S&P Global
Market Intelligence

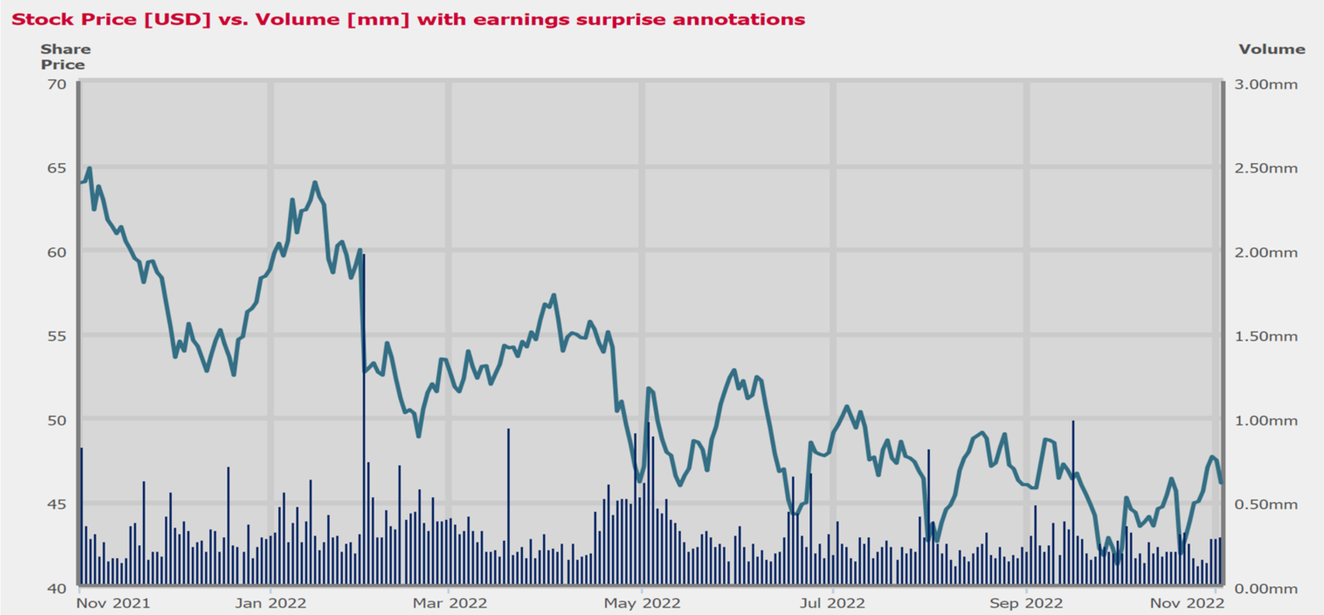
Kemper Corporation NYSE:KMPR
FQ3 2022 Earnings Call Transcripts

Wednesday, November 2, 2022 9:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2022-			-FQ4 2022-	-FY 2022-	-FY 2023-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	(0.58)	(0.48)	NM	(0.08)	(2.29)	NA
Revenue (mm)	1406.60	1409.20	▲0.18	1377.29	5640.47	NA

Currency: USD
Consensus as of Nov-03-2022 1:42 PM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ4 2021	(0.28)	(2.05)	NM
FQ1 2022	(1.29)	(0.94)	NM
FQ2 2022	(0.68)	(0.62)	NM
FQ3 2022	(0.58)	(0.48)	NM

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Call Participants

EXECUTIVES

Duane Allen Sanders
Executive VP and President of P&C Claims & Personal Insurance

James J. McKinney
Executive VP & CFO

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

Karen Guerra
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ANALYSTS

Andrew Scott Kligerman
Crédit Suisse AG, Research Division

Brian Robert Meredith
UBS Investment Bank, Research Division

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Gary Kent Ransom
Dowling & Partners Securities, LLC

Paul Newsome
Piper Sandler & Co., Research Division

Presentation

Operator

Good afternoon, ladies and gentlemen, and welcome to Kemper's Third Quarter 2022 Earnings Conference Call. My name is Drew, and I'll be coordinating your call today. [Operator Instructions] As a reminder, this conference call is being recorded for replay purposes.

I would now like to introduce your host for today's conference call, Karen Guerra, Kemper's Vice President of Investor Relations. Ms. Guerra, you may begin.

Karen Guerra
Vice President of Investor Relations

Thank you, operator. Good afternoon, everyone, and welcome to Kemper's discussion of our third quarter 2022 results. This afternoon, you'll hear from Joe Lacher, Kemper's President, Chief Executive Officer and Chairman; Jim McKinney, Kemper's Executive Vice President and Chief Financial Officer; and Duane Sanders, Kemper's Executive Vice President and Property & Casualty Division President. We'll make a few opening remarks to provide context around our third quarter results and then open the call for a Q&A session. During the interactive portion of our call, our presenters will be joined by John Boschelli, Kemper's Executive Vice President and Chief Investment Officer.

After the market closed today, we issued our earnings release and published our earnings presentation and financial supplement and Form 10-Q. You can find these documents on the Investors section of the website, kemper.com.

Our discussion today may contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements include, but are not limited to, the company's outlook and its future results of operations and financial conditions. Our actual future results and financial condition may differ materially from these statements. These statements may also be impacted by COVID-19 pandemic. For information on additional risks that may impact these forward-looking statements, please refer to our 2021 Form 10-K as well as our third quarter earnings release.

