

American Financial Group, Inc. NYSE:AFG

FQ3 2017 Earnings Call Transcripts

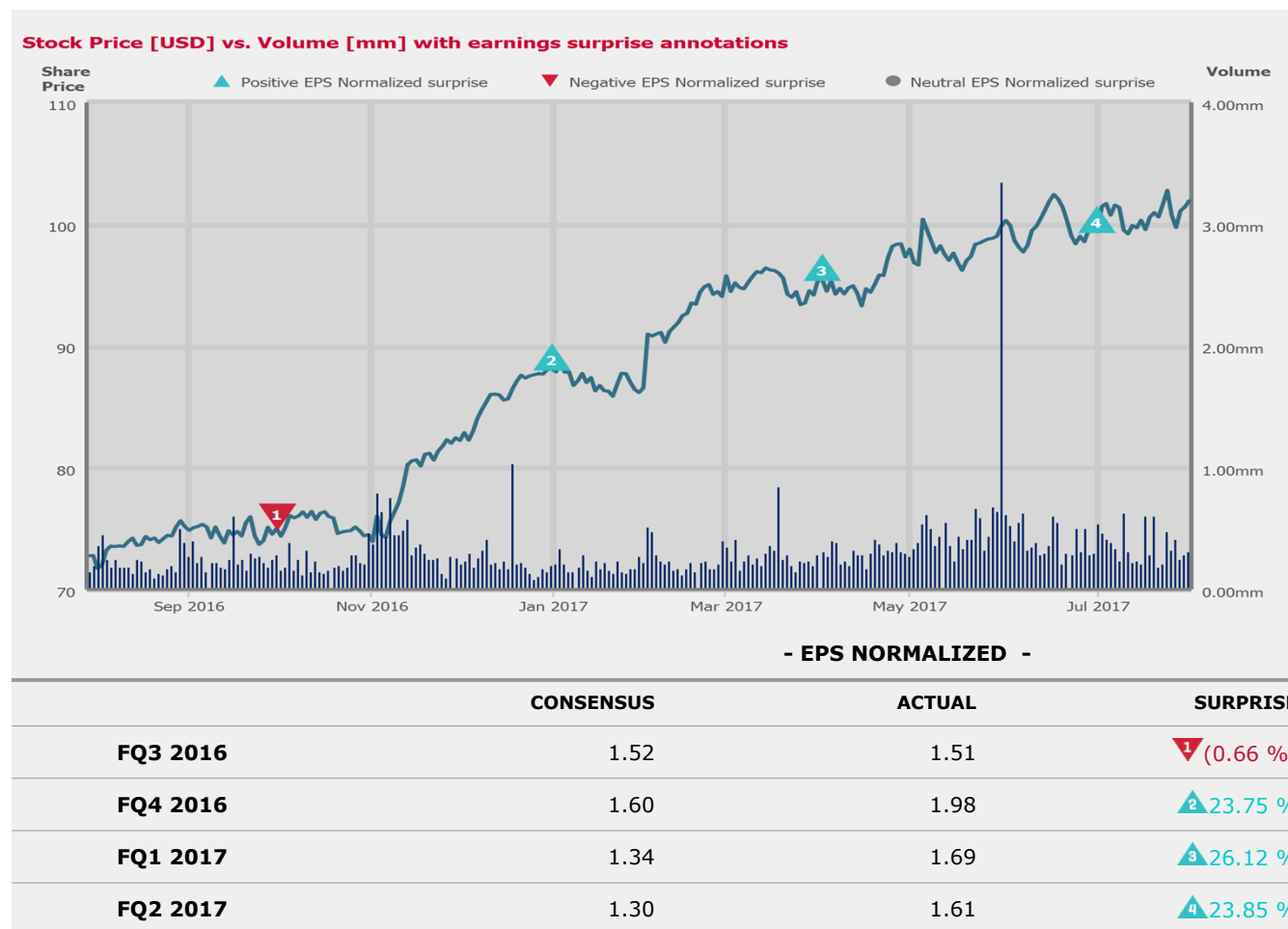
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S&P Capital IQ Estimates

	-FQ3 2017-			-FQ4 2017-	-FY 2017-	-FY 2018-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.84	1.06	▲24.71	1.81	5.96	6.75
Revenue (mm)	979.50	1267.00	▲29.35	1095.45	4063.80	4365.75

Currency: USD

Consensus as of Oct-13-2017 6:28 AM GMT



Call Participants

EXECUTIVES

Carl H. Lindner

Co-Chief Executive Officer, Co-President and Director

Diane P. Weidner

Assistant Vice President of Investors Relations

Joseph E. Consolino

CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd

S. Craig Lindner

Co-Chief Executive Officer, Co-President and Director

ANALYSTS

Amit Kumar

The Buckingham Research Group Incorporated

Charles Gregory Peters

Raymond James & Associates, Inc., Research Division

Jay Adam Cohen

BofA Merrill Lynch, Research Division

Jon Paul Newsome

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Lawrence David Greenberg

Janney Montgomery Scott LLC, Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the American Financial Group 2017 Third Quarter Results Conference Call. [Operator Instructions] As a reminder, this call is being recorded.

I would now like to introduce your host for today's conference, Ms. Diane Weidner, Assistant Vice President, Investor Relations. Ma'am, you may begin.

Diane P. Weidner

Assistant Vice President of Investors Relations

Good morning, and thank you. Welcome to American Financial Group's Third Quarter 2017 Earnings Results Conference Call.

I'm joined this morning by Carl Lindner III and Craig Lindner, Co-CEOs of American Financial Group; and Jeff Consolino, AFG's CFO.

Our press release, investor supplement and webcast presentation are posted on AFG's website. These materials will be referenced during portions of the call.

