some difficulty with has been the weather patterns of the last several years. If you recall, not so much last year but the couple of years before that, when there was a lot of tornado experience that was creating both non-cat as well as cat weather, there was oftentimes a lot of hail with that. And when the hail manifested itself, usually it was several months later; in some cases, even longer periods of time than that.

Particularly last year, what we saw when we had storm activity was, first of all, an expectation on our part that the hail development would continue as we had been seeing it. And in fact what turned out to be the case was there was very little long-tail hail immersion, if you will, that came about.

So there is nothing really different about the way we are reserving, but it is just using the facts and circumstances that emerge over time to come up with the best estimates, and then revise those when new information comes up.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Got you. Great. Thanks. Then, I guess the other question, talking about really focusing on the lowest-performing cohort and taking as much rate as you can there, Brian. It seems like that has also been a philosophy that has been in place for a little while.

How much more do you think opportunity there is in that cohort to continue to push for right-size rate? Like, how long will it take to push that cohort into the good bucket? Thanks.

A - Brian MacLean {BIO 4679150 <GO>}

Yes, so a couple points in there. When you look at that cohort, we will continue to move stuff up -- we don't have the crystal ball as to know exactly when and what we will be able to do going forward.

When we look at the results that we have seen in recent quarters, we are encouraged that we don't see any change. So we continue to work it account by account.

One of the things I -- you started with we get as much as we can.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Right.

A - Brian MacLean {BIO 4679150 <GO>}

The philosophy is a little different than that. We are looking at these -- in every cohort, there is always a distribution of accounts. We are looking account by account within that cohort. We are trying to work with the customer and with the agent to come up with what is the appropriate number for that account.

In aggregate, we have been able to maintain at about that 20% rate increase level. But there is a distribution of accounts within there, so while we will continue to work at it.

There will always be new business that we'll write that will -- we don't write new business planning for it to be in cohort 5; but there will be some that will end up there. There will be other accounts that will have loss experience that will have them deteriorate, and they will go down into cohort 5.

But as you can see from the data we show, it is continuing to shrink. So it will never get to zero, but --.

But right now, we feel pretty good that we are still able to take the actions we need to take on the accounts in that cohort. And where we can, we are happy to retain the business; and where we can't, we lose some of it. I don't know if that's helpful.

Q - Michael Nannizzi {BIO 15198493 <GO>}

Okay. Great. No, that helps. Thank you very much.

Operator

Jay Gelb, Barclays.

Q - Jay Gelb {BIO 21247396 <GO>}

Thank you. The first question I have is on the merger and acquisition environment. Clearly we have seen a more hostile environment emerge in Bermuda. And I know that is not at all a focus area for Travelers.

But, Jay, I was wondering if you could focus on the M&A environment currently and whether you might be interested in more bolt-on deals like the Dominion opportunity, or perhaps even something more transformational.

A - Jay Fishman {BIO 14011069 <GO>}

Sure, Jay. While not -- we don't compete in the reinsurance arena at all, actually, so I don't have any particular insight into that segment or the dynamics around it. You all understand that, have a different view of that than I ever could; so I will leave that to your commentary.

Our own situation is really unchanged, which is that we will look at anything, because you always learn by whatever you look at; but our interest is very selective. We have achieved a level of performance and returns and profitability that we, at least domestically, don't need to be any bigger to be successful.

If we can be and continue to be successful, that's fine. Being bigger and being less successful is a bad trade-off. So we are always evaluating whatever we look at in the context of return on invested capital. On invested capital importantly, it's margins, profitability, all that.

So we will -- I would say that our interest domestically remains unchanged, but relatively highly selective. We have always said that there were a few environments outside the United States that from a long-term perspective we were quite interested in.

Brazil was one of them, and we had the opportunity to partner with the Malucelli firm; and that transaction has gone just really well. In the context of a joint venture, where so many things can go wrong, so many things in this one have gone right, and it has really been a terrific experience.

It has actually reinvigorated my belief that you can actually do a joint venture and have both parties feel good about it and be successful and do good business.

Canada was opportunistic in that there were very few acquisition candidates that were really available. This was a decision by the owner of Dominion to exit the business strategically.

We were approached with a very small number of other people. And it moved us, as I have commented before, I think the numbers were from 21st largest in Canada to now the 10th largest.

