S&P Global
Market Intelligence

CNA Financial Corporation NYSE:CNA

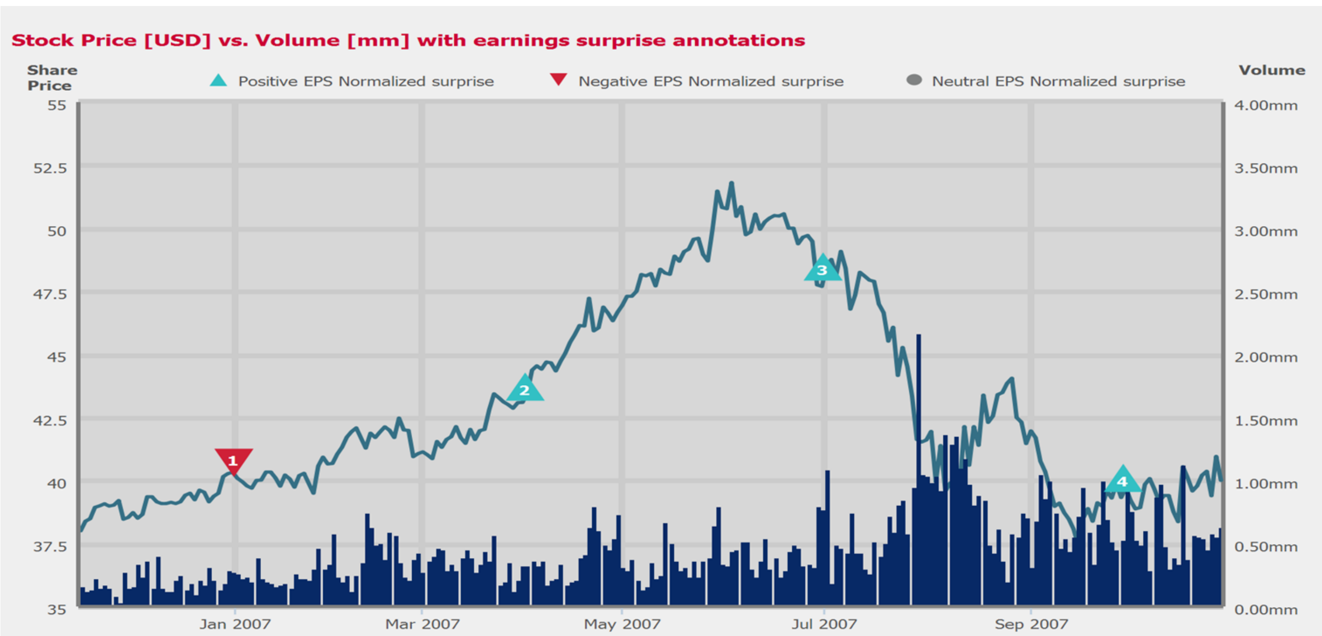
FQ4 2007 Earnings Call Transcripts

Monday, February 11, 2008 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2007-			-FQ1 2008-	-FY 2007-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	1.02	0.82	▲(19.61 %)	1.12	4.14	3.90
Revenue	-	-	▲0.62	-	-	-
Revenue (mm)	1619.95	1630.00	-	1664.00	6762.95	6777.00

Currency: USD
Consensus as of Feb-09-2008 4:30 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2006	1.01	0.92	▼1 (8.91 %)
FQ1 2007	1.03	1.13	▲2 9.71 %
FQ2 2007	1.09	1.17	▲3 7.34 %
FQ3 2007	0.68	0.78	▲4 14.71 %

Table of Contents

Call Participants

EXECUTIVES

D. Craig Mense

James R. Lewis

Jonathan D. Kantor

Nancy M. Bufalino

Stephen W. Lilienthal

ANALYSTS

Bob Glasspiegel
Langen McAlenney

Christopher Neczypor
Goldman Sachs

Richard L. Greenberg
Donald, Smith & Company

Presentation

Operator

Good day and welcome to CNA Financial Corporation's Fourth Quarter and Full Year 2007 Earnings Conference call. Today's call is being recorded.

At this time, I would like to turn the conference over to Nancy Bufalino. Please go ahead.

Nancy M. Bufalino

Thank you, Dana and good morning. Welcome to CNA's fourth quarter and year-end 2007 financial results conference call. Hopefully, everyone has had an opportunity to review the press release and financial supplement, which we released earlier this morning and can be found on the CNA website. We will be referring to the specific information found in this supplement during the call.

With us this morning to discuss our financial results is Steve Lilienthal, Chairman and CEO; Craig Mense, CFO; Jim Lewis, President and CEO of P&C Operations, as well as other members of our senior management team.