Before I turn the discussion over to Carl, I would like to draw your attention to the notes on Slide 2 of our webcast. Certain statements made during the call may be considered forward-looking as defined under the Private Securities Litigation Reform Act of 1995. These statements are not guarantees of future performance. Investors should consider the risks and uncertainties that could cause actual results and/or financial condition to differ materially from these statements. A detailed description of these risks and uncertainties can be found in AFG's filings with the Securities and Exchange Commission, which are also available on our website.

We may include references to core net operating earnings, a non-GAAP financial measure, in our remarks or in responses to questions. A reconciliation of net earnings attributable to shareholders to core net operating earnings is included in our earnings release.

And if you are reading a transcript of this call, please note that it may not be authorized or reviewed for accuracy. Thus, it may contain factual or transcription errors that could materially alter the intent or meaning of our statements.

Now I'm pleased to turn the call over to Carl Lindner III to discuss our results.

Carl H. Lindner

Co-Chief Executive Officer, Co-President and Director

Good morning. As we begin our remarks this morning, it's important to acknowledge that our thoughts and prayers remain with those who have been impacted by the catastrophic events these past few months. We are grateful to our claims professionals and insurance specialists who are helping our policyholders recover, restore their businesses and rebuild their communities.

We released our 2017 third quarter results yesterday afternoon. If you'd please turn to Slide 3 of the webcast slides for an overview.

Natural catastrophes and low interest rates notwithstanding, we reported core earnings per share of \$1.06 per share. These results include \$0.95 per share in previously announced catastrophe losses, the primary reason for the lower year-over-year operating earnings in our P&C insurance operations. Our third quarter cat losses did not change from what was preannounced a few weeks ago, and while significant, were within our risk tolerances. Third quarter annualized core operating return on equity was 8.1% for 2017 compared to 12.2% in '16.

Craig and I are pleased to report meaningful operating earnings amid an unprecedented level of natural disasters and a continued low interest rate environment, especially when many peers have reported net losses and/or declines in book value this quarter. Circumstances like these demonstrate the solid fundamentals underlying our business and the value within our diversified specialty insurance franchise.

Net earnings per diluted share were \$0.13. These results include noncore charges of \$0.82 per share to strengthen our A&E reserves, and also net realized losses on securities of \$0.08 per share, and as announced last quarter, \$0.03 per share related to the early retirement of debt.

Based on results through the first 9 months of 2017, we revised AFG's 2017 core operating earnings guidance to a range of \$5.90 to \$6.20 per share, a decrease from the range of \$6.40 to \$6.90 per share announced previously. This revised range includes our results through the first 9 months of the year and our expectations for fourth quarter catastrophe losses, including the California wildfires. And Craig and I will discuss our guidance for each segment of our business later in the call.

We continue to be encouraged by reports on tax reform and the lower corporate tax rate that both the Trump administration and congressional Republicans are advocating. This work is essential to enabling U.S. businesses to remain competitive. Beyond that, this work is essential also to ending a continuing pattern of U.S. businesses losing market share to offshore peers. We believe it's incumbent upon Congress to close the loophole provided by affiliate reinsurance that creates an unlevel playing field to benefit foreign competitors in both the property and casualty and annuity markets and deprives the U.S. Treasury of billions of dollars in tax revenue.

Now I'd like to turn our focus to our Property and Casualty operations. If you'd please turn to Slides 4 and 5 of the webcast, which include an overview of third quarter results. As I noted earlier, it's been a challenging few months for the industry overall, yet I'm pleased with the strong growth across our portfolio of P&C businesses and otherwise strong Specialty Property and Casualty underwriting profitability reported during the quarter.

On Slide 4, you'll see that gross and net written premiums increased 11% and 13%, respectively, in the 2017 third quarter compared to the same quarter a year earlier. Property and Casualty operating earnings were 38% lower year-over-year, with Specialty Property and Casualty underwriting profit down significantly due to higher catastrophe losses, primarily from Harvey, Irma, Maria and 2 earthquakes in Mexico.

The third quarter 2017 Specialty Property and Casualty combined ratio of 99.3% was 6.1 points higher than last year's third quarter and included 8.4 points in catastrophe losses and 2.9 points of favorable prior year reserve development. Overall, renewal pricing in our Specialty P&C Group was up 1% during the third quarter.

Now I'd like to turn to Slide 5 to review a few highlights from each of our Specialty Property and Casualty business groups. Our Property and Transportation Group reported third quarter underwriting profitability of \$6 million compared to \$44 million in the prior year period. Lower underwriting profits in our crop, property and inland marine and ocean marine businesses were the primary drivers of these results. Note, though, the comparable 2016 quarter included very strong profitability in our crop business. Catastrophe losses for this group were \$25 million in the third quarter of '17 compared to \$7 million in the comparable prior year period.

At this point in the year, we have a more complete view of our expected crop results, which are shaping up to be a bit better than we had planned. We expect to have a slightly above-average crop year. Fall harvest prices were established at the close of business yesterday with corn futures at \$3.49, down 11.9% from spring discovery prices; and soybeans at \$9.75, down 4.3%. Both are well within acceptable ranges from spring discovery prices. Corn and soybean yields are above the 5-year trend line averages. And we're pleased that our initial concerns with regards to drought conditions in the Dakotas and Montana didn't materialize to the extent that we had anticipated.

For Property and Transportation, third quarter gross and net written premiums were 8% and 7% higher, respectively, than the comparable 2016 period. The increase was largely the result of higher year-over-

year premiums in our agricultural and transportation businesses. This growth was partially offset by lower premiums resulting from an exit from the custom bonds business, which was part of our ocean marine operations. Overall renewal rates in this group increased 2% on average for the third quarter of '17, with most of our price increase coming from commercial auto and non-crop agribusiness operations.

Specialty Casualty Group reported third quarter underwriting profitability of \$2 million compared to \$13 million in the prior year period. Higher underwriting profitability in our excess and surplus lines, targeted markets, workers' compensation and professional liability businesses were more than offset by lower underwriting profitability within Neon, primarily the result of third quarter catastrophe losses. Neon's book includes property cat-exposed business which is consistent with its Lloyd's peers. Catastrophe losses for this group were \$56 million and \$2 million, respectively, in the third quarters of '17 and of '16, respectively.