This afternoon's discussion also includes non-GAAP financial measures we believe are meaningful to investors. In our financial supplement, earnings presentation and earnings release, we defined and reconciled all the non-GAAP financial measures to GAAP where required in accordance with the SEC rules. You can find each of these documents on the Investors section of our website, kemper.com. All comparative references will be to the corresponding 2021 period unless otherwise stated.

I will now turn the call over to Joe.

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

Thank you, Karen. Good afternoon, everyone, and welcome to our third quarter conference call. In addition to our financial results for the quarter, on today's call, we're also going to highlight a series of strategic initiatives that are underway. I'll start by providing some context to the 2 main areas of our strategic update: first, a sharpening of our business focus; and second, specific initiatives to enhance our operating model.

On Page 3, we profile our strategic intent, the team and culture that fuel it, the characteristics of our target markets and differentiating capabilities and our foundational businesses. As a reminder, we focus our energy and capital on markets that are underserved or require specialization where we have or can build systematic, sustainable, competitive advantages and our offerings improve customer lives through better customer understanding and favorable pricing. Kemper Auto and Kemper Life demonstrate how our tailored focus that builds off our differentiated capabilities is leveraged to meet our target customers' unique needs better and more completely than our competition.

In both of these businesses, we have leading franchises that provide valuable protection services at attractive prices. As part of our annual planning process, we review our portfolio of businesses to determine if our businesses deliver a competitive advantage and if they are either made better by being part of our portfolio or make the rest of the portfolio better. As a result of this, we've initiated a strategic review of Kemper Personal Insurance, our preferred home and auto business. This includes restructuring to potential divestiture of the segment or components of the segment. We'll provide a further update when we have more information to share. In addition, the sale of Reserve National Insurance Company and its subsidiaries, otherwise known as Kemper Health, to Medical Mutual of Ohio remains on track to close in the fourth quarter.

Moving to the second key component of our strategic update. We have initiated several operating model enhancements to enable additional productivity and growth within our core businesses. First, to ensure we have the ability to meet our customers' needs at the lowest possible price, we're always looking for ways to optimize capital usage. To that end, we've established an offshore captive that has unlocked a substantial amount of trapped capital. Additionally, we are in the process of creating a reciprocal exchange. This will enhance customer pricing, lower the cost of capital, reduce earnings volatility and improve returns on equity. And finally, to ensure our organization is best positioned to thrive in the post-pandemic era, we're announcing a restructuring program that will reduce cost across our business and accelerate capability advancements.

The cumulative result of these initiatives will result in a franchise with rapidly improving profitability and a strengthened position to meet current and future customer needs. Jim will share more details on the anticipated benefits from these actions later in this presentation.

Moving to Page 5 to review the quarter's highlights. Today, we reported results that showed ongoing progress towards restoring profitability. This quarter, we again exceeded our P&C rate taking forecast. The cumulative benefit of the planned rate and nonrate actions taken over the past year continues to earn in at an accelerating pace. Although severity inflation remained elevated, incrementally, it was less severe than in previous quarters.

We remain laser-focused on our work to both further accelerate underlying profitability improvement and ultimately grow our franchise. Our actions have more than offset the incremental loss cost pressure, particularly in specialty personal auto. They continue to have the anticipated impact. Their benefits are accelerating. Since July 2021, private passenger auto received 35 points of cumulative written rate on 45% of our total auto book. We saw progress displayed in financial results this quarter with a cumulative impact of 4.5 points of rate earning into the book. I'm confident these actions, combined with our nonrate actions, will restore Kemper Auto's underwriting profitability next year.

In addition, in the life and health segment, profitability improved from declining mortality and higher investment yields. I see things trending in the right direction, and certainly, the enhancements in our operating model will only further advance profitability gains.

I'll now turn the call over to Jim to discuss additional details on operating results.

James J. McKinney
Executive VP & CFO

Thank you, Joe. I'll take it on Page 6 with our consolidated financial results. The ongoing environmental challenges facing the P&C and life insurance industries continue to impact Kemper's results. Notable factors include severity trend inflation, elevated mortality and Hurricane Ian.

For the quarter, we generated a net loss of $1.19 per diluted share and an adjusted consolidated net operating loss of $0.48 per diluted share. This included capacity losses of $27 million, of which approximately $16 million was related to Hurricane Ian. Against this backdrop, we continue to make progress in restoring the business to profitability. Highlights include the approximately 3-point sequential quarter improvement in Kemper Auto private passenger auto underlying combined ratio, continued strong profitable growth in commercial vehicle and a $5.5 million decrease in life policy owner benefits due to lower mortality.

Next, I would note that the earn-in on profit restoration items continues to accelerate. In our P&C segments, the spread between earned rate and ongoing severity trend is widening. This will lead to continued underwriting profit margin improvements. Within life and health, mortality trends continue to moderate and move toward prepandemic levels. Together, these items provide a tailwind to continued profitability improvements.

Finally, in the quarter, we had roughly $7 million of favorable prior year development. For the year, we have had approximately $22 million of favorable prior year development. In this challenging and dynamic environment, these outcomes demonstrate the quality of our information, analytics and commitment to operating transparency.

Moving to Slide 7. We highlight a few key updates. First, this quarter, we ceded 80% of our life business to our wholly owned, newly established offshore captive. This initiative unlocks substantial trapped capital and enabled a $300 million extraordinary dividend to the holding company, resulting in additional liquidity and capital availability. Second, we remain committed to our long-term debt-to-capital target of 17% to 22%, excluding unrealized fixed income gains and losses. Correspondingly, we have earmarked $150 million to reduce the principal we will eventually refinance in connection with the February 2025 debt maturity. Third, Kemper is adopting the new LDTI accounting guidance effective January 1, 2023, using the modified retrospective method. Discount rates as of September 30, 2022, result in an increase to shareholders' equity of between $175 million and $275 million.