Before we get started, I'd like to advice everyone that during this call there maybe forward-looking statements made in references to non-GAAP financial measures. Please see the section of the earnings release headed Forward-Looking Statements in regard to both. In addition, the forward-looking statements speak only as of today, February 11th, 2008. CNA expressly disclaims any obligation to update or revise any forward-looking statements made during this call. This call is being recorded and webcast. During the next week, the call maybe accessed again on CNA's website at www.cna.com. Following the conclusion of today's prepared remark by CNA's senior management, we will open the discussion to question from investment community.

And with that, I'll turn the call over CNA's Chairman and CEO, Steve Lilienthal.

Stephen W. Lilienthal

Thank you, Nancy and good morning everybody. Thanks for joining us today. 2007, was a very strong for CNA from both a financial and on an operational standpoint. Our balance sheet is in excellent condition and CNA's strategic position in the commercial insurance marketplace is quite strong and sustainable. And without minimizing the challenges ahead, I would submit the following.

CNA is delivering solid financial results that reflect our sustained focus on the bottom line. CNA's delivery of repeated years of profitability validates our assertion that we have skilled technical people, quality data and the requisite tools to sustain our profitable course. Our core P&C portfolio is highly diversified and is very well balanced, and we feel this is a significant advantage in navigating through the market cycle.

And lastly, operationally, CNA is efficient and effective. And before I turn this call over to Craig and to Jim, for more detailed discussion of the year and the quarter and what we see going forward, I would like to highlight a number of key results. Our 2007, non-operating income of $1.60 billion was a virtual match to last year's record operating earnings, even after $108 million after tax impact of the Hancock IGI settlement, run-off operations and in spite of a rapidly accelerating softening market.

Net operating ROE of 11% was consistent with 2006, and much improved from the previous five years. Net income of $851 million was down to prior year and was obviously impacted by the issues related to the subprime crisis and credit spread widening during the year. Based on your past model of interest and questions, you'll notice that we expanded the disclosures in our financial supplement regarding our structured securities and the related underlying collateral. Craig will provide more color and detail on this in his remarks.

Book value per share increased $1.33, about 4% for the year, on top of $4.77 or 15% improvement in 2006. We declared our first dividend in thirty years and increased it six months later. Despite falling financial and insurance markets, CNA receives an upgrade to an air rating from fixed ratings during 2007.

And with respect to our core Property & Casualty Operations, we continue to talk to perform very well. P&C Ops combined ratio for the year was 94.8%, continuing the improvement over the past few years. We did benefit from a 1.8 points of favorable development during 2007.

Production metrics... excuse me... production metrics were consistent with selective underwriting in the softening market. Net written premiums were down 4% for the year, our retentions held up when... well, coming in at about 81%. New business was appropriately reduced to 18% of total production in response to market conditions. We continue to get a nice lift in cross-sell; that is selling more CNA products to each and every customer.

The P&C Ops expense ratio continue to stay below 30% for the year, but was pressured by declining revenue base. Expense issues were addressed during the year by way of a reorgan and reduction in staff during the third quarter, and Jim Lewis will provide more detail on this in a moment.

And by the way, we are also prepared to discuss the insurance related exposure to subprime by way of our specialty products. John Kantor, General Counsel and Head of our Strategic Claims is with us today, he will answer any questions you might have. To-date we will characterize claim activity as manageable.

All in all, 2007 was a very strong year, a very solid year for CNA and build quite nicely on equally strong solid year in 2006. Following earnings, a strong balance sheet, operational effectiveness and efficiency and a strong strategic position are key benchmarks in our business and CNA delivered strong performance across the board.

2008 will present significant challenges as the market continue to deteriorate, and the weather will not always be our friend. Going forward, our emphasis will be strong performance in our core Property & Casualty Operations through portfolio optimization, data driven underwriting, cross-selling, claims excellence and capacity exposure management. Containing the risk associated with our run-off business, continuing to manage our expenses persistently, aggressively and even more urgently to face the top line pressure and finally, but always an unwavering and relentless focus on the bottom line.

In summary, I feel good about what we accomplished in 2007, many, many challenges remaining, but I am confident that CNA can and will rise to the occasion and continue to deliver quality results. Craig?

D. Craig Mense

Thanks Steve. Good morning everyone. I am pleased to share our fourth quarter and year-end results, which I would describe as solid and reflective of our discipline in response to pressures from both the insurance cycle and financial markets.

Fourth quarter net operating income was $223 million and continue to reflect solid performance of our core Property & Casualty Operations business, in spite of the increasing market pressure. Operating return on equity at 9% for the quarter and 11% for the year was respectable, but on the lower end of our targeted range. We continue to increase book value, which is up slightly from the third quarter and up 4% for the year, which is a continuation of the positive trend over the last few years.