Gross and net written premiums increased 18% and 24%, respectively, for the third quarter of '17 when compared to the same prior year period. New accounts written in our targeted markets businesses were the primary driver of the increase. Additionally, higher premiums in our workers' comp businesses, primarily the result of rate increases in Florida, coupled with the growth in our executive liability, excess and surplus businesses and Neon, contributed to the year-over-year growth. In addition, net written premiums were higher as a result of timing of reinsurance placements within Neon. Renewal pricing for this group increased by 1% in the third quarter. Pricing decreases that continued in our California workers' comp operations were more than offset by pricing increases in our other workers' comp businesses and with our -- and within our excess and surplus lines businesses.

Now our Specialty Financial Group reported an underwriting loss of \$3 million in the third quarter compared to an underwriting profit of \$19 million in the third quarter of '16. The decrease was due primarily to catastrophe losses in the lender-placed mortgage property book. Most of the other businesses in this group continue to achieve strong underwriting margins. Catastrophe losses for this group were \$31 million and \$5 million, respectively, in the third quarters of '17 and 2016, respectively.

Gross written premiums decreased by 3% and net written premiums increased 1% in the third quarter when compared to the same 2016 period. Lower premiums in our financial institutions business were partially offset by higher premiums in our surety business. Renewal pricing in this group decreased by 1% for the quarter, driven by a decrease in our lender-placed mortgage property insurance book.

Now please turn to Slide 6 for some review of our 2017 outlook for the Specialty Property and Casualty operations. Based on results through the first 9 months of '17 as well as our expectations for fourth quarter cat losses, we estimate a combined ratio between 94% and 95%, which is slightly higher than the range of 92% to 94% estimated before a very active third quarter for catastrophes. We now expect growth in net written premiums to be in the range of 6% to 9%, which is up from our previous estimate of 3% to 7%. And we've adjusted assumptions within each of our Specialty Property and Casualty groups slightly.

Our revised P&C earnings guidance includes an initial estimate of expected losses from the California wildfires in October. Based on the information available at this time, we estimate a pretax loss from these events, net of reinsurance and inclusive of reinstatement premiums, in the range of \$20 million to \$25 million, the midpoint of which is approximately \$0.18 per share.

We now estimate a combined ratio in the range of 92% to 94% in our Property and Transportation Group, narrowed a bit from the range of 91% to 95% estimated previously. Growth in net written premiums is now expected to be in the range of 3% to 6%, a change from the 2% to 6% estimated previously.

And our Specialty Casualty Group is now expected to produce a combined ratio in the range of 96% to 98%, 2 points higher than the range of 94% to 96% estimated previously. Growth in net written premiums is now expected to be in the range of 10% to 13%, up from our previous estimate of 7% to 11%.

The combined ratio in our Specialty Financial Group is now expected to be in the range of 88% to 90%, revised upward from the range of 84% to 88% previously announced. Additionally, we expect net written premiums in this group to be up 2% to 5%, slightly higher than our previous range of flat to 4%.

We continue to expect overall Property and Casualty renewal pricing in 2017 to be flat to up 1%. I surely expect there to be implications from the magnitude of the recent catastrophe losses as insurers, reinsurers and capital providers take a hard look at the erosion of surplus and what it will take to achieve appropriate risk-adjusted returns. We intend to be out front on improved underwriting selection and pricing for property business, and especially cat-exposed property business, in anticipation of price increases in the reinsurance markets. Our strategy is to continue to have a lower relative net catastrophe exposure when compared to industry peers. We'll give you an update on our outlook for 2018 pricing when we release our fourth quarter results.

Finally, we expect 2017 Property and Casualty investment income to grow between 4% and 6% year-over-year.

Now I'll turn the discussion over to Craig to review the results in our Annuity segment and AFG's investment performance.

S. Craig Lindner

Co-Chief Executive Officer, Co-President and Director

Thank you, Carl. I'll start with a review of our Annuity results for the third quarter, beginning on Slide 7. The Annuity segment reported \$102 million in pretax operating earnings in the 2017 third quarter compared to \$107 million in the third quarter of 2016. Under GAAP rules, a portion of reserves for FIAs is considered an embedded derivative and is recorded at fair value using assumptions for items such as projected interest rates, option costs and surrenders. Variances from those assumptions as well as changes in the stock market and interest expense related to the embedded derivative reserve are recognized through AFG's recorded core earnings. Many of these adjustments are not economic in nature, but rather impact the timing of reported results.

In the third quarter of 2017, the benefit of a higher stock market was more than offset by lower interest rates, resulting in a \$4 million unfavorable impact to Annuity operating earnings. In the third quarter of 2016, the impact from changes in the stock market and interest rates was a positive \$1 million. Annuity earnings before the impact of fair value accounting were \$106 million in both the third quarters of 2017 and 2016.

As you'll see on Slide 8, AFG's quarterly average Annuity investments and reserves grew by approximately 11% and 12%, respectively, year-over-year. However, the benefit of this growth was offset by the runoff of higher-yielding investments. Both quarterly periods included the positive impact from a strong stock market and higher-than-expected income from certain investments required to be marked to market through earnings.

AFG's Annuity segment reported statutory premiums of \$876 million in the third quarter of 2017 compared to \$941 million in the third quarter of 2016. This decrease resulted from AFG's adherence to pricing discipline and a relatively low and decreasing interest rate environment during the year as well as from aggressive pricing by certain of our competitors. Additional information can be found in AFG's Quarterly Investor Supplement posted on our website.

Please turn to Slide 9 for a summary of the 2017 outlook for the Annuity segment. Based on results through the first 9 months of 2017, we now expect 2017 earnings before fair value accounting for fixed-indexed annuities to be in the range of \$395 million to \$410 million, an increase from the \$385 million to \$405 million previously estimated. This is the third increase this year of our pre-fair value guidance.

