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Earnings Call

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Call Participants

EXECUTIVES

James J. McKinney
Executive VP & CFO

Joseph Patrick Lacher
Chairman, CEO & President

Karen Guerra
Vice President of Investor Relations

Matthew Andrew Hunton
Executive VP & President of Kemper Auto

ANALYSTS

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

Jon Paul Newsome
Piper Sandler & Co., Research Division

Presentation

Operator

Good afternoon, ladies and gentlemen, and welcome to Kemper's Second Quarter 2023 Earnings Conference Call. My name is J.P. and I will be your coordinator 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 second quarter 2023 results. This afternoon, you'll hear from Joe Lacher, Kemper's President and Chief Executive Officer and Chairman; Jim McKinney, Kemper's Executive Vice President and Chief Financial Officer; and Matt Hunton, Kemper's Executive Vice President and President of Kemper Auto. We'll make a few opening remarks to provide context around our second quarter results, followed by 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 markets closed today, we issued our earnings release and published our earnings presentation, financial supplement and Form 10-Q. You can find these documents on the Investors section of our 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 condition. Our actual future results and financial condition may differ materially from these statements. For information on additional risks that may impact these forward-looking statements, please refer to our 2020 Form 10-K as well as our second 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 have 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 2022 period unless otherwise stated.

I will now turn the call over to Joe.

Joseph Patrick Lacher
Chairman, CEO & President

Thanks, Karen. Good afternoon, everyone, and thank you for joining us today. The industry continues to operate in what I believe is the most disruptive personal lend environment we've ever experienced. Recent competitors' earnings reports underscore this. While our financial results through the first half of 2023 fell short of our targets, we believe the actions we've taken and continue to take have positioned us to succeed in this difficult environment. Before talking about our results, I want to take a moment to explain a bit about this operating environment.

Traditionally, historical patterns are used by the industry to predict future behavior, and they're producing patterns outside their historical norms. This variance is seen in broad aspects of consumer behavior. A few examples include buying triggers, price elasticity and changes in driving patterns, propensities to file claims, seek medical treatments and repair vehicles, and the willingness to litigate.

These pattern changes are exacerbated by subsequent broad swings in competitors' action. We believe this environment will continue for at least the next couple of years. Correspondingly, it has created a hard market that will likely persist for an extended period of time. Our specialty market expertise and our nimble and efficient operating model position us to effectively navigate this environment.

We're continuing to evolve our capabilities. This includes investing in broad enhancements and business intelligence and accelerating the speed that we digest and execute on insights. We have and continue to increase the forward-looking predictive analytics we use to operate our business. At the same time, we've increased our execution margin of safety. Our ultimate priority is to achieve target returns, and we are continuing to focus ourselves and our business to facilitate this and ultimately, to position ourselves to grow profitably and safely at the right time.

Against this backdrop, let's discuss our results. Turning to our presentation. I hope you'll take away the following: first, we had strong sequential improvement in the underlying profitability of each of our businesses; second, the strategic initiatives we announced last November are on track to realize their anticipated benefits and produce meaningful value for our stakeholders; third, we reiterate our guidance. We expect to achieve an underwriting profit in the second half of 2023. And for 2024, we expect to generate a return on equity equal to or greater than 10%.

Moving to Page 4. The consolidated results included strong aligned profitability improvement against the backdrop of elevated catastrophe losses and adverse prior year element largely related to the second half of 2022. The 6 point sequential improvement in Specialty P&C was the result of accelerating impacts of earned rate and non-rate actions exceeding loss trend as well as the normalizing of the episodic items we experienced last quarter. This improvement demonstrates that our actions are taking hold and producing the anticipated benefits.

One final financial highlight I'd like to point out is our recent approval of approximately 30 points of rate by the California Department of Insurance for our Specialty P&C private passenger auto book. The collaborative effort between our teams and the CDI enabled the successful outcome. The rate change was effective August 4.