As a reminder, our asset liability management philosophy aims to closely align our life assets and liabilities. We evaluate life liability cash flows using both economic and accounting views to mitigate economic and short-term valuation volatility. Potential asset liability rate risk is managed to less than $15 million annually. Short-term fixed income valuation volatility relative to the A-rated eval is limited to $100 million. During the quarter, our asset liability management philosophy resulted in an equity gain of approximately $20 million.

Moving to Page 8. We maintained significant capital and liquidity positions. At the end of the third quarter, we held a healthy liquidity balance of nearly $1.4 billion. The increase in liquidity relative to the second quarter was driven by the aforementioned $300 million life dividend. The Bermuda reinsurance initiative also impacted our life and health RBC ratio and improved 535% from 405%. The debt-to-capital ratio, excluding fixed income gains and losses, is above our long-term target. The previously mentioned debt reduction initiative and the net transition impact from LDTI are expected to reduce the debt-to-capital ratio by approximately 4.5 points. Further targeted debt repayments using cash on hand and improved operating cash flows will enable us to return to our long target debt-to-capital range of 17% to 22% over the next couple of years.

Turning to Page 9. Net investment income for the quarter was $98 million. New investment yields are up 250 to 275 basis points over the prior year, leading to a pretax equivalent annualized book yield of 4.2%. We estimate $275 million to $325 million of our fixed income portfolio will be subject to reinvestment in 2023. New money yields are expected to yield 140 basis points higher relative to the investments maturing over the next year. This will provide incremental improvements to future core portfolio net investment income.

I'll now turn the call over to Duane to provide details on our P&C segment.

Duane Allen Sanders
Executive VP and President of P&C Claims & Personal Insurance

Thank you, Jim, and good afternoon, everyone. Moving to Page 10, we'll begin with our Specialty P&C business details. Specialty Auto experienced sequential underlying combined ratio improvement of 2 points. We more than offset the incremental severity we experienced in the quarter through rate and nonrate actions. For this segment, policies in-force declined about 14% year-over-year and earned premium down 2.7% for the same period.

This quarter, for private passenger auto, we exceeded our expectations for filed rates, filing an additional 16% on 7% of the book. We plan to file for an additional 5% on 14% of the book in the fourth quarter. At this stage, we have 4.7 points of earned rate, an increase from 2.4 points last quarter. In the fourth quarter, we expect 3.1 points of additional earned rates. The incremental benefits of earned rate and underwriting actions are expected to more than offset fourth quarter normal seasonality with incremental net trend leading to at least 1 point of sequential improvement in PPA underlying combined ratio.

Our commercial vehicle business continues to build momentum with strong results in the quarter. The year-to-date underlying combined ratio, including third quarter seasonality, is 92.7%. Year-over-year, net premium grew 34% and policies in-force grew 16%. The strength of the underlying business model and our ability to continue to achieve rate will enable us to continue to profitably grow this business.

Now let's turn to Page 11. Preferred auto experienced a sequential underlying combined ratio increase of 2.4 points, driven by a slight seasonal increase in BI claim activity and metal severity. We continue to make progress towards offsetting severity through rate and nonrate actions.

Looking at the chart on the upper right, we filed for an additional 18% of rate on 40% of our preferred auto book during the third quarter and have 2.5 points of earned rate. We're planning to file an additional 15% of rate on 9% of the book in the fourth quarter. We also expect 1.5 points of additional earned rate in the fourth quarter. Although actions will take time to earning to the book, the pace will accelerate in the fourth quarter and throughout 2023.

I'll now turn the call back to Joe.

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

Thank you, Duane. Turning to our life and health segment on Page 12. Profitability improved due to 2 primary items. First, COVID-related mortality declined. We've now experienced 2 quarters of sequential decline. Consistent with national trends, mortality is above prepandemic levels but trending back towards prepandemic levels. Second, we had solid investment performance driven by a high-quality portfolio and new money yields increasing long-term spread margin. New rates are exceeding yield maturities by approximately 100 points.

Additionally, life new business sales continue to be at prepandemic levels. These items provide a favorable tailwind to restore the business to its prepandemic levels of profitability. From a run rate perspective, we anticipate this will occur in the back half of 2023.

I'll now turn the call back to Jim so he can share additional details on the strategic initiatives.

James J. McKinney
Executive VP & CFO

Moving to Page 13. Here, we outlined initiatives that will strengthen our competitive advantages and accelerate our path to target profitability. These include programs to enhance and optimize spend within LAE, enterprise expense and real estate. In total, we expect to achieve annualized expense savings in excess of $150 million. The cost to bring these savings to fruition is between $150 million to $200 million in pretax charges that will be incurred over the next 3 years. A portion of this expense is noncash.

To enable tracking, the table on this page will be provided quarterly with our earnings updates. The actions displayed here are underway. We expect to start to earn some of these benefits in the fourth quarter. The majority of benefits will be realized by the end of 2023 with additional savings in '24 and in 2025.