We are also pleased to continue return on capital to our shareholders via the quarterly dividend, which we first initiated in the second quarter of '07 at $0.10 a share and which is now at $0.15 per share.

Finally, we remain firmly focused on continuously improving the operating and financial fundamentals of the business, which really is the key to our ability to successfully navigate the market cycle.

Now I would like to give you a bit more detail on financials. For the fourth quarter, net operating income from continuing operations was $223 million or $0.82 per diluted share, compared with $248 million or $0.91 per diluted share in the prior year period.

Net operating income from core Property & Casualty Operations were down $6 million and our Non-Core segments were down $19 million. Net income for the quarter, which includes the impact of discontinued operations as well as realized investment gains and losses was $164 million or $0.60 per diluted share compared with $329 million or $1.22 per diluted share last year. The drivers were lower net operating income as well as net realized investment losses, which I would discuss later.

Property & Casualty Operations produced fourth quarter net operating income of $269 million compared with $275 million in the prior year period. The decrease was primarily driven by lower net investment income and higher current accident year losses. We believe we are responsibly increasing loss ratios in response to rate declines.

Speaking of P&C Ops, I want to remind you that the results reported today are on the basis of our resized, revised P&C segment. We revived the Standard and Specialty line segments to confirm to a realignment of our management responsibilities during the fourth quarter. There is further detail in the 8-K we filed in January and also additional detail in the 10-K to be filed later this month.

With respect to Non-Core segments, Life and Group produced the fourth quarter net operating loss of $17 million compared to a loss of $1 million in the prior year period. Drivers were decreased results in the life settlement business and unfavorable invested margins in the pensions deposit business.

Corporate segment had a fourth quarter net operating loss of $29 million, roughly comparable to $26 million loss in the prior year period. The 2007 results include unfavorable net prior year development of $17 million related to mass tort, after tax impact of that was approximately $45 million. The 2006 results were also negatively affected by a similar amount of mass tort adverse development.

Pre-tax net investment income in the fourth quarter was $574 million, which compares to $690 million in the prior year period. For the year, investment income was approximately $2.4 billion, slightly ahead of 2006. You can see the details of that on page 14 of the supplement.

During the fourth quarter and the year, our fixed income portfolio continued to produce steady results and we also benefited from lower interest expense on fund withheld. These positives were more than offset in the fourth quarter by two factors: significantly lower results in our trading portfolio and reduced limited partnership income, which was unusually strong in the prior year period. You will also recall that the trading portfolio results are largely passed on to contract and policy holders.

Our invested assets grew by over $300 million in the course of the quarter, and are up $141 billion for the year, reflective of our continued positive cash flow. Net realized investment losses were $61 million in the fourth quarter compared with $108 million gain in the prior year period. The decrease was driven by increased impairments caused by the decline in credit market conditions, including significant credit spread widening as well as our exposures to subprime collateral.

After tax impairment losses were $188 million in the fourth quarter of 07 as compared to $56 million in the fourth quarter of 06. Write-downs in this quarter related to subprime investments accounted for $90 million of that total.

We feel numerous inquiries about our invested portfolio over the past few months, either at investor conferences or on your individual calls to us. Almost all those questions have centered on our structured securities portfolio. I want to be responsive to those questions and we trust that the expanded disclosure in our supplement, which is... you'll find on pages 6 through 9, will provide you with improved insights as well what we hope is improved understanding of why we are comfortable with the portfolio.

I like to take some time now to actually walk you through the supplemental disclosures. So; you may want to pull it out for reference as we talk. Now while you do that, I'd like to spend a few minutes talking about our tax exempt municipal holdings. We own approximately $7.7 billion in municipals; you can also see that on page 5 as well as page 6 of this supplement, which is 18% of our invested assets. Of that amount, $3.6 billion or slightly under 50% are issues wrapped by bond insurers.

As with other parts of the portfolio, we always look through the enhanced rating to the underlying credit when making investment decisions. The overall credit quality of our insurance enhanced tax exempt municipal holdings on that look through basis is 8 plus. The overall credit quality of our total $7.7 of tax exempt municipal holdings is AA plus with the insurance enhancement. On a look through basis, the average credit quality would be AA minus. We are comfortable holding these investments and do not expect any meaningful negative impact from possible bond insurer downgrade.

And I also don't want to engage in accounting seminar, but before we start into the supplement, I would like to remind you of our rigorous disciplined impairment process. The judgment as to whether impairment is other than temporary incorporates many factors, including the likelihood of the security recovering cost and as importantly, our intent to hold until any anticipated recovery. The majority of our OTTI losses were driven by that lack of intend to hold until the anticipated full recovery to cost or maturity.