Our forecast assumes modest increases in interest rates and the stock market in the fourth quarter as well as a more normalized expectation of earnings from certain investments required to be marked to market through earnings.

We continue to expect our 2017 pretax Annuity operating earnings to be in the range of \$370 million to \$390 million. Fluctuations in the returns on investments that are required to be marked to market through earnings or large changes in interest rates and/or the stock market as compared to our expectations could lead to additional positive or negative impacts on the Annuity segment's results. These earnings expectations do not reflect any potential impact from our fourth quarter review or unlocking of the major actuarial assumptions in our fixed annuity business.

Based on premiums through the first 9 months of the year and our recent level of sales, we now expect 2017 Annuity premiums to be slightly lower than the \$4.4 billion reported in 2016, a slight decrease from our previous estimate that premiums would remain flat year-over-year.

The Department of Labor Fiduciary Rule became effective on June 9, 2017, although the DOL delayed certain requirements until January 1, 2018. As a result, insurance-only agents are able to continue selling fixed-indexed annuities through the end of 2017 provided the agent acts in the customer's best interest, makes no misleading statements and receives only reasonable compensation. The DOL recently released a proposal to delay full implementation of the rule until July 1, 2019. There is uncertainty as to whether the rule will take effect in its current form at that date. We continue to believe that full implementation is likely to cause short-term disruption in annuity premiums. Nonetheless, we do not believe the new rule will have a material impact on AFG's results of operations. We believe that our business model, which we adopted many years ago, positions us well in a changing regulatory environment.

Please turn to Slide 11 for a few highlights regarding our \$45 billion investment portfolio. AFG's third quarter 2017 net realized losses on securities of \$8 million after-tax and after deferred acquisition costs compared to net realized gains on securities of \$1 million in the comparable prior year period. As of September 30, 2017, unrealized gains on fixed maturities were \$533 million after-tax, after DAC, and unrealized gains on equities were \$173 million after-tax.

As you'll see on Slide 12, our portfolio continues to be high quality, with 90% of our fixed maturity portfolio rated investment grade and 98% with an NAIC designation of 1 or 2, its highest 2 categories.

We provided additional detailed information on the various segments of our investment portfolio in the Quarterly Investor Supplement on our website.

I will now turn the discussion over to Jeff, who will wrap up our comments with an overview of our consolidated third quarter 2017 results and share a few comments about capital and liquidity.

Joseph E. Consolino

CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd

Thank you, Craig, and good morning, everyone. We're pleased to report \$1.06 in core EPS in a particularly challenging quarter for our industry. Slide 13 summarizes the operating earnings results that Carl and Craig have covered. The \$1.06 is based on core net operating earnings in the quarter of \$95 million. You'll see a more detailed view of the components on Page 4 of our Quarterly Investor Supplement.

Property and Casualty pretax operating earnings were down by \$58 million when compared to the 2016 third quarter. Significantly higher catastrophe losses were the story in the quarter for our P&C segment and for the P&C industry. We had preannounced pretax catastrophe losses of \$105 million for the quarter on October 3. These cat losses were \$91 million higher year-over-year when you compare the \$105 million in Q3 2017 to the \$14 million in last year's third quarter.

One year ago, we were preparing to close the merger with National Interstate, which was completed in November 2016. The elimination of the noncontrolling interests, which was booked in P&C other expense, and the double taxation related to National Interstate, coupled with improvements in underwriting profitability, resulted in National Interstate contributing \$0.17 per share to AFG's third quarter 2017 results compared to only \$0.03 per share in the previous year's third quarter.

As Craig noted earlier, annuity earnings before fair value accounting were flat year-over-year. Pretax annuity operating earnings decreased by \$5 million due to fair value accounting adjustments.

Parent company interest expense increased by \$2 million. Other expenses were \$9 million lower year-over-year, primarily the result of lower holding company expenses.

We had an extraordinarily high effective tax rate on core operating earnings during the third quarter of 40%. This is driven by catastrophe losses in Neon for which no tax benefit can be recognized. AFG's effective tax rate on core earnings through the first 9 months of the year was 33%. Our full year earnings guidance for 2017 now assumes an effective tax rate of approximately 32% on core pretax operating earnings.

Slide 14 provides a reconciliation of core net operating earnings to net earnings. In addition to realized losses on securities and the loss on the retirement of AFG's 5 3/4% senior notes, net earnings were reduced by an A&E reserve strengthening of \$74 million or \$0.82 per share. The detail of our special A&E charge is presented at the bottom of Slide 14. According to data provided by S&P Global Market Intelligence, industry 3-year survival ratios for asbestos and environmental reserves were 6.4x paid losses as of year-end 2016. The 3-year survival ratio for AFG's P&C insurance businesses now stands at 14.6x paid losses.

As indicated on Slide 15, AFG's adjusted book value per share was \$55.08 as of September 30, 2017. Note that we paid dividends of \$2.44 per share year-to-date. The result is growth in book value plus dividends was 8.3% through the first 9 months of 2017. Adjusted tangible book value per share was \$52.50 at September 30, 2017.

At the end of the quarter, parent cash was \$435 million. We maintain sufficient capital in our insurance businesses to meet our commitments to the rating agencies. And our overall excess capital stood at approximately \$1.1 billion at September 30, 2017. This is substantially equivalent to the balance at the outset of the quarter.

The payment of the second quarter 2017 special dividend and the cat losses in the third quarter will not preclude our consideration of a special dividend later in the year. We returned \$27 million to our shareholders through dividends during the quarter. We announced in August that our board had approved an increase in the company's regular annual dividend from \$1.25 per share to \$1.40. That was a 12% increase and it commenced with the dividend we paid in October. The company has increased its dividend in each of the last 12 years.