At 21st, you are not sustainable. It really becomes difficult to hire talented people, to invest in systems and infrastructure. I don't mean to say that the people who worked for Travelers of Canada were not talented; they obviously were. It just puts a stress on the organization.

So having the opportunity to acquire Dominion and then most importantly, most importantly, were two elements of it that were intriguing to us. First, we thought they were on the right path to doing the right things to make their own business more profitable. We thought we could accelerate the time frame, that our skills, size and scale and our experiences that we have had could accelerate that.

And then the more intermediate and longer-term aspect of taking our commercial products, exporting them up into Canada, and using Dominion's remarkable distribution organization to leverage, that remains just right clear in focus. It's just so important for us to do.

I have expressed before, although I am less optimistic that we can -- that it will happen -- I would love to find us in India in some way. The challenge there is that it takes a tremendous amount of time and investment. Not dollars, because it is a relatively small market; time and investment in people and infrastructure, management attention, for a 26% ownership. And it's difficult to make sense of that.

If we had a higher degree of confidence that that regulatory prohibition would be lifted, it would become 49%, we would be more aggressive. There are certainly plenty of partners in India who have raised their hand and have expressed interest in partnering with us.

So the identification of a partner is not the issue. The issue is making real sense of an investment longer-term.

We are a P&C company. That is what we're going to be. There may be other environments that will pop up and we will take a look at.

Continental Europe broadly is over-insured and under-returned and doesn't hold a lot of excitement for us. So it's going to be case-by-case.

We hope to use the venture in Brazil to look at other South American opportunities. So we will continue to find those spots where we think that our skills, the attributes, the partner's ability to bring value to the transaction make sense and we will invest in. So that's as comprehensive an answer as I can give you.

Q - Jay Gelb {BIO 21247396 <GO>}

That is very comprehensive, thank you. Then just on capital management, with the increase in the dividend and the strong level of retained earnings, any thoughts as to whether Travelers could increase the combined share buyback and dividend to be more than an annual level of operating income going forward?

A - Jay Benet {BIO 2456473 <GO>}

Well, the basis upon which the capital management starts is with the operating company capital. So to the extent that you are making -- your earnings are creating capital that you don't need, that is the basis for the share buybacks and the dividends.

We are always looking at other things that will free up capital. You might recall from a couple years ago, we mentioned that we had had reductions in the amount of reinsurance recoverables we had, or there was a sale of a runoff business -- that both freed up capital. So we look for those kinds of opportunities, but those are things that may or may not happen.

The real juice, the real underlying current that gives rise to the ability to return capital, that is the earnings.

Q - Jay Gelb {BIO 21247396 <GO>}

Thank you.

Operator

Josh Stirling, Sanford Bernstein.

Q - Josh Stirling {BIO 17463087 <GO>}

Good morning, and congratulations on a great quarter. First, just a question of the numbers and how we should think about them.

Last year you guys ran I think over a 15% ROE; this quarter it was nearly 18%. And the accident year ROE you mentioned earlier I think was -- rounds up to 15%.

I know we all need to normalize for many things, as I think you guys do internally. But when you think about where you are, what should we think of as where you are in your core run-rate ROE?

And how far really are you from the mid-teens ROE target that you have over time? Are we there? And if not, how much -- if you bring this back to the point, how much more rate momentum do you think you would need to get us to that target?

A - Jay Fishman {BIO 14011069 <GO>}

Josh, it's Jay Fishman. We are not there. Most definitively we are not there.

In order to achieve our goal -- and it is not vague by intention; it's vague because our business is simply not as precise as some people tend to think, this mid-teens ROE over time.

To achieve that, you're going to have to achieve periods of time where you exceed mid-teens, because there will be good weather, there will be bad weather, and that is going to move back and forth. So we still have to make progress.

So there is no particular change in our approach, our philosophy, what we are trying to achieve. Jay will tell you that when we -- if you take out the workers comp assessment change, that that impacts ROE by 90 basis points or something, by something like 90 basis points. So you can take the 14.6% and you can make it --.

There are so many moving parts and so many unusual (technical difficulty) unusual. There are -- every quarter has unusual pluses and unusual minuses, and they just keep washing out over time.

We have more to do if we're going to get back on track. At this level of interest rate, I am still not 100% convinced that it is achievable in today's environment.