I'd like to now move to our strategic projects. As a reminder, last November, we announced a series of initiatives to unlock additional shareholder value. All these programs are on track to be completed on time and produce or exceed their financial targets and operational benefits. Key updates on these initiatives include: we received approval from the Illinois Department of Insurance for the formation of our reciprocal. Phase 2 of our Bermuda optimization effort is outperforming initial benefit projections. We completed the strategic review of our Preferred P&C segment and announced our decision to exit that business. This action will enhance our return on capital and support profitable growth in our core businesses.

And finally, we are achieving the expected expense savings with our cost structure initiatives. We are highly focused on maximizing shareholder value, and this begins with returning the business to profitability. The solid progress we achieved this quarter is proof that the actions we have taken are generating the intended outcomes. All the while, we are advancing our long-term initiatives to enhance Kemper's strategic and financial profile.

I'll now turn the call over to Jim to talk about more details.

James J. McKinney
Executive VP & CFO

Thank you, Joe. I'll begin on Page 5 with our consolidated financial results. We are pleased that each of our segments had strong underlying improvements that position us for profitability in the back half of the year. Several factors offset this progress, including goodwill impairment, catastrophes and prior year development.

For the quarter, we had a net loss of $1.52 per diluted share and an adjusted consolidated net operating loss of $0.26. The net loss included approximately $46 million of goodwill impairment charge connected to the strategic review of the Preferred P&C segment. The noncash charge represents the full value of the goodwill associated with this business. The net loss and adjusted consolidated net operating loss included

$39 million of current year catastrophe losses, the result of a very active cat quarter for the industry and $26 million of adverse reserve development.

Turning to the prior year reserve development on Page 6. The adverse development was primarily driven by bodily injury and property damage activity that occurred during the second half of 2022. This was caused by pattern changes between the second and the third quarters of 2022. These include an extension in claim reporting time lines and more claims closing with payment. The first quarter of 2023 and accident quarters prior to the third quarter of 2022 generally aligned with or were favorable to our prior loss selections. The short-tail nature of our business and the speed with which we collect and assess data provide us with high confidence in our reserving processes and their continued ability to react quickly to evolving conditions.

Turning to Page 7. As Joe mentioned, we are reiterating our previous financial guidance. Despite the dynamic environment, we are committed to producing an underwriting profit in the second half of 2023 and achieving an ROE equal to or greater than 10% in 2024.

Turning to Page 8. Here, we outlined Specialty Auto's path to underwriting profitability. Our second quarter underlying combined ratio guidance was 103% to 107%. We reported an underlying combined ratio of 102%, slightly below the low end of our range. In the third quarter, we expect further improvement and to generate an underlying combined ratio between 99% and 101%. Assumptions and risks are outlined on Pages 7 and 8.

Pages 9 and 10 provide an update on our strategic initiatives. Each program is on track to be completed on time and produce or exceed its targeted financial and operational benefits. Starting with the reciprocal, the Illinois Department of Insurance approved the formation of Kemper Reciprocal. We expect to write business within the reciprocal in the third quarter. We will provide additional program schedule details during our third quarter call.

Our Bermuda optimization initiative launched in 2022 is expected to unlock a higher amount of life dividend to the parent. We expect at least $200 million to be released before year-end, up from $100 million as previously indicated.

As Joe mentioned, we recently completed our review of the Preferred P&C segment. The business will be wound down and the focus will be on our people, policyholders and working with our regulators to achieve the best possible outcome. The wind down of the business will enable the redeployment of more than $300 million in capital to our core segments. This will simplify the business and enhance capital deployment efficiency. As a result, starting in the third quarter, our segment reporting will only reflect our Specialty P&C and Life & Health businesses.

And finally, our cost reduction initiatives are on track to produce their intended benefits, consistent with our timing expectations. Since the program's inception, we have achieved approximately $117 million in run rate savings or roughly 80% of the intended run rate savings goal previously anticipated to be achieved by 2025. Once completed, we expect these initiatives will significantly enhance Kemper's financial profile, including enhancing cash flow generation and reducing volatility.