Turning to Page 14. As we previously discussed the offshore captive, I'm going to start with the transformation of our P&C personal lines businesses to fee-based models through the incorporation of a reciprocal exchange. An example of this model is Erie. If you are not familiar with this model, it's an alternative way to structure an insurance company. In this configuration, Kemper will be responsible for the day-to-day management of a carrier owned by policyholders, will be paid a fee for our services and will be removed from underwriting risk. Over a 5- to 7-year period, we expect this will free up over 50% of the capital we currently have deployed to support these underwriting activities. In addition, it will provide meaningful tax advantages that we'll use to optimize pricing.

The aforementioned capital release will largely be back-ended due to the time it will take for the carrier to become self-sufficient and for us to subsequently deconsolidate it. From a timing perspective, we're at an advanced stage of the planning process and intend to submit our plan to regulators before year-end. We anticipate beginning to write business in the reciprocal in the third quarter of 2023. We're excited about the long-term prospects of this insurance model, and we'll continue to provide updates on further investor calls.

I'll now turn the call over to Joe for closing remarks.

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

Thanks, Jim. As a reminder, we recently published our 2022 ESG report. Updates include enhancement to our ESG transparency with new disclosures aligned to the Sustainability Accounting Standards Board. You can read more about these topics in the report available on kemper.com.

In closing, I'd like to reiterate that the strategic initiatives we announced today are aimed at improving our company and strengthening our strategy over the long term that will enable us to continue to expand our market share in our core businesses and improve margins. We're continuously enhancing and advancing platforms and capabilities that help us better serve the affordability and ease of use needs of our specialty and underserved markets. We aim to decrease capital requirements, lower costs, enhance customer product offerings and reduce our risk profile. This will better position us to serve the needs of our customers and employees and provide significant long-term shareholder value.

Finally, I'm confident our actions will generate the necessary results to restore underwriting profitability and make us a stronger organization. Today, we have 4.5 points of earned rate running through our personal line auto books. Don't miss the fact that based on actions already effective by this time next year, we'll have at least 19 points of earned rate running through these books. Further, our operating model enhancements will advance capabilities, and our expense initiatives will drive further cost advantages. As always, I want to thank our employees for continuing to strengthen our company, serve our customers and ensure a bright future.
I'll now turn the call over to the operator for questions.

Question and Answer

Operator

[Operator Instructions] Our first question today comes from Greg Peters from Raymond James.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

So a lot of formation, and I appreciate the slide deck. Let's -- I guess my first question would just start off on the specialty P&C insurance segment. Some of your peers have reported some continuing adverse development and some reserve charges. It seemed like you avoided that this quarter. So maybe you could comment on the state of your reserves.

And then secondly, on rate. I'm looking at the table that you put on Page 10, and it still seems like there's some rate opportunities. So maybe you can give us some color what's going on state by state.

James J. McKinney
Executive VP & CFO

Okay. Greg, this is Jim. I'll start with the reserve question. We'll tag team, or Duane and Joe will jump in on the rate, and I can follow up if there's something missed there.

Big picture from a reserving perspective, we feel pretty good in terms of where we're at. Obviously, as we've indicated previously, we try to have a forward view of where these things are going. We try to make sure that we understand each of the underlying pieces and what has to be true for those things to come to fruition. And those things are included in our viewpoints. We get a lot of data on a day in and day out basis and on a quarterly basis that enables us to kind of a very thoughtful quarterly pick and to watch that through.

And secondarily, I'll remind folks. When you think about a 50-50 pick, from a confidence perspective that comes into that, we look to have a 60-plus percent [generally] confidence, especially in an environment like this with that pick. So there's a, I don't want to say, conservatism because it's a consistency with which we apply to that. But I think those elements kind of come together to highlight both our reserving philosophy and why you can have good confidence in the quality of our loss ratio picks and the quality of our balance sheet.

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

I'll take a start, Greg, on the rate piece and see if there's additional comments after. Look, we've been taking a lot of rate, and we'll continue to take a lot of rate. This only shows 3 quarters on Slide 10. So don't forget, there's rate we took and the ones that have sort of rolled off that page that's there for historical information. We didn't try here to present the totality. But that is why I gave you sort of that cumulative, over the last 1.5 years, what's been running through.

We are in states outside of California, basically taking our full rate indications, and whenever they're available, taking more. For the large part, we've done that at this point. When the rate indications show that there's an ability to file for more rate, we will. The story in California, there's no particular news to update. I think you've probably seen that they've approved a couple of individual companies' rate programs. They've got an election on Tuesday. We continue to watch the environment, and we'll continue to appropriately file for rate there and move forward once the ones we have are approved.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

That's helpful. I guess my second question. Strategically, you've announced a bunch of moves, and I'm particularly interested in the potential divestiture of the preferred business, and of course, the establishment of a reciprocal. So obviously, you're not going to share with us everything that's going on, but maybe you could establish some guideposts on how the Board and management is thinking about these important moves that you're making and how we as investors should be looking at them on a quarterly and annual basis as you deploy whatever strategies you've announced.

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

Sure. And Jim and I will tag team this a little bit. Maybe I'll start with the PI. And then on the other pieces of the enhancements, Jim, I think, has outlined a couple of those guidelines. But we'll add a couple more on top of that.

We're in a strategic review process with personal insurance. We understand that this is a challenging environment for most of the P&C personal lines industry at this point. We've seen our combined ratios start to drop, but I think you're still seeing a lot of folks seeing this climb. That will make this a challenging environment to go through that thought process. We are looking at every option we have in terms of how to think through that business and what we can do on our own or what might make sense with another partner, and we're going to need a little time to work through that.

I don't imagine that will take us more than a couple of quarters to have a point of view on how to resolve that. It will likely take longer than that to complete whatever we're doing. But we'll have a point of view there. I'd just highlight for you that it's a challenging environment for everybody in this space now, and that's going to impact the optionality.