We said several quarters ago; I will reiterate it today -- it remains an aspirational goal. I think that it is critical in an organization to express a strategic goal and, absent something fundamentally changing that is permanent, sticking with it.

It's not just words that we use here in a webcast. It's embedded in the systems by which we price product; it's embedded in the systems by which we evaluate risk selection; it's what people in the field, underwriters, understand their mission to be.

So we don't mess with it lightly. We leave it as it is because it takes so long to get the DNA of an organization to reflect these strategic initiatives.

We've got two things going on. Interest rates remain at overall historical lows, and the weather patterns are simply less predictable than they were. Both of those remain, and we are not yet at the pricing level, and so we are going to keep going.

I don't know exactly how to quantify it. I really don't.

I am not holding back. I don't know how to quantify X points of rate in various businesses, in various product lines, and help you -- I wish we had that kind of granular understanding about returns and losses and the rest; I just don't know how to do it.

I just know that as I look at each quarter and analyze it and break it down, that we are still not there yet.

Q - Josh Stirling {BIO 17463087 <GO>}

Yes. That's helpful. That's helpful. If I -- this is going to seem like a non sequitur in a way, because you are still raising pricing, but if -- we are all looking forward and trying to look maybe six months out again, so what we will be talking about in six months and things like that.

So the question, if I ask you a bigger question, Jay, this used to be a boom and bust sector. And I think you called -- among the first to get the post-cycle idea out, into the discussion three or four years ago, and no one believed you.

But with improvements in data analytics and more responsible behavior across the board, we have seen three years of pricing firming. So everybody is starting to dust off questions as pricing slows, look back at history, and what does history tell us.

Last time, history -- last time we saw pricing start to slow, there was seven years of price-cutting and a 40% decline in commercial lines. It was obviously a different story. It was a lot of -- the backdrop was very different.

But I am wondering; as you guys put your strategic planning hats on, and you think about the market, can you help us think about what here has been structurally changed? If we were to put on a three; to five-year view, what you think we will see if we get --if we move -- we decisively pass the firming part of the cycle.

A - Jay Fishman {BIO 14011069 <GO>}

Sure. I will start off by saying we could be wrong. Just because we believe it and manage our business that way doesn't by definition mean it will be right.

It's entirely possible that we just don't see it right. But -- and it's important, because otherwise -- you always have to consider the prospect of, what if you're wrong.

We have been talking about much less amplitude in the cyclicality of our business for a lot more than three to five years. I think you can go back almost 10, certainly eight, where it began to get increasingly clear to us that the factors that we thought had contributed to that remarkable cyclicality were being moderated.

They were much better data. I know that we led that effort because of our history; but we are not unique in the sense of one and only in that regard. Better data, better analytics, broadly across the business, the industry, particularly amongst the best competitors.

I think that Sarbanes-Oxley actually had a meaningful impact on our business. It brought Boards of Directors into the discussions of reserve setting and the controls and procedures behind it.

Those were really good things. Not because they changed bad behavior -- because you can presume that in my comment; I don't mean it that way. But it improved the processes. It fundamentally improved the processes by which managements are held accountable, which Boards embrace.

That's a big deal. That was a meaningful change in our industry that I don't think a lot of people really understood; and I believe that now.

So now, I will tell you -- at least, this is a Travelers' view. I am not speaking for anybody else, but I will tell you for us.

We don't -- the question that we get asked probably more than any other, which we just scratch our head about is, well, now that returns are where you want them to be, why don't you grow?

And talk about a non sequitur question, it's one that we so struggle to understand. There is a presumption in that question that we can moderate our rate gains on the margin and somehow grow our business and change behavior.

First of all, I don't know how to moderate thousands of transactions in any given quarter one at a time and move it on the margin. We give our folks tools, we give them processes, we give them goals, and we let them manage it. And the numbers, in the end, end up the way they end up.

We also don't believe that you can on the margin grow your business by cutting price marginally. I think, we think, that is just a fool's approach to the business. If you really want to use prices, that type of a competitive approach, you've got to cut it to the point where you will accept materially lower returns than anybody else. That will change it; and my guess is it will be at a level of profit that is simply unsupportable for the long term.

So we at least, we reject the notion that you can moderate pricing to grow your business. Now that doesn't mean that we are free from that obligation. We try really hard to grow our businesses, and in many cases we have been extremely successful.