Moving to Page 11. Our insurance companies are appropriately capitalized and have significant sources of liquidity. At the end of the quarter, we had approximately $1 billion in availability. We continue to have the capital needed to navigate this environment while continuing to appropriately invest in our advancing our core capabilities. Further, as previously disclosed, we are committed to reducing debt outstanding by $150 million and bringing our debt-to-capital ratio back to our long-term target of 17% to 22%.

Moving to Page 12. Net investment income for the quarter was $106 million. Our pretax equivalent annualized book yield was 4.5%. Average investment grade new money yields for the quarter were 5% to 6%.

I'll now turn the call over to Matt to discuss the Specialty P&C business.

Matthew Andrew Hunton
Executive VP & President of Kemper Auto

Thank you, Jim, and good afternoon, everyone. Moving to Page 13 in our Specialty P&C business. We closed the second quarter with an underlying combined ratio improvement of 6 points. This was driven by the combination of incremental earned rate, tightened underwriting action, the normalizing of episodic items and expense efficiencies. We observed loss trend continuing to moderate. Frequency was flat year-over-year, and severity was up 2% sequentially. Catastrophe losses in the quarter were elevated. The 2 points or $17 million we experienced was above average and included a higher level of events from Florida floods to Texas hailstorms.

Including the recent California rate approvals Joe mentioned, the cumulative written rate since the second quarter of 2021 is expected to increase to 54 points next quarter. Of this rate, 17 points have earned in and that will increase to approximately 23 points by the end of the third quarter. We expect earned-in rate to accelerate as the California book renews in future quarters. We will continue to file for additional rate in all states as needed.

Shifting to the commercial vehicle business. Our underwriting and rate actions are continuing to positively impact loss performance. In the second quarter, the underlying combined ratio was 93.9%. The business is expected to deliver strong underwriting profits in the second half of 2023.

The loss environment continues to be volatile, and we are being appropriately cautious in writing new business. We expect to continue to suppress new business throughout the third quarter. In the fourth quarter, we plan to selectively write incremental new business to test new customer cohort buying and claim behavior. Particular items of interest include price elasticity, reporting patterns, and treatment and repair propensity. This will enhance our ability to optimally manage customer acquisition in a more disruptive operating environment. We will make monthly and quarterly evaluations on the gradual expansion of new business based on, first, our current view of underwriting profitability as well as the learnings from these tests.

In summary, we expect a continued volatile operating environment for at least the next couple of years. We believe our actions will provide continued improvement to underwriting performance, delivering on our profitability targets during the second half of 2023 and 2024. Through this period, we will continue a test-and-learn approach to safely and profitably manage new customer acquisition.

I will now turn the call over to Joe to cover the preferred and life businesses.

Joseph Patrick Lacher
Chairman, CEO & President

Thanks, Matt. Moving to Page 14 in our Preferred P&C segment. This quarter, the benefits of profit restoration actions including the continuation of lower frequency from non-rate actions offset higher catastrophe losses of $21 million. Both auto and home and other had sequential improvement in their underlying combined ratios. Through the second quarter, our personal auto book had 10 points of rate earned that will increase to approximately 14 points in the third quarter. As previously discussed, our strategic review is complete. Going forward, the segment will be noncore.

Turning to our Life & Health business on Page 15. I think we're all still getting used to how to read and interpret life financial statements post LDTI adoption. To help provide clarity into items that impact distributable cash flow trends, my comments will focus on the drivers that impact this measure. These items have not been impacted by LDTI adoption.

This quarter, we saw the lowest level of mortality frequency in at least the last 10 years. It is 12% below the 2018 and 2019 averages. Year-over-year, the average incurred gross debt benefit is down over 1%. Issued premium is up 0.5%. Life persistency is aligned with pre-pandemic levels. The combination of these items positions the business for continued improved profitability and attractive distributable cash flow.