Approximately 4.1 million shares remain under our repurchase authorization as of November 1. We plan to hold approximately \$200 million to \$300 million as dry powder to maintain flexibility for opportunities that may arise. We review all opportunities for the deployment of capital on a regular basis.

In closing, Page 16 presents a single-page summary of our 2017 core earnings guidance. AFG's expected 2017 core operating results exclude noncore items such as realized gains and losses and other significant items that may not be indicative of ongoing operations.

Now we'd like to open the line for any questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Amit Kumar with Buckingham Research.

Amit Kumar

The Buckingham Research Group Incorporated

Just a few couple of questions. The first question goes back to the discussion on guidance. You mentioned the California wildfire number. Can you sort of help us like maybe just state what exactly -- what's the dollar amount of the number that you're factoring in, just so that we're on the same page?

Carl H. Lindner

Co-Chief Executive Officer, Co-President and Director

A range of \$20 million to \$25 million pretax after SC reinstatements in that. I think we said \$0.18 per share is what we're figuring.

Amit Kumar

The Buckingham Research Group Incorporated

Okay. I missed that. Apologies for that.

Carl H. Lindner

Co-Chief Executive Officer, Co-President and Director

That's all right. I think probably a lot of that will fall in probably Specialty Casualty related to winery losses.

Amit Kumar

The Buckingham Research Group Incorporated

Got it. That's helpful. The second question I had was on the underlying loss ratio in Property and Transportation as well as Specialty Financial. Can you guys talk about why the underlying loss ratio was higher in those 2 segments compared to Q3 2016?

Joseph E. Consolino

CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd

Amit, this is Jeff. For Property and Transportation, I know that you're well acquainted with our crop business. And last year, the crop business performed at a very high level for us. So I'm looking at our investor supplement. When you look at the underlying combined ratio, it moved up by 5.4 points quarter-over-quarter. Now if you go back and look at where we were in the third quarter of 2015, which was more of a normal crop year, it's substantially equivalent in the third quarter of '17 than it was in the third quarter of '15. And so what you're seeing there is the impact that a very good crop year could have on the Property and Transportation segment. Carl, previously in the call, referred to the 2017 crop year as slightly above average, and we'll certainly update you on that when we get to the fourth quarter results of operations.

In terms of the Specialty Financial, it's our smallest P&C subsegment and it has a unique aggregation of businesses, many of which aren't correlated with the overall P&C markets. We've always encouraged people not to look at the loss ratio there, but to look at the combined ratio. And so when you look at the underlying combined ratio, that's moved by 2.2 points down during the course of the quarter. So a lot of times when you have movements up in the loss ratio, there are offsets in the expense ratio that would affect that. So I would continue to encourage you to view that segment on that basis rather than just picking out the loss ratio data.

Amit Kumar

The Buckingham Research Group Incorporated

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Got it. The other -- the only other question I had for now was the overall expense ratio was lower. And is that due to comp accrual numbers or was there anything else why the overall expense ratio in P&C was lower?

Joseph E. Consolino

CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd

That would be one element. Also, when you look at our release as it relates to the third quarter catastrophe events -- and that ties into what we were just talking about -- one of the offsets to the catastrophe losses after reinsurance and after reinstatement premiums was a release or reversal of previously accrued profit commissions, particularly in the Specialty Financial subsegment. We quantify that as \$8 million. So that also would contribute to a lower overall P&C expense ratio.

Operator

Our next question comes from Paul Newsome with Sandler O'Neill.

Jon Paul Newsome

Sandler O'Neill + Partners, L.P., Research Division

I want to ask first a broad-based question about possible changes, if any, and specifically how you're underwriting post the numerous hurricanes? And is it just you're going to be a little bit more tougher -- welcome -- or even welcome higher prices? Are you actually changing specifically how you're underwriting, maybe getting out of businesses or restrictions of any kind on your underwriting prospectively post the third quarter?

Carl H. Lindner

Co-Chief Executive Officer, Co-President and Director

I think it's some of all of the above, Paul. This is Carl. Generally, when things -- when catastrophes like the string of catastrophes happen, I always -- the first thing I do is ask our operating guys 2 questions: what did you learn? And what are you going to -- what adjustments are you going to make? Well, just like a lot of other companies, we're in the middle of lessons learned and also how we're going to adjust our approach to things. There's always -- every event always has some unexpected twists and turns. Harvey, I think, surprised the industry with the size of the flood component there with the storm just kind of -- rain settling in there for days at a time in that. I'm not sure the models really assume that, for instance. The California wildfires, I think, generally, the industry probably thought the communities themselves would be protected and you couldn't have the size of losses that you had in Santa Rosa. So we're right in the middle of the lessons learned part and we're also right in the middle of adopting what our strategy is going to be. And it could be different for different parts of the business in that. Obviously, on Neon's property cat book, prices are going up and the D&F book. We're determining what those are. In our wildfire-exposed business, we're in the middle of also reviewing that. And we're -- I'd say, generally, as I mentioned in our call, we intend on moving forward and adjusting prices and terms and underwriting appetite as we feel is necessary to achieve the right returns long term. So that's our approach to the property business right now.

Jon Paul Newsome

Sandler O'Neill + Partners, L.P., Research Division

Could you also talk about the asbestos charge in the third quarter? It seemed to me quite large in size. And I would have expected maybe some asbestos charge, but seeing how it -- it doesn't seem to ever end. But if anything, it looks like it's getting worse, not better in an environment where theoretically people exposed to these -- to the asbestos should have been no longer with us as we all age. So I'm surprised and should we just continue to think that asbestos reserves just need to be pumped up by somewhere in that same range every quarter -- in every third quarter?

Joseph E. Consolino

CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd

You kind of had me when you said every quarter. This is Jeff Consolino, Paul.

Jon Paul Newsome*Sandler O'Neill + Partners, L.P., Research Division*

Yes, that would scare us all, I suppose.