James J. McKinney
Executive VP & CFO

Greg, from a reciprocal standpoint, I'd highlight kind of where we start from a principal-based perspective. We're always looking for ways to enable ourselves to be able to provide customers with the lowest potential pricing that we can for the quality products that we provide. The reciprocal structure has several benefits of it, but 1 or 2 of them that are really notable are the positive impacts. It's there from a capital perspective in terms of lower charges, things of that nature, for the policyholder as well as some tax benefits and things like that, that are inside there.

When we look at that model, you start with that customer standpoint. It's something that can help us advance the ball, further elongate some of the pricing advantages in that, that we have. And it's also very positive for the remainder of our stakeholders, that being effectively the stockholders of the company as well as employees.

That pricing advantage, that gives us further competitive advantages inside the market, makes us stronger, more stable, enables us to grow over the longer term in an accelerated way, making us a further stronger company from that perspective, and then again, removing some of the volatility or the elements that you would see from a day in, day out model perspective that would be in today's model, I think, is good for essentially our stockholders. And so this is our move in that direction. We've been working on this for a while, and we're excited to continue on that path and to unlock these benefits both for our customers and for our stockholders.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

The last reciprocal strategy sounds really interesting. Just from a capital perspective, Jim, it sounds like -- I mean you're going to have to have capital to establish reciprocal exchange. At the same time, are you going to get the capital from your existing subsidiaries as they move it over to the -- I guess I'm just trying to understand sequencing of capital movements between the entities.

James J. McKinney
Executive VP & CFO

Yes. So we'll start with a surplus note and other from a capital perspective. It will then obviously create over time. This is one of the reasons it takes 5 to 7 years to fully appreciate those benefits. But then that surplus note, right, will become repayable as you go forward in the future as the reciprocal in and of itself becomes self-sufficient. Again, that will take about 5 to 7 years to fully come to fruition, but that capital benefit is very meaningful. That comes there for our customers. And it will obviously provide meaningful capital to the organization as a whole in terms of our ongoing endeavors to continue to grow the business. Or if the right option there is to return the capital, we'll return the capital. So both of those things, I think, are big positives. And effectively, that's how we're going to start.

Operator

Our next question today comes from Paul Newsome from Piper Sandler.

Paul Newsome
Piper Sandler & Co., Research Division

A little bit of follow-up on the reciprocal idea. Is the idea here that essentially the reciprocal would start with its own sort of fresh policy licenses and filings and then would be independent from what you currently have? Or are you -- is there some sort of transfer process that happens theoretically that would -- and then I guess mechanically, how would that work for -- would you be transferring the book? Or is it simply starting new business with the reciprocal and then letting whatever the existing...

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

Good question. I'm sorry. I didn't mean to interrupt. I thought you were done.

Paul Newsome
Piper Sandler & Co., Research Division

Go ahead. I'm good.

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

Okay. No, good question. What we'll do is we will start and create a fresh entity with fresh licenses and fresh filings. It will be, in many cases, mirror of the products we're using already, and we will write new business into that entity. If we took state X and we started doing it, we would stop writing new business in our old entities and write all the new business in the new entity. As Jim mentioned, you started with a surplus note to get it capitalized. And then as it takes the surplus contributions that are part of the policy or the premium and the underwriting profit it makes and it's generating its own capital over time, and we'll fill it up.

So what will happen, as the new business gets written there and we stop new business in other entities, it would gradually naturally shift over. Very similar to how you -- sometimes you'll see a company do an open book, closed book strategy where they change products. [indiscernible] a different legal entity inside the organization. The old program winds down and the new one grows. This will do the same thing in that process. And that's, again, part of why it takes a little bit of time. It's because it transfers on new and because it has to build up its own capital.

Paul Newsome
Piper Sandler & Co., Research Division

That makes sense. The reciprocal -- this is just for the specialty business. It wouldn't be for the preferred. Or would it be for the commercial business as well? Or is that separate?

James J. McKinney
Executive VP & CFO

Paul, good question. At this time, it's intended to be for the personal line -- the P&C personal lines underwritings as we go forward. So we've got to go through complete essentially our strategic review of PI but depending on what direction. It would also be included on this depending on what the outcome is of that review. Or it will be the [KA] PPA underwritings.

The commercial business, it has the potential to go through here, but our intent at this stage is for it to continue to write in the entities that it's currently in. This is the current benefits and where we think about it. At this point in time, there's a very cool benefit for the PPA side. It's a little bit more -- it's a little more cloudy, if you will, on whether or not there is that benefit. But if it were to produce that benefit, then we would head in that direction, again, so we can provide this. But right now, it's the intent for the PPA writings to go through that.

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

And to be clear, Paul, we're going to start with the specialty PPA and be working there. I agree 100% with Jim, but we'll complete our review -- strategic review of PI before we conducted any opportunity to move in that direction.

Paul Newsome
Piper Sandler & Co., Research Division

Okay. That's great. And then I guess I'll ask one question I wanted to ask. I wanted to know kind of the cash flow process of the life captive. Did that tie to the operating cash flow negativity and your date? And I guess relatedly, trapped captive, was that purely a statutory capital amount? So you're essentially holding a little less or able to hold less capital on the captive? Or is it something that you were able to do with the life reserves as part of the transfer?