It has not been based on price. It has been based on risk selection. Importantly, identifying the competitive advantages that you have in your business and applying them more broadly to business opportunities that arise.

We had the best national accounts workers comp business there was, and lots of you have been exposed to that and you understand the competitive dynamics that exist and the advantages we bring. Once we decided that we could apply that expertise to the small commercial business, we were able to grow that segment in small commercial meaningfully, really meaningfully, and it mattered.

In our middle-market business, when we decided to get much more specific and program-driven, less generalist, we've actually been able to grow the premiums from -- going back to 2005 -- a little over $2 billion to now a little over $3 billion in that business. Real growth, not by price, because in that period of time largely price has either been flat or it's increased. But by identifying segments of risk, risk return, where the return trade-off was worthwhile and it made sense for us to apply those competitive advantages.

Now -- so we don't -- we're not -- we may get dragged into it; maybe there will be other competitors that will be willing to accept subpar returns at a level that at some point force everybody to respond. That was the old days.

I think the industry is smarter than that. I may be wrong. I think it is.

We are running our business with that in mind. And I am hopeful, hopeful, that that will convert into a financial services business, an industry in P&C, that looks more like so many others, greater consistency, less volatility.

That level of volatility is in no one's interest. It's not even in the customer's interest. It's in nobody's interest.

Consistency of risk management and its costs are important economically, and I am hopeful that we will get there. But ultimately, every company makes its own decision, every company pursues its own strategy, so all I am expressing to you is ours, recognizing that we could be wrong.

But that's my view of why things are different -- our view of why things are different today than they were perhaps 20 years ago.

Q - Josh Stirling {BIO 17463087 <GO>}

That's really helpful, Jay. Thank you. Thanks and good luck.

Operator

Vinay Misquith, Evercore.

Q - Vinay Misquith {BIO 6989856 <GO>}

Hi. Good morning. The first question is on the accident year loss ratio ex-cats for the Business Insurance segment. We had some very small improvement, maybe around 20 basis points of year-over-year improvement in that segment. I understand there is some non-cat weather. But if you could help me understand how you look at these numbers that would be helpful, given that pricing is in excess of loss cost trends. Thanks.

A - Brian MacLean {BIO 4679150 <GO>}

So -- and I lost track of the numbers you were doing. So you were looking at ex-cat, accident year --

Q - Vinay Misquith {BIO 6989856 <GO>}

Loss ratio. Correct. So that is about 60.2 points this quarter versus 60.4 points in last year's First Quarter, so that is a small improvement.

Most of the improvement on the accident year combined ratio came from the expense ratio, I believe, 150 basis points outside of the workers comp. So since you are setting pricing in excess of loss costs, I would have thought that the loss ratio would have had more significant improvement.

A - Brian MacLean {BIO 4679150 <GO>}

Yes, okay. Jay has got the numbers.

A - Jay Benet {BIO 2456473 <GO>}

Yes, without getting into the specifics of -- yes, this is how we react to it. I mean, the way we react is we obviously have some very specific views as to what the components of the changes are.

So in blowing apart that 20 basis points, we look at, well, what is the impact of rate earning in versus loss trends? And how does that compare to prior quarters? And are the trends that we had been seeing inherent in this number that we are seeing here?

And the answer to that is yes. We continue to earn in rate in excess of loss trends.

Then the next obvious question then is, well, okay, if that is the case, how come it's not showing up? As you had said, this is a quarter where the weather has, on a non-cat basis as well as a cat basis in an area like Business Insurance, been much more of an impact than it was in the First Quarter of last year.

When you think about the weather this particular quarter with the winter storms, one of the questions that we had been mulling over in here was if you look at the relationship of losses, weather-related losses in BI versus PI. Personal Insurance, while it had weather events this quarter, they really looked not all that dissimilar from where they had been in the prior year.

And in the case of BI, they were much higher, both in terms of cat and non-cat. Looking further at that, we find that in Business Insurance you are dealing with insureds that have many more flat roofs, that when there are ice storms and snowstorms sustain more damage than sloped roofs and homes that people own. And then secondarily you have a lot of sprinkler systems in businesses; and when sprinkler systems freeze and then water damage results, the damage is extensive, much more so than the homeowners business.

So in pulling all these things apart, we look at the data, we look at the relationships, we look at the causality, and see that it all makes sense to us. In this particular case what you are seeing are the 20 basis points of improvement, but it is really the rate in excess of loss trend benefit being offset in large measure by the weather.