Turning to Page 16. In summary, I'll leave you and remind you of this. The strong sequential results we generated this quarter demonstrate a meaningful step in the right direction. I continue to be confident about our ability to return the business to underwriting profitability in what is a difficult and dynamic operating environment. Highlights for the quarter again include significant rate progress in the state of California receiving approximately 30 points of specialty personal auto rate; strong progress in our strategic initiatives, including our Bermuda optimization effort and the establishment of the reciprocal exchange; the realization of over half of the desired benefits from the restructuring and integration initiatives and the completion of the strategic review of our Preferred P&C segment.

In closing, I'd like to thank our entire Kemper team for their continued dedication to executing our strategic priorities to generate consistent long-term shareholder value.
With that, operator, we may now take questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Greg Peters from Raymond James.

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

So I'll ask a couple of [Technical Difficulty]

James J. McKinney
Executive VP & CFO

Greg, I'm not sure -- unfortunately, we can't hear you.

Operator

Your next question comes from the line of Paul Newsome from Piper Sandler.

Jon Paul Newsome
Piper Sandler & Co., Research Division

I was hoping you could talk a little bit more about the impact of non-rate actions in the quarter on the underlying business, whether we've seen the full impact there and it's just going to be sort of the impacted rate prospectively or if there's some other things that are happening under the hood that would be helpful.

Joseph Patrick Lacher
Chairman, CEO & President

Sure, Paul. And maybe I'll take a start, and we'll tag team this a little bit. I'm going to give you a broad comment, and then the guys can talk a little bit specifically. We're going to continue to have a set of non-rate actions that are going on, and they're going to have differing potential impacts. As an example, we significantly slowed down new business last quarter and will likely have that slow down largely in the third quarter. That provides -- it's a non-rate action that provides an immediate benefit to calendar year losses. When we think about a cohort or its experience, it tends to have higher losses in its first year and lower losses in subsequent years. So if you slow that new business down in the period, to do it, it gives you a little juice.

Eventually, we're going to be writing more new business, and that will expand. Matt was very careful in his comments and so was I that we are likely to do some gradual expansion in the fourth quarter but very much with a test-and-learn orientation to look at the patterns of what's going on in the environment. That may provide a nominal pressure, but we're going to be focused first on underwriting profitability and making sure that it's not a significant driver there and that we're using it to learn what patterns are going on. That will likely cause us to add underwriting tools to our toolbox or how we use them given the volatile nature of the current environment. So I'm going to expect we're going to continue to find different non-rate actions to manage things going forward.

I think what you're asking is how to model in what you're looking for, and what I might guide you to is you might want to take an earned rate measure for improvement for a while until we target or we get close to target profitability. And then you're going to work off our guidance from there. The measure should be focusing on our guidance and the timing that comes from that. As we hit those targets, we don't anticipate dropping to a 75 combined ratio. We anticipate that once we've clearly solidly and comfortably gotten there with our expanded margin of safety, we'll move towards growing. Again, I'm not signaling to growing in the third or the fourth quarter, but we'll move in that direction. So we will start offsetting some of that.

James J. McKinney
Executive VP & CFO

Paul, this is Jim. The only thing I would add on to what Joe said is I think you have a couple -- a little bit of incremental benefit that you might see coming in, in the third quarter from underwriting actions. But most of what you're going to see at this stage is going to be incremental earned rate that will flow into the book. And that will, again, similar -- aligned with Joe's comments on the other, that will begin to offset and take the place of some of the underwriting actions that have been put in place to date to help us get to this position as we move forward.

Joseph Patrick Lacher
Chairman, CEO & President

We started, Paul, giving you guys some rate and non-rate direction a year or so ago, partly to try to help get to a number. And we acknowledged at the time that as the rate came in, we might unwind some of those non-rate actions. And I think I want to go back to what I said a moment ago. All of those crossing items are in our guidance, and we're trying to give you the answer rather than ask you to sort of work the components underneath because it's on -- be almost impossible for you to work the individual components or just trying to give you the answer at this point. And it's probably a little less important to try to break those 2 apart going forward, and we're going to have more trouble helping you break them apart because they're going to move in multiple directions.