James J. McKinney
Executive VP & CFO

So Paul, if I understand correctly, I'm going to answer. And if I don't get to what you're looking for, please ask a follow-up on this. Big picture, it's 100% consolidated with our -- first of all. Second of all, when we went through with the transferring of that, we then received an extraordinary dividend that effectively went to the holdco from essentially United or the entity that was essentially holding the reserves today.

In terms of what you're going to see on an ongoing basis, it's going to act in the same way that the rest of our business does. This is a statutory capital release versus -- in trapped capital versus essentially, I guess, a GAAP capital in terms of where you're at. But in terms of our ability for uses and other elements, we obviously have the same freedom. And then if you're thinking about kind of what that reinsurance structure looks like, it's done on a funds withheld basis. So happy to talk through your questions if you've got them further inside there. But hopefully, I hit on the points that you were hoping I would touch on.

Paul Newsome
Piper Sandler & Co., Research Division

No. I think again, it's just the question is like how much capital is actually in the captive versus what got pulled out of the insurance subsidiary, if there's a difference there that...

James J. McKinney
Executive VP & CFO

There's still about $400 million of capital that's inside the entity that's there. As we continue to work through sort of the benefits as you go forward, just the natural, you would expect another $100 million or so to come out over the next year or so that will go to the holdco. And you'll see us run the life entities at very similar ratios that we've run at in the past. Obviously, right now, we're much higher than that. But that really should be highlighting kind of the strength and just where we're at from an overall position there.

Operator

Our next question today comes from Brian Meredith from UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

A couple of them here for you. First, just on the operating model enhancements here. So I just want to make sure I understand this correctly. So in theory, over the next couple of years, we're going to see your LAE ratio decline by 2.5 to 3 points. And also your expense ratio, I think if I look at $60 million to $70 million run rate, that's about 1 point to 1.5 points on your expense rate. Is that the way to kind of think about it? And then a real estate optimization a little bit more?

James J. McKinney
Executive VP & CFO

Brian, I think you're thinking about it the right way. Now again, different sizes or whatnot would be there. But yes, if you just extrapolate it to where we're at today, that is the right directional answer.

Brian Robert Meredith
UBS Investment Bank, Research Division

Excellent. And then second question, I'm just curious. Obviously, you put through a lot of rate increases so far. Where are you with respect to rate adequacy right now you think in your book of business as far as what you've filed as of today? And the reason I'm asking is, is there a point at which we could maybe start to see some sequential improvements in PIF, obviously, excluding California because that's a different animal?

Duane Allen Sanders
Executive VP and President of P&C Claims & Personal Insurance

This is Duane. Yes, good question. I'd say outside of California, we're there. We're largely rate adequate, and we continue to -- I think, as Joe mentioned, we're looking at indications on a regular basis, and we'll address that should we need rate.

Brian Robert Meredith
UBS Investment Bank, Research Division

Got you. So you're in a position to perhaps start to grow again outside of California?

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

Yes. That's -- we're trying to be careful with our words here. So I'm going to be really blunt about it. We believe we're rate adequate. We believe that there's still a significant inflation from inflationary environment around. So we'll remain, for the moment, modestly cautious outside of those geographies. We want to see that rate earn-in. I want to see a little bit more on what inflation does and make sure that we're following up with the rate behind it because we don't want to be behind. Again, we want to get back out in front of it. So we'll be a little tempered in when we step on the gas.

Duane Allen Sanders
Executive VP and President of P&C Claims & Personal Insurance

And the only other piece to that I would add is that it's your position in the marketplace relative to others. So sometimes is that -- are we moving in tandem or we move differently? And so depending on how that -- how you find that in the marketplace will also dictate our ability to grow.

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

Right. If our prices are higher than everybody else as we moved earlier, we might not be growing because we're not competitive. It's not just an underwriting filter. It might be customers going to choose to [indiscernible] still inadequate.

Brian Robert Meredith
UBS Investment Bank, Research Division

Got you. Makes sense. And then last, just a quick question. I'm just curious, post Hurricane Ian, I know some things happened in Florida from a regulatory perspective. One of them, I believe, is that they've suspended use-and-file. Does that change at all your kind of outlook at Florida right now as far as where you are with respect to growing in that state or doing stuff in that state?

Duane Allen Sanders
Executive VP and President of P&C Claims & Personal Insurance

Not at this time. Again, Florida has been one of the states where we've been very active in terms of trying to get us in the right place from a rate position. And we'll continue -- as those rules change, we'll continue to abide accordingly. And if we have to go through an approval process on that on the front end as some of the other states that we're in do, then that's what we'll do.

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

A lot of times, what you find is the states have an official regulatory category, use-and-file, file-and-use, prior approval, however they describe it. And then there's how do they function. They may be changing some of the rules. It doesn't appear that they're changing here in terms of how they function in what they're doing.

And to clarify sort of my last thought, Brian, I don't want to leave my last comment to suggest we think we're price uncompetitive. I think we've taken a lot of rate. We think we've gotten ourselves rate adequate. But Duane's point was generally you got to be responsive to what else is going on in the market and what's happening there. You're just seeing -- you're not seeing the same shopping activity, the same moving activity, the same other activity, and we'll be in that spot. I still think we have a very strong competitive advantage and attractive expense profile and attractive ability to serve our customer needs. And I think when we're confident it's time to grow, the ability is there.

Operator

Our next question comes from Matt Carletti from JMP. Looks like the question dropped there. So our next question is from Gary Ransom from Dowling & Partners.