Joseph E. Consolino*CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd*

Let me start with the fact that, as you say, the third quarter of every year is when we take a more in-depth look at these legacy exposures, asbestos and environmental. We alternate years. This year is part of the every other year cycle where we have an outside expert or a group of outside experts come in and help us look at our exposures. That would include an internationally recognized expert actuarial firm as well as other subject matter experts and expert counsel. And so last year would have been the off year where we would have looked internally. So when you go through and look at the history of our third quarter movements on A&E, I wouldn't necessarily compare the third quarter of '17 to the third quarter of '16 because the reason we hire outside experts is to augment the expertise we have with an outside or fresh perspective. Also, since the third quarter evaluation of 2016, you would have seen that A.M. Best published in November of 2016 their updated look at these exposures for the industry based on their review of the statutory annual statement footnote 33 data. The result there was that A.M. Best did not change their ultimate loss expectation for environmental, but moved up their asbestos ultimate expectation for the industry from \$85 billion to \$100 billion, which is about an 18% increase there. And in that, on the asbestos side, they took note of the fact that for workers who were in their peak working years when asbestos use peaked out, they're well on in age as you referred to, but life expectancy [indiscernible]. As a result, Paul, what you have is people living longer and having a longer gestation period under which they might develop a concern over some kind of illness that they would associate with asbestos exposure. And so A.M. Best and other outside experts [use that] in saying the industry needs more pure IBNR and also needs to [indiscernible] patterns for asbestos. On the environmental side, for us, it's all very site-specific. And so we look at the sites. Certainly, as we said, the length of time that we're seeing to resolve these specific sites and payments for defense and evaluation are increasing somewhat. That's what led to that move. Taking a step back, we're never going to promise that this is all behind us. These are complex exposures. We're doing our best to reserve at an appropriate level across the business, including with this. And that's the number we came up with this quarter. I wouldn't read that into anything for future quarters or future years.

Operator

Our next question comes from Greg Peters with Raymond James.

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

Carl and Jeff, could you talk a little bit about the reinsurance structure for your crop business and possibly how it might change next year considering this year's results? And then maybe broaden it out to potential changes in reinsurance costs for other parts of your business going into next year?

Joseph E. Consolino*CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd*

Thanks, Greg. Starting with crop, we make effective use in our crop business of both quota share reinsurance and also stop-loss reinsurance. And we think that we've got an excellent set of reinsurers and strong reinsurance partners involved in that. Our quota share is a multiyear treaty, although we have the ability to flex the amount ceded. So that would not be something that we'd be making wholesale changes to at this point. More broadly in the reinsurance ceded part of our business, we have concluded some treaties that cover some among our 35 specialty P&C businesses in the last couple of weeks, months. And for those businesses which are generally not property exposed, we've continued to get very favorable terms, including favorable ceding commissions. So we're pleased with that.

We do renew our corporate property catastrophe and property-per-risk treaties at January 1. And Neon also renews its treaties at the outset of the year. Certainly, we're aware of the discussion and rhetoric

about increased reinsurance costs. Notwithstanding this year, we feel like Great American, for example, has done an excellent business to reinsure over a long period of time given our approach. So we'll go into the market and work with our partners to work out whatever the best and most appropriate deal is when it comes to that renewal. I guess I don't want to really prejudice those discussions with a lot of extraneous commentary at this point, but we'll certainly let you know how it went when we get back together for the fourth quarter call.

Charles Gregory Peters

Raymond James & Associates, Inc., Research Division

On the catastrophe loss in the Specialty Financial book, I know you talked a little bit about it in your prepared comments and in one of your answers. But I was kind of surprised by the loss, and I'm curious whether it's something we should start to anticipate in our projections going forward, that there will be periodic catastrophe losses of that size in that business.

Carl H. Lindner

Co-Chief Executive Officer, Co-President and Director

I think it's basically a property book. So I think -- and it's a large book. It's some \$300 million or so. So the book does have catastrophe exposures. And this book, we've tried to manage, as in some of our other businesses, to lean towards accounts that aren't as heavily coastal-property exposed. But when you're writing accounts that have broad geographic mixes, you're bound to have some coastal property in it. So this was an unusual event or an unusual quarter when you had the number of sizable events that there was. So I think that's the unusual thing when you look at the whole industry's numbers company-by-company, pretty -- they're larger than usual. So I know -- that would be -- those will be my thoughts.

Joseph E. Consolino

CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd

Greg, if I could pile on. This is Jeff Consolino. What we saw in the third quarter was a frequency of severity, the multiple events striking the U.S. and also other parts of the world. One observation we made in our pre-announcement in early October was we have a comprehensive reinsurance program which provides us with a lot of vertical cover against extreme events. But when you have multiple events, we are going to be retaining a net loss before the reinsurance towers kick in.

You asked about expectations going forward. Year-to-date, our cat loss as a percent of earned premium is below 4%, in the high 3s. If you look over a 15-year period for our company, a year would typically run at about 1.5 points. And so echo Carl's thought that this is an unusual quarter. But anytime you have a lot of cat activity, lessons are learned and different things happen. Years where we've had cat losses exceeding 2% of earned premium, you'd have to go back to years like 2008 with Ike and Gustav and other U.S. windstorms, 2005 which was the KRW year, and 2004 with Charley, Frances, Ivan, and Jeanne. So the nature of catastrophes is they're lumpy. They're infrequent. I just gave you a number that spans a 15-year period as well as some points that exceed the 15-year average. How that plays out in any one year, it's up to providence to tell us with retrospect. What doesn't change is we are going to maintain a prudently cautious approach to accepting catastrophe risk. And we'll maintain a comprehensive outward set of reinsurance protections to manage against the extreme events. So maybe that's one way to think about it and one way to frame the question you asked, but that's what I would offer at this point.