Q - Vinay Misquith {BIO 6989856 <GO>}

Sure, that's helpful. Just as a follow-up to that, we have seen the expense ratio improve meaningfully in this segment -- that is, the Business Insurance segment -- and the other segments. Curious as to whether this is repeatable and whether this is a function of management action, because you feel that the pace of rate increases are now starting to moderate. Thanks.

A - Jay Benet {BIO 2456473 <GO>}

Yes, there is a combination of stories here. First of all, in Business Insurance, Business Insurance is where the benefit that we called out in the press release relating to the workers comp assessments is coming through. So that is the lion's share of what is taking place here.

We continue to manage expenses very, very carefully in Business Insurance, and we are getting some benefit of expense leverage here that is also contributing to the reduction that you are seeing. But the primary driver in Business Insurance was the reevaluation of the estimated liability that we called out.

In other areas, we have changes in commission rates that we have talked about that have come through; also the expense saves that we talked about in PI. So there is lots of different stories, but it all goes back in most cases to a very diligent view as to how to manage expenses in this place.

Q - Vinay Misquith {BIO 6989856 <GO>}

That's helpful. Thank you.

Operator

Amit Kumar, Macquarie.

Q - Amit Kumar {BIO 15025799 <GO>}

Thanks. Good morning, and congrats on the quarter. Two quick questions.

The first question is on loss cost trends in Business Insurance. Maybe using California comp as a backdrop, has anything changed in terms of loss cost trends when you look at Q1 versus Q4?

A - Brian MacLean {BIO 4679150 <GO>}

This is Brian. The short answer is no.

Your comment of taking California comp as a backdrop, I don't think I would ever use California comp as the standard for things broadly across the book of business. So in our comp business and the other lines, really no significant movements at all this quarter from what we have been seeing historically.

Q - Amit Kumar {BIO 15025799 <GO>}

I can see now I was unclear. I was alluding to SB 863 and its impact.

A - Brian MacLean {BIO 4679150 <GO>}

Yes, specifically in California.

Q - Amit Kumar {BIO 15025799 <GO>}

Yes.

A - Brian MacLean {BIO 4679150 <GO>}

Yes, I don't think we want to go that granular in talking about specific trends. I mean, we have got a decent sized book in California and continue to manage it on a granular basis and feel good about it.

But -- yes. Everything, all those changes are reflected in the results that we have got in our book. So we would prefer not to delve that deeply into one state's specific actions.

Q - Amit Kumar {BIO 15025799 <GO>}

Okay. I guess switching gears and going back to the discussion on Quantum 2.0, it's in 38 states -- it's in 28 states right now.

What I was trying to get at was, how should we think about the impact it might be having on premiums right now? I.e., is there some way to segregate the impact when we look at the numbers?

A - Jay Fishman {BIO 14011069 <GO>}

This is Jay Fishman. In the aggregate, no. And were we to dive into the individual states where the product has been rolled out, what you would see -- I am trying to recall. Almost universally, maybe that is not exactly so, but you would see a meaningful increase, meaningful increase in new business in each of those states. And because it has only been out for a few months and it's only still out in 28 states and the D of C, there is still some time to go before it evidences itself in our numbers.

I think the best that I could provide to you -- this is not a budget. I want to make it clear; it's not a budget. It is to some extent a guess on our part; and of course competitive reaction can change all of this.

But our guess is that if we keep going at the pace and things remain as unchanged as they are now, that by the time we get to the Fourth Quarter of this year that we will achieve breakeven status. Meaning that in the Fourth Quarter the book will no longer be shrinking. So it will shrink again in the Second Quarter; it will shrink again in the third; by the time we get to the fourth, we should be able to hit breakeven.

And that gives you, I think, a sense of its intermediate-term impact on a book of our size. Remember that it's -- all new is coming out 2.0. Renewal is at the agent's discretion based upon the individual customer's need.

And I am be reminded here by everybody that my comment about the Fourth Quarter is that that's the policies in force, not premium dollars. Policies in force should, we hope, given everything we see, would project to flatten out in the Fourth Quarter.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. That is extremely helpful.

A - Gabriella Nawi {BIO 2211991 <GO>}

Sorry. This is Gabi. Just to remind you, Amit, you can also see on page 18 of the webcast that new business in auto has picked up pretty meaningfully, and that is obviously largely driven by Quantum 2.0.