Gary Kent Ransom
Dowling & Partners Securities, LLC

A lot of my questions on the reciprocal have been answered, but I have a couple more. The way you seem to be describing it, it sounds like you put in a surplus note. You write some new business. If things go well, you put in another surplus note. You write some more business. That process continues over this 5 to 7 years. I'm trying to understand exactly what you mean by the transition at that point.

Are you saying that that's when it's self-sufficient and you don't have to put any more funding into it? Or are you self-sufficient at that point because you've already gotten all the surplus notes back and you can deconsolidate at that point?

James J. McKinney
Executive VP & CFO

Yes. So good question. You may not have all of the surplus notes back, but you would be self-sufficient from -- you wouldn't necessarily need to be putting any more capital in from that perspective, from reinsurance or other elements that you would look at. And it's making earnings along that journey, and those are building up. And at that point in time, it's self-sufficient for writing new business or other elements that would come into the entity at that point. The note in and of itself, probably it's an extended term note, right, that would come out in kind of normal course. Think about it like a 30-year mortgage or something to that extent.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Right. Yes. Okay. I understand. And then when I think about the other reciprocals out there, whether Erie, USAA, Farmers, there's more of a preferred writing bent to it, yours being a little bit more shorter duration or shorter lifetime customers. And I was just wondering if that, in any way, affects how you are thinking about the buildup of that transition, if you're kind of -- you have to [start] churning these customers a little more than other reciprocals.

James J. McKinney
Executive VP & CFO

So I think the Erie remodel is a good model to reference. I think what I would actually highlight and why I think this becomes more of a challenge necessarily for maybe preferred or standard companies versus maybe specialty or nonstandard is it just takes longer to move the entire business and to recover those benefits. Because our policy life isn't quite as long as what you would see, right, on that term, it actually happens faster.

And so, Gary, I actually think there's more benefits for someone like us, or at least that's what our modeling and other elements would suggest, that it's actually better and more favorable for us. And the difference that might be used, if I was 100% standard preferred and I didn't have -- it might be more like a 10- to 15-year period before you got to that deconsolidation versus kind of our 5 to 7.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Great. And one a little -- a couple of other little detail questions. Are you -- when you're talking about tax benefits, are you imagining that the premium the customer pays might be partly attributed to a capital contribution?

James J. McKinney
Executive VP & CFO

That is correct, yes. And so that component of it that's there obviously creates that tax benefit that come through. And if you think about that being maybe 50% of the margin that you might have, you might think of it as small, but you might think of it as large. It just depends on how you're thinking about it.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Right. And then where -- what domicile are you setting up the reciprocal in?

James J. McKinney
Executive VP & CFO

So we haven't announced that. There's a couple though that I would say, 2 or 3 that were fairly deep, and what we're working on is the final details there and where it's going to be kind of the optimal location for us. And so there'll be more detail due to come up shortly.

Gary Kent Ransom
Dowling & Partners Securities, LLC

It's not actually finalized yet then. Okay. All right. And yes, I guess that's it. I think I understand.

Operator

Our final question comes from Andrew Kligerman from Credit Suisse.

Andrew Scott Kligerman
Crédit Suisse AG, Research Division

I just want to fill on a bunch of banks. A lot of good answers. So just looking at Slide 10 and the written overall impact, it looks like you'll get a little less than 1% written impact. And I think earlier, you said that you feel like you're pretty -- you said we're there, I think. So I guess that illustrates that you're pretty far along everywhere in California. Correct?

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

Can you -- I'm not seeing what you're seeing, Andrew. Can you help one more time with where you are in the 1%?

Andrew Scott Kligerman
Crédit Suisse AG, Research Division

Yes. In other words, going from 13.7% on written overall impact to 14.6%. So a little less than 1% impact or multiplying the 14% times 5 in the fourth quarter. It doesn't seem like you need a lot more. And hence, your comment, we're there, that reflects it, right?

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

Yes. I think what you've seen in that overall impact column is that the written impact of the rate, [it's working]. So I'm not sure I would read the 13.7% to the 14.6% as being 1 point and that's driving it. What that's just saying is another quarter, another group of policies renewed or written new at the effective rate level, and that's the weighted average impact on the overall book. I think the earned rate is really what you want to look to in terms of how it's working through the earnings because that's what's impacting the current period, the loss ratio.

The 4.7% you see in the third quarter, I pointed out that the rate we've taken on the overall book, when you look at that, it will come out to be about 19 points of earned rate by this time next year. So the 4.7% works up to a 7.8%. It will be -- that number will be about 19 by this time -- at least 19 this time next year. And I think the earned impact is what you want to watch because that's when the eggs fully [indiscernible] and working through.

When we say we're about there, you won't see it on the slide. That becomes a state-level price adequacy or rate adequacy analysis. And we were saying that we believe we're about rate adequate in all states other than California, which means if there was no inflation or what we expected over the next couple of months, we'd have rates that were adequate for what we needed. Now we got to watch what the inflation is because if that rises up, then we're now inadequate again.

And again, that's normal ordinary course. If you expected it to be 8 and it was 10, you're 2 points light. If you expect it to be 10 and it's 7, you're 3 points heavy. We've got some of those views baked into our pricing. That's what's helping us say that we're in rate adequate and everywhere -- roughly rate adequate everywhere other than California in this business. You can't quite pull it off the chart.

Andrew Scott Kligerman
Crédit Suisse AG, Research Division

Right, right. I guess I was just getting at it. It just doesn't look like there's incrementally much rate to be taken going forward. And I guess I would throw in nonrate actions. Is that fair to look, think about it that way, that probably across your entire book ex California, you're probably not looking at much more than 1% or 2% in the next quarter?