Charles Gregory Peters

Raymond James & Associates, Inc., Research Division

Craig, if I could just ask one question to you, or actually in 2 parts. Can you update us on where American Financial is in the cycle of reduction of crediting rates? And if there's any room further for reduction or if there's any plans? And then on the annuity sales by channel, I know you provided some color in your opening comments, but I -- hoping that you could provide us some additional color on sales by the bank channel, by independent agent channel, et cetera.

S. Craig Lindner

Co-Chief Executive Officer, Co-President and Director

Okay. Let me address your first question. We have the ability to lower credited rates on \$24.4 billion of reserves by another 88 basis points. So a significant amount of room. Now whether -- how much of that we are going to implement really will be a function of the level of interest rates. Because of our model, generally, lower cost of putting business on the books, we have been able to maintain credited rates longer than many of our competitors even in a declining interest rate environment. But it is nice to have the cushion that we have in the event that interest rates would fall from here, which we don't expect, but it's certainly a possibility. And we have a tremendous amount of room to continue to lower credited rates if we would need to, to maintain spreads and profitability. Second question, hang on one minute. Let me get the breakdown on premiums.

Charles Gregory Peters

Raymond James & Associates, Inc., Research Division

I was looking at Slide 15 in your supplement, I believe, where you provide statutory annuity premiums, Craig.

S. Craig Lindner

Co-Chief Executive Officer, Co-President and Director

Okay. Let me go to that, Greg.

Operator

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

Jay Adam Cohen

BofA Merrill Lynch, Research Division

I'll be patient while you get that question.

Diane P. Weidner

Assistant Vice President of Investors Relations

I think we're going to go back to Mr. Peters' question on the annuity section for just one moment, and then we'll address Jay's question. Thank you.

S. Craig Lindner

Co-Chief Executive Officer, Co-President and Director

So your question on the premiums, it shows us the breakdown here between retail and financial institutions. In the quarter, financial institutions did -- premiums did slow a bit in -- as we can see in the numbers. What was your specific question on the breakdown of premiums, Greg? I mean, Greg, we think that longer term, the financial institutions side of the business will continue to be the growth engine for us, although we were happy to see the retail premiums pick up a bit. Our hope is we're going to be able to, over time, continue to grow both sides of the business.

Jay Adam Cohen

BofA Merrill Lynch, Research Division

Can you guys hear me? It's Jay Cohen.

Diane P. Weidner

Assistant Vice President of Investors Relations

Jay, if you could go ahead and continue. I think you're next in the queue. Thank you.

Jay Adam Cohen

BofA Merrill Lynch, Research Division

On the Property and Transportation specifically, I guess it's the crop business. I probably didn't appreciate the seasonality in that business. It does -- now that I look back, it appears that the third quarter loss ratio tends to be higher than the first half. First, is that accurate? Secondly, why is that?

Joseph E. Consolino*CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd*

Jay, this is Jeff. You definitely are on to something there. Agriculture itself is a seasonal business and as a result, our profit is seasonal. I mean, in general, when you look at our premiums in the Property and Transportation segment, and I'm looking at Slide 8 in our deck, you can see a significant amount of premium coming through in the third quarter, both in '16 and in '17 compared to the other quarters. And so this is the quarter where we recognize a lot of the premium from the crop business. I would distinguish that from profit, where generally we wait to know how the crop year has turned out. So we tend to have the bulk of our profit come through in the fourth quarter once we've gotten through the averaging period that Carl gave the statistics on. And so that's how the crop business works. And for better or for worse, we tend to book only modest or no underwriting profit leading up to the time that we're through the averaging period. Just so you may recall in past years, some other companies that didn't have the same approach would go ahead and book profits. And then if you had either a fall in price or a decline in yield or drought or other conditions, they'd have to turn around and unbook previously booked profits that they shouldn't have booked in the first place. So we want to make sure that we're appropriately recognizing the profit once all the unknowns have been resolved.

Carl H. Lindner*Co-Chief Executive Officer, Co-President and Director*

And Jay, the first quarter sometimes can be a true-up. There are some crops, like citrus and things, you don't know what the answer is, or in years where there are lots in numbers of claims, it takes a while. And you may not have a complete picture until you get through the first quarter. So if the profit ends up being larger in those years, some of that gets booked in the first quarter of the following year.

Jay Adam Cohen*BofA Merrill Lynch, Research Division*

Got it. Got it. I've only covered you guys for 20 years. I probably should have picked up on this earlier, but glad I did now, so thank you for that. Second question, on the casualty business, you mentioned there was some benefit from timing. Can you quantify what the growth rate would have been excluding that timing impact?

Joseph E. Consolino*CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd*

Jay, this is Jeff. I'm not going to quantify it right now because I want to be precise, not give you numbers. But directionally, the timing difference was with Neon, the new management team conducted their strategic review in the first part of 2016 and as a result, had pushed a lot of their reinsurance decisions until after they made a decision on what the business is going to be. So that resulted in a lot of outwards reinsurance being placed for Neon in the third quarter of 2016. Once that project was completed, Neon reverted to more of a traditional January-centric purchase of reinsurance. And so you've got apples-and-oranges in terms of Neon ceded premium between Q3 of '16 and Q3 of '17.

Jay Adam Cohen*BofA Merrill Lynch, Research Division*

Got it. I mean, it's really just a net to gross then. So going forward, it really shouldn't have much of an impact?

Joseph E. Consolino*CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd*

That's correct. I mean, there's a lot else going on in Specialty Casualty premiums this quarter with growth in our targeted markets business and other lines, but Neon's contribution is timing, not anything other than that.

Jay Adam Cohen*BofA Merrill Lynch, Research Division*

That is helpful. Last question. Carl, you may have touched on this during your commentary, but for some reason, the sound quality when you were speaking was not very good. The question is on workers' compensation. Florida arguably should be getting better given the price increases, but certainly, we hear about competitive conditions outside of California -- Florida, where prices generally are going down. Net-net, does workers' comp get better as you move into 2018 or is there some downward pressure on the margins?