A - Brian MacLean {BIO 4679150 <GO>}

Totally driven.

A - Gabriella Nawi {BIO 2211991 <GO>}

Totally driven.

Q - Amit Kumar {BIO 15025799 <GO>}

Got it. Yes, that's very helpful. That's all I have. Thanks for the answer.

Operator

Jay Cohen, Bank of America Merrill Lynch.

Q - Jay Cohen {BIO 1498813 <GO>}

Thank you. Two questions. The first is in the management liability business; we see an increase in the acceleration I should say of the price increase. I am I guess a little surprised by that. I am wondering what is happening in that business.

Secondly, related to Canada and Dominion, are you able to take capital out of that business now? If not, when will you be able to?

A - Alan Schnitzer {BIO 3529437 <GO>}

Jay, it's Alan Schnitzer. Let me start with the first one, then I will turn the second one over to Jay. In management liability, what you are seeing there is RPC, renewal price change. That has got two components, one is rate and one is exposure.

The rate underlying that sequentially in quarters would be pretty consistent. Up slightly, but I would call it consistent with the prior quarter.

What you see in addition to that, though, is exposure. That is us being able to improve our position in some accounts that have been performing well, in some cases from an excess position to a primary layer, and then just an improvement in ratable. So it is really those two pieces that you are seeing there.

A - Gabriella Nawi {BIO 2211991 <GO>}

Sorry, this is Gabi. Just to clarify. It is renewal premium change on the page in the webcast, not renewal price change.

Q - Jay Cohen {BIO 1498813 <GO>}

Got it.

A - Jay Benet {BIO 2456473 <GO>}

As it relates to your question about the capital position and taking capital out of Canada, first and foremost is looking at the opportunity that we have with Dominion to both integrate it, get it into Travelers in as seamless a fashion as we can, and then take advantage of the business opportunities up in Canada.

So we will maintain a capital base in Canada that will support those business activities. Your question is a good one, but it is complicated by both profitability and growth; and we will just manage it very carefully up there.

Q - Jay Cohen {BIO 1498813 <GO>}

Okay, thank you.

Operator

Randy Binner, FBR.

Q - Randy Binner {BIO 15145081 <GO>}

Great. Thanks. On the change in the estimated liability for workers comp state assessments, could you clarify what states that applies to and what exactly changed in the nature of the assessment?

A - Jay Benet {BIO 2456473 <GO>}

Yes, this is Jay Benet again. The state is New York State.

New York has been going through some rethinking of how they manage things associated with workers comp. You might recall from last year, I think it was in the First Quarter, maybe the second. It was first? We had had a change in the way certain reopened workers comp claims were funded; and that actually had a cost to us last year that went through prior-year development.

What New York State has done recently is change the way they fund the workers comp bureaus in New York. Effective 1/1 of this year, instead of doing something that they had done historically -- and without getting into all the complications associated with it -- we had, along with others, charged policyholders surcharges in particular years and then collected those. That was the basis upon which we were supposed to be funding at a later time what the costs were that we were being assessed by New York State for operating their various bureaus.

And there was a disjoint, frankly, between what our surcharges were and what we were actually assessed by the state of New York. At times we saw that assessment being higher than what we collected, and that caused us to look at our obligations for that and build up an estimated liability associated with that.

When New York State changed the law effective 1/1, it didn't change the surcharges we had collected. In fact, there was a true-up period where you looked back four years from that date. You looked at what you assessed in that time frame -- I'm sorry, what the surcharges were in the time frame, what you had paid, and then settled up with New York. And we paid that.

But what it did was it eliminated going forward this uncertainty as to a breakage, if you will, between the surcharges and the assessment. So this estimated liability for that breakage in effect was what we no longer required.

And going forward, the matching of the surcharges and the payments to New York State will be something that will be very definable, so there is really no need for this estimated liability anymore. It is a one-time thing. It is a true-up and it is not something that will recur.

Q - Randy Binner {BIO 15145081 <GO>}

But it transfers to the expense ratio rather than the loss ratio because it is more of a pay-as-you-go?

A - Jay Benet {BIO 2456473 <GO>}

No, it goes through taxes, licenses, and fees. It's just the way statutory accounting works.