James J. McKinney
Executive VP & CFO

I'm not -- so this is Jim. I would not look at it that way. Our actual rate filing activity is on the page. I think we're highlighting that we're -- had to file at about 14% of the premium that will be impacted at a weighted average rate of 5%. So I think that tells you what we're doing. I mean we've generally outperformed kind of those numbers. And I think if you're looking to say what is it that we're doing over the next quarter, 2 quarters or others, I think that's the right one to kind of look at.

When you think about the right side of the written, this is about how it runs into the book or what has essentially been priced against it, right? And this is telling you when you think about like the percentage of the book that had these pricing elements against it, this is telling you that that's at the 14.6% component, right, that's working its way in there. So we just should be careful between the tables what we're trying to express. And I think the right one for you to think about, if you're looking at what we're doing from a rate perspective is what we're planning to do from a filing perspective.

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

On the left side of the chart -- on the left side of the dotted line is the incremental changes to the rate card in this time period. The right side of the chart is the cumulative impact of all prior changes. And our comments on rate adequacy are not represented here. So what you could take away from this is that if we believe we are rate adequate in all states other than California now that we are also planning on taking 5% of rate on roughly 14% of our book because that is in rate indications, and we are conservatively and thoughtfully saying we want to make sure we're ahead of this, not behind this. Now we were taking a weighted average rate of 16 and 19 in the 2 previous quarters. So we're slowing down the pace, but it's not as slow as you were thinking.

Andrew Scott Kligerman
Crédit Suisse AG, Research Division

Right. Yes, that makes a lot of sense. So 14 times 5, and maybe you'll do more after that, but it makes plenty of sense. And then maybe...

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

Again, I'm going to interrupt you for 1 second, Andrew. You might be right to 14 times 5 might be 1 point on the whole book. I think what you're trying to get -- what's more important to get is that when we're going into those states, we're still looking for about a 5% rate increase, not a 1%, a 5. The impact on the whole book might be about 1, but it's a 5, and that would be indicative of what we would be thinking in other geographies. Your math on converting it to an [earn-in] might be appropriate, but I don't want other folks to miss directionally where we're saying we're going.

Andrew Scott Kligerman
Crédit Suisse AG, Research Division

Yes. The only reason I was still in there was just it feels like you're coming toward the end of the line there. And that's why I just sort of multiplied the 14 to 0.5. But I think we're on the same page. So no need to...

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

What we were trying to communicate, Andrew, is that outside of California, we feel like we're nearing rate adequacy that you're seeing earned rate in. And I think the last comment I made before we took questions or close to the last comment was by this time next year, if we did nothing else, we already have taken actions that are going to push 19 points of earned rate through this book. All of that benefit is coming. Now we are going to do more on top of that, but that's in the bank. It's just -- but for the passage of time, it will come out.

Andrew Scott Kligerman
Crédit Suisse AG, Research Division

And absolutely clear and highly significant. And then maybe shifting over to the preferred business and the potential sale. As we think about it with the loss experience being so challenged at this point in time, how much capital is tied up in the preferred business? And would you anticipate that you could get a premium to that value or there may be a cost to that value? How are you thinking about potential exit values on that business without being too specific, obviously?

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

Look, this is -- you made a couple of good points there, and they conflict a little bit. And one, you highlighted that the losses are challenged there and remind us that it's a difficult environment. That would be putting downward pressure on the value. Then you asked if there was a premium, which is an upward pressure. We're going to go through a process. I'm not sure this is the right forum for us to describe that before we've talked to potential interested parties. That's what our -- work our way through that. But you can do your own evaluation of what you think the business' current position in the market environment.

James J. McKinney

Executive VP & CFO

And the secondary question in terms of the capital, you could see this from various calls, but it's between $400 million and $500 million. The reason that I highlight that range is just it's obviously dependent on underwritings, mix of business, things of that nature. But that's essentially -- however you're going to work through it, that's the capital that's pledged against the business.

Andrew Scott Kligerman
Crédit Suisse AG, Research Division

Okay. That's helpful. And then as I think about the reciprocal, as I think about the captive that -- where you're able to extract $300 million, how are the rating agencies looking at these 2 specific entities? I know they're very different. How -- where are you rated now by the agencies on claims paying ability? And where would you see them coming out in -- as we move down the line with each of these businesses?

James J. McKinney
Executive VP & CFO

So I would just highlight, we're rated an A inside the business. We expect that to continue. When you're thinking about this in terms of the overall transaction, we're stronger, right? We have a tighter -- we have a higher RBC ratio. We have greater flexibility, and we will be less leveraged as a company because of this. All of those things are very positive, right, from a credit perspective. And notice that what we're highlighting is our first priorities and our uses for capital is to maintain that very strong risk profile. And so I would -- yes, I would tell you, I think these are all positive elements. And we don't foresee any changes in terms of the way we're managing the business or other that would come through and any kind of change of ratings.

Operator

There are no further questions at this time. I will now hand you back over to Joe Lacher for closing remarks.

Joseph Patrick Lacher
Non-Executive Chairman, CEO & President

Thank you, everybody, for joining us on our call today, for your interest and your questions. We're excited about where we're headed and are making good progress on restoring underlying profitability of the organization. And I think as we mentioned a couple of quarters ago, we're going to spend some time on what we refer to as home improvement projects, and you're going to start to see the fruit of those labors being brought online. Look forward to speaking to you again next quarter. Take care.

Operator
This concludes Kemper's third quarter earnings conference call. You may now disconnect.