Jon Paul Newsome
Piper Sandler & Co., Research Division

But still nevertheless helpful to understand what could be happening so [we see] it. I want to ask a little bit more about the life operation and the capital optimization. So a couple of hundred million bucks potentially moved from the life U.S. subsidiary to the parent. Maybe you can talk about sort of what ends up being the actual capital behind the life operation? Because I was looking at the statutory statements. It looks like there's not that much more than a couple of hundred million dollars of statutory capital in the life subsidiaries at least to [core and the SML]. And -- but I also presume that there's an amount of life capital that's sitting in the Bermuda subsidiary as well. So can you talk about sort of where that total life capital ends up and maybe both in size as well as where it ends up being distributed?

James J. McKinney
Executive VP & CFO

Yes, happy to kind of walk through it, Paul. Good question. Big picture-wise, yes, there is capital in the Bermuda entity. When you think about it across both, you're talking about $280 million that would be sitting there today. In total, one of the things I think you need to look at is we're resetting or there's a component that is resetting some of our reserves that will release reserves and equity that is currently held inside those entities. So it will increase up. So you won't see a meaningful change in the actual capital level that's inside the life companies.

Some of the things that we've done is essentially we had initial filings and placements with the Department of Illinois and others that go back many years as it relates to our mortality trends. And we said that we would come back and update those appropriately once we had really strong mortality tables and experience. We've done that coupled with our Bermuda initiative, and that is essentially freeing up equity basically from a statutory perspective that will then be able to come up. And so you won't see a meaningful change in the overall capital dollars to that. You'll just see a difference in the reserve level in total, as those reserves are reset to represent more of a true mortality curve and the benefits that we've had from an experience perspective.

Operator

Your next question comes from the line of Greg Peters from Raymond James.

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

Hopefully, you can hear me now.

Joseph Patrick Lacher

Chairman, CEO & President

Welcome back.

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

That's good. So I wanted to start my question -- the first question off with, Joe, in your comments, you talked about this being an unprecedented time for the personal lines business. And you mentioned buying triggers embedded in that as we mentioned. I'm just curious, with all the rate that's being thrown at the consumer -- and it's just not your company. It's other companies, but particularly when I think about your company being in the specialty business, which is lower limits, I'm curious how the consumer is responding to this because it feels like you're probably pushing the envelope of what the consumers can afford. So do you have some perspective on that?

Joseph Patrick Lacher
Chairman, CEO & President

Yes, sure. Let's tag team this. I know Matt has a couple of thoughts. Then, I'll add some in a second.

Matthew Andrew Hunton
Executive VP & President of Kemper Auto

Greg, so what we're seeing from a consumer perspective is that persistency or take rates, retention rates are at or higher than what we would have observed historically. And that is against, right, what we would have modeled in normal times. The function of this is less of a demand dynamic and more of a lack of supply dynamic. So as we're seeing competitors in the market slow down appetite, specifically in markets like California and Florida and now we're starting to see it rise in Texas, we're seeing that the take rate on pretty high average premium dislocations is actually sticking.

And we'll see, as the markets start to get more rate adequate and as consumers are moving through sort of elasticity maturing, if those persistency rates will hold. But for now, we're actually seeing that, that rate is sticking. But when we think about the outlook of our business and how we're managing through, that's a highly sensitive variable for us in terms of our projections.

Joseph Patrick Lacher
Chairman, CEO & President

A part of what we're thinking, Greg, as we go through this, I'll give you an example, and this is a generalization, not a specific item, but a rule of thumb might have been that if somebody gets more than a 10% rate increase, they're likely to shop and that's likely to start to impact your retention or persistency. In a normal environment, there's a -- this is a supply issue Matt's talking about. There's generally broad availability and there's some place to go.

In a more restricted environment where folks are either tightening underwriting, competitors are tightening underwriting, are also raising rates, they might not have an option that's more competitive, so that 20 or 30 point rate change, they might take. In a very low unemployment environment, those folks are needing to have the car to get to work. They've got incoming cash, so that likely has a very important value to them. They need the insurance. They need the car. They need to work that. So that's triggering.