Q - Randy Binner {BIO 15145081 <GO>}

Okay, understood. And that's -- I guess the follow-up there is that it's -- everything you described was more procedural. But there hasn't been any -- has there been any other kind of reform or structural change to that, to the way that New York approaches that second injury fund?

A - Jay Benet {BIO 2456473 <GO>}

Nothing this year. Like I said, last year there was a change.

Q - Randy Binner {BIO 15145081 <GO>}

Nothing like a SBA 863 in California? Nothing like -- to fix the real problem? This is more just procedural in how it operates?

A - Jay Benet {BIO 2456473 <GO>}

This is procedural as to how the funding of this particular element operates, yes.

Q - Randy Binner {BIO 15145081 <GO>}

Okay. That's perfect. Thanks.

Operator

Adam Klauber, William Blair.

Q - Adam Klauber {BIO 1494359 <GO>}

Thanks. Good morning, everyone. My question is around workers comp. Clearly you have been working on that line pretty hard, and the accident year in 2013 came down by several hundred basis points.

For this year and next year can we expect more of a gradual change? Or is it possible you could see some more significant improvement also?

A - Brian MacLean {BIO 4679150 <GO>}

You are talking about in the combined ratio?

Q - Adam Klauber {BIO 1494359 <GO>}

Yes, in the workers comp.

A - Brian MacLean {BIO 4679150 <GO>}

It is tough to forecast what we are going to see. I think we feel great about our comp experience and the capabilities we have and the risk selection we have gone through, and feel confident that we are appropriately recording the things as we see them today.

A - Jay Fishman {BIO 14011069 <GO>}

And our pricing strategies are similar to what we described earlier. Where there are accounts that have been poor-performing or under return we have been seeking rate gains to improve the profitability; and ultimately that will evidence itself in the numbers.

So -- I am not -- yes. Other than that, do loss costs develop as we contemplate they will? That is always the variable.

Q - Adam Klauber {BIO 1494359 <GO>}

Okay. How are medical loss cost trends running?

A - Brian MacLean {BIO 4679150 <GO>}

Consistent with what our expectations have been. We are not going to disclose specific numbers there, but -- I don't think we have in the past. But you can read what is going on in medical loss cost inflation broadly in society and in the economy, and it is higher than normal inflation, but something that is consistent.

I think for us, one of the things that is really fundamental to our success in this line is literally 20 years ago we decided we were going to invest heavily in our abilities to manage the medical component of the comp claims; and I think we have got clearly industry-leading capabilities there and that really matters for us.

So we are obviously looking at what the trend is on our book, and I don't know if it's different than what other companies are seeing. But it's clearly been within our expectations and something we watch very, very closely but right now feel good about.

Q - Adam Klauber {BIO 1494359 <GO>}

Okay. Thanks a lot.

A - Gabriella Nawi {BIO 2211991 <GO>}

Thank you. This will be our last question. Thank you.

Operator

Larry Greenberg, Janney Capital.

Q - Larry Greenberg {BIO 16478161 <GO>}

Thanks. I will make it a quick one.

I think last quarter, Alan suggested that for FPI to think in terms of a 92% underlying combined ratio for this year; the First Quarter came in a couple of points better than that. And you guys referenced the management liability treaty as being partly a factor.

Does that change that suggested guidance for the year?

A - Alan Schnitzer {BIO 3529437 <GO>}

Hi, Larry; it's Alan. No, it doesn't.

We certainly took that into account when we gave the outlook a quarter ago. If you look in our 10-Q and you look in the outlook, we really say the same thing about the balance of the year, meaning the next three quarters we expect to be broadly consistent with full-year 2013.

So obviously we did come in under that in the First Quarter. So if you just do the math, that would suggest a slight improvement on the full year. But again I would just point you back to the word broadly consistent and tell you that we continue to expect the same.

Q - Larry Greenberg {BIO 16478161 <GO>}

Okay. Great. Thanks.

Operator

Ms. Nawi, I will now turn the call back over to you. Please continue with your presentation or closing remarks.

A - Gabriella Nawi {BIO 2211991 <GO>}

Very good. Thank you all for joining us today. As always, Andrew Hersom and myself are available in Investor Relations for additional questions. Thank you all and have a good day.

Operator

Ladies and gentlemen, that does conclude the call for today. We thank you for your participation and ask you to please disconnect your lines.