Carl H. Lindner

Co-Chief Executive Officer, Co-President and Director

We're talking specifically about Summit? Is that what your focus is on?

Jay Adam Cohen

BofA Merrill Lynch, Research Division

I was thinking of comp more broadly. Obviously, Summit's a big piece of it.

Carl H. Lindner

Co-Chief Executive Officer, Co-President and Director

I think you almost have to kind of look at the pieces in our case. And then I think Summit, which is Florida and Southeast, we've been real pleased with their results and by the caliber of the management team we have there. We've had good underwriting profitability since we acquired it. Still with the Florida rate change this year and the predictive analytics being used there, we feel good about this year being able to be an overall profitable year from an underwriting standpoint at Summit. And one thing you may be referring to is, there's a rate decrease in the State of Florida which has not been approved yet, which is around 9% that's being proposed. I think in the case of Florida, Florida's underwriting profit, if that rate decrease is taken, will be smaller underwriting profit. I think with that, we figure we'll still be able to make a -- maybe a very small underwriting profit. Overall though, Summit should make a solid underwriting profit. There are some pricing adjustments in some of the other Southeastern states that has had an impact there. Generally, when you see the price increases or price decreases, it's a response towards historical accident year profitability being better. So it's kind of good news, bad news. Yes, your premium's impacted, but when we look at our overall reserve position in Summit, it's very solid. So that's my perspective. For continued overall -- I think in the Summit business, we'll continue to make an overall solid underwriting profit. Florida, if that rate is approved, maybe that piece not as -- still make an underwriting profit, but not a -- a small one. In California, another -- well, a state that's significant for us, our outlook for this year is for a solid accident year underwriting profit. Again, a similar type of situation, a rate decline of about 10% this year. And there's a small January 1, '18, decrease that -- of a couple -- maybe 3 to 4 -- somewhere in the 3% to 5% probably for us going forward in '18 that's projected. I think on an accident year basis, I think we'll make -- we'll continue to make a small accident year underwriting profit next year. Although that's still at a double-digit return on equity in that. Again, because of the improving industry results and the prior accident years being better, we have a -- I consider to be a strong reserve position in our California comp company. We still -- we feel real positive about the claims environment and reform is holding in California. We don't see really any change in that claims environment happening over the next couple of years. The loss cost trends and loss ratio trends seem to be very mild. And we're implementing predictive analytics starting this past September in both underwriting, pricing and claims there. So I think that will also offset some of the impact on the rate. Those are our 2 biggest pockets. National Interstate writes some workers' comp. I think rates aren't really moving much either way there. And that business has been profitable. So that's -- that would be my perspective on our business.

Jay Adam Cohen

BofA Merrill Lynch, Research Division

That's a great update.

Joseph E. Consolino

CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd

Jay, this is Jeff. Carl had encouraged me to be a little bit more precise in my answer to the Specialty Casualty growth. So when you look at the third quarter, our third quarter net written premium in that segment is \$624 million. That's up \$120 million from the \$504 million a year ago. Out of that \$120 million, approximately \$20 million is attributable to the timing of the Neon reinsurance purchases. And then point out also that Neon is growing on a gross basis beyond that and contributes to the overall growth, probably at the same level that a Summit would or something. But the biggest component of the growth when you take out the timing is the targeted markets business, as we had indicated.

Operator

[Operator Instructions] And our next question comes from Larry Greenberg with Janney Montgomery.

Lawrence David Greenberg

Janney Montgomery Scott LLC, Research Division

Just 3 quickies, I think, all related to the California fires. The first, you mentioned that it was going to be mostly in Specialty Casualty. So I assume that's Neon, and I assume that would suggest maybe a slightly elevated tax rate again for the fourth quarter. And then, are these going to be treated as one or multiple events? And then finally, just when you talk about the cat load for this, do you just -- would you just be adding that to your normal fourth quarter cat load? Or when you think about guidance, is it netted against a piece of what would be the normal cat load?

Carl H. Lindner

Co-Chief Executive Officer, Co-President and Director

Maybe I'll address the question about Neon and with the wildfire. Actually, Neon is really not that big of a piece of the wildfire. It's really mainly within our targeted markets business, within our Specialty Casualty area written by Great American.

Joseph E. Consolino

CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd

Larry, just to continue on with that. So that's why we had made the comment about -- at the midpoint at \$0.18 a share. So when you work through that math, that would not therefore distort our expected tax rate in the fourth quarter. And when I had gone through what we expected our tax rate to be for the full year, that would be considered in there.

As for whether this is an event or a series of events, I think for a company in the abstract, they would have to go back and review the terms of their outwards reinsurance. Many reinsurance contracts are subject to things like hours clauses or things like contiguous or co-located events within a certain radius or diameter of a footprint. We believe that the California wildfires are a single event, even though they have multiple PCF numbers as you apply that our reinsurance.

Lawrence David Greenberg

Janney Montgomery Scott LLC, Research Division

And then -- and just the final one. Would you just add what you expect from the California wildfires to your normal cat load or do you net it against a piece of that?

Joseph E. Consolino

CFO, Executive VP, Director and Chairman of the Board of Neon Capital Ltd

Yes, I think, Larry, the -- we're probably closer in our guidance to adding on top of the normal cat load, but we might have made a tweak here or there on top of what we were expecting for the quarter to reflect the fact that we're end of the quarter and have some events. But this is not -- we have additional assumptions about further cat losses, i.e., a cat load in the fourth quarter that would be greater than what we have talked about here for the California wildfires. So there's some cat buffer, if you will, in our thinking.

Operator

At this time, I'm showing no further questions. I would like to turn the call back over to Ms. Diane Weidner for closing remarks.

Diane P. Weidner

Assistant Vice President of Investors Relations

Thank you. Thank you all for joining us this morning, and we look forward to talking with you again at the end of next quarter.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program. You may now disconnect. Everyone, have a great day.

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