And part of what we've been highlighting and sort of a normal model, hypothetically, if we took -- pick your number. 25 points of rate, we'd expect a certain persistency drop. We saw persistency go up. If that in fact occurs, one of the questions that comes out is will that result in a buying decision change a year from now. Or will people just get used to the new rate and we reset later? When we talk about test and learn from gradual expansion, what we're actually looking for is trying to measure each of those behavior changes.

Right now in this strong employment, low unemployment environment, we're seeing behaviors that sort of make sense to us, but it's different than historical patterns. We're asking ourselves and are aware, and that's why we have a wider margin of safety going forward, to say what might happen in the future, and we're very much focused on increasing our business intelligence, increasing our predictive analytics, increasing our very scientific method of testing and watching to see whether those behavior changes will move going forward. Does that help?

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

Yes. It does provide some color. It's surprising that retention is going up because your rates are going up. I wanted to pivot and sort of in connection with those comments and then some of the other things you said in your prepared remarks. On Slide 13, I like that 1 chart you have where you do the cumulative PPA rate activity since the second quarter '21. And what I was intrigued by this chart is the filed rates that pops up to 54.8% in the second quarter and then only goes to 56% in the third quarter. Yet in the third quarter of this year, you've just got this 30% rate approval that's effective. So I would have expected the filed rate to go up even more relative to where it was in the second quarter. Does that question make sense to you?

Joseph Patrick Lacher
Chairman, CEO & President

It's the -- the filed, don't overthink that as much as just the delayed. You're expecting it to go up further. Let me make sure I got your view.

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

Yes, I would expect the 54.8% to go up to 70% or 65% or something with the additional California approval.

Joseph Patrick Lacher
Chairman, CEO & President

The 54.8% included the California filed rate. It hadn't been approved. This is filed, not approved.

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

Got it. Okay.

Joseph Patrick Lacher
Chairman, CEO & President

And so when that is approved and you're starting to see the written go up because on August 4, we started writing it, and so in the third quarter, it will become part of the written rate. And remember, the entire book won't have it, but everything written in the quarter will have it. So that's why it moves up there, and we will renew them over the course of their policy term.

James J. McKinney
Executive VP & CFO

Greg, to your point, that's the secondary piece, which is following that earned, right, which is the 23% moving towards that 56% or that 54% that we're representing. So that's where it earns across the totality of the book.

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

Got it. It makes sense now. And then on Slide 6 in discussion of your adverse reserve development, you talked about some elongated development patterns in the second half of '22, more claims closing with payments, how do you see those trends in the first half of '23 versus what you saw in the second half of '22? And are we going to be looking at another situation 6 months from now where there's going to be another reset because there's been another adverse change in how those patterns are looking in your book of business?

James J. McKinney
Executive VP & CFO

So yes, a great question. A couple of points on that. The first point is what we saw at least across our book, and it's really become much more transparent at this stage, is a jump up in terms of the ultimate losses that we incurred between Q2 and Q3, which then has continued forward of last year. If you think about the trajectory on we were consistently for 3 quarters in a row, had been down 1.5 points, 2 points, a little bit more at times, kind of averaging that 2 point trajectory. And then now as you would see if you push everything back, we actually have an increase that occurred in Q3. And so that pattern changed, and we've effectively incorporated that going forward.

So I don't think that it's likely to repeat again. When we look at our Q1 results, those actually developed favorable from an entry year about $6 million that was inside of it, so modest. But based on what we're seeing at this stage, we feel really good about kind of our -- well, we feel really good about our loss picks. We had obviously a pattern or a trend change that was very unusual from an industry perspective and from what we've seen across our book. We dove underneath that. We continue to segment that. And that pattern change, whether it's an environmental or other, is essentially what has led to the development that we've had to date. It's unfortunate but we think we've got it covered, and we feel pretty good about the book as a whole.

Joseph Patrick Lacher
Chairman, CEO & President

If I can add a little bit, Greg, and I think Jim was completely clear, we saw that pattern change between second and third quarter, and the new pattern is incorporated in all our current picks. I think you had a second -- I think part of your question was did we include it in our current picks and part of it is will there be another pattern change. I'd like to be able to forecast that for you.

What we've tried to highlight is this is a disrupted environment. Your question on pricing is a great one. Okay? What if somebody gets a 20 or 30 point price increase and then a year later, they get another 20? At what point do they stop buying insurance? At what point does a claim pattern change? We're watching all of that. And when I say our margin of error is wider, we intentionally are looking at that and having our radar up watching for it.

We can't tell you if it's going to happen because, by definition, a pattern change has -- like it's a change. But we're way more sensitive to watching it and way more cautious in what we're doing and way quicker to respond on a defensive posture to those items in this environment, and we expect to have that margin of safety and defensiveness for some period of time.

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

Okay. I guess the final question sort of comment I have. It's going to be on your guidance, the third quarter but the ROE guidance for next year, too. I guess considering all the volatility that's going on, I just questioned whether it's worthwhile to put out the guidance that we understand that's your objective, but it seems that there's risk that we've observed with other companies of putting numbers out there or missing them, especially the near term considering the volatility. But when I look at your ROE targets and then you talk about the preferred business being run off, does the ROE targets include or exclude the preferred business? And from an accounting perspective, is that going to go into a discontinued bucket, so it's going to be just below everything, below line in the income statement?

James J. McKinney
Executive VP & CFO

So a couple of points. The guidance does not include the redeployment of capital from the personal insurance or the preferred personal insurance business. That will be a positive as it comes through or a tailwind. It does include what our expected results were and where we thought the business would triangulate to. So it's in from that perspective, but there'll be an enhancement from a capital deployment element that will be a slight tailwind. I would not think about that as a major tailwind. It's much more a tailwind over the 2-, 3-, 4-year period.

The secondary component that I would highlight is we expect to report our core businesses going forward. And then noncore would include things, likely the preferred personal insurance business. That election would likely be made through our review in the third quarter, but our core businesses are the KA business and the life business. So hopefully, that's helpful.

Joseph Patrick Lacher
Chairman, CEO & President

We understand completely your question around the guidance, and we're trying to do a couple of things. One, you pointed to Slide 13, and you saw the written and filed rate connecting and Jim made a distinct point of saying looking at the difference between the earned rate and the written rate. That rate will earn in. It's filed. It's approved. It's being written right now. That's not anymore -- when we filed something and it hadn't been approved, you might argue there was some hope involved in that.

Now it's not hope. It's processing that works its way through. So we're recognizing that. And we're also highlighting that there's a lot of things going on in the environment. We're very quick to respond. It's a very short-tail business, but we're also highlighting that there's things we don't know. And we're confident we're on the right path, and we're confident we're going to find those things quicker. And we're making very significant and thoughtful test-and-learn investments to respond quickly, but don't, in any way, shape or form, anticipate that we've got a crystal ball and we'll be able to see those things before they happen. We're not promising we're going to see them, but we are promising we're going to respond quick.

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

Got it. And just one final cleanup question because I can't help myself. But litigation was mentioned, increased attorney rep. Is that just state specific? Or is that across your entire footprint?

James J. McKinney
Executive VP & CFO

Greg, no, great question. It's across the entirety of the footprint. We're seeing different behavior there and some might call it social inflation. Others might call it attorney abuse. I'll let you decide which it is. But we're definitely seeing more of it. I think that's something that's an industry pattern, and we're doing what we can to create the best outcomes we can for our customers.

Operator

[Operator Instructions] There are no further questions at this time. I will now hand over the call to Joe Lacher. Please continue.

Joseph Patrick Lacher
Chairman, CEO & President

Thank you, operator, and thank you, everybody, for joining our call today. We appreciate your time and attention and look forward to speaking to you again with our third quarter results.

Operator
Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.