I'd also like to remind you of another important characteristic of our portfolio. That is, our investments are separated into two distinct portfolios. The larger portfolio, approximately 76% of it or $29 billion of our fixed securities support the P&C and Corporate segment. A smaller, but significant portion, approximately 24% or $9 billion, are investment segregated to support long-term liabilities primarily in the Life Group Non-Core segment, such as annuities, structured settlements and long-term care products. The primary objective is each portfolio is to optimize investment return relative to underlying liability, returnable cash flows and liquidity needs.

The effective duration of the invested match to Life Group segments were 10.7 years at 12/31/07. The effective duration of the remaining 76% of our fixed income investments were 3.3 years and the overall total duration of the fixed income portfolio was 5.1 years.

Turning your attention back to the supplement, the investment disclosure starts on page 5 of the supplement with a simple presentation of our invested assets, which have a total fair value of $41.8 billion. The expanded disclosure follows on page 6 to 9 and it is intended to provide additional insight into our structured investments, which had a total fair value of $11.4 billion at year-end. You can see that sub-total in the box at the top of page 6. You will also note that we are providing a book value comparative throughout the investments disclosure in addition to fair value.

The bottom of page 6 gives you a breakdown by type and quality surrounding the $11.4 billion of total structured investment holdings and again offers comparative book and fair value. At year-end, the $11.4 billion of fair value in structured securities held reflected an unrealized loss of $367 million, which is only 3% less than book value. You'll also note that 88% of our structured investments are either rated AAA or issued by a U.S. government agency. In addition, you should note that, the below investment grade portion of the structured investment is only $44 million or less than four-tenths of 1% of the total.

Page 7, provides you with a detailed breakdown of our subprime and Alt-A investments. Again you can see that the subprime securities held had an unrealized loss of $109 million at year-end, which is about 9% under book value and the Alt-A securities had an unrealized loss of $46 million, which is less than 4% under book value.

63% of the subprime positions are rated AAA and 97% are rated A or better. If you look at the same comparisons on Alt-A, you can see that 90% of the Alt-A positions are rated AAA and 98% are rated A or better.

Couple of other points that aren't detailed on the disclosures, which I think you'd find important are that, we do not own any subprime Alt-A or commercial mortgage-backed loans directly. All the exposures are through an investment vehicle. The weighted average life of the securities held with subprime exposure is 1.7 years and 55% of our subprime exposure has a weighted average life of one year or less.

As I indicated in the third quarter call, we view these markets as opportunities to find value through disciplined investment practices. During the fourth quarter, we increased our position in subprime exposures by over $200 million net based on market opportunities to acquire structurally advantaged securities with short average weighted life at attractive prices.

Now if you turn to page 8, you can see details on our MBS and CMO holdings. The MBS are all government sponsored agency issues. If you look at now to the CMOs, you'll see that the majority of our Alt-A investments and a small portion of our subprime investments are underlying collateral in the CMO holdings. You'll also notice $5.8 billion or a vast majority of the CMOs are backed by high quality prime credits.

Now if you turn to page 9, you'll notice, there is the total exposure of $1.77 billion in commercial mortgage-backed securities, need to add both the asset-backs and the CDOs for that. This represents less than 3% of our total invested assets and approximately 9% of all structured securities. You'll also see that 80% of the commercial mortgage-backed collateral held is rated AA or better. Only $10 million, meaning 1% of the total commercial mortgage-backed is graded less than investment grade.

Page 9 also details the remainder of the asset-backed holdings and incorporates the majority of the subprime holdings discussed earlier.

Let me end the investment presentation by re-emphasizing that we continue to find opportunities in the market, with the requisite analysis of certain distressed asset-backed securities.

Turning for a moment to expenses, the PC Op expense ratio was 30.7% for the fourth quarter and 29.5% for the year. We were disappointed to go over 30% in the fourth quarter, but remain very competitive with peers. And you should expect us to sustain our emphasis on expense management, but recognize that market pressures will make it a challenge and beyond on this score in '08.

With that, I'll turn it over to Jim.

James R. Lewis

Thanks Craig and good morning everyone. P&C Operations had a good quarter and a very good year. For most quarters of the combined ratio under 100%, expense ratio under 30% for the year, very strong performance from the specialty line and further progress by standard lines on operating fundamental. This is our second consecutive year of very strong results.

We benefited from the like win, but we didn't rely on it. Instead we continue to play from our strength, underwriting disciplines, a diversified portfolio and a strong market franchise. And in spite of the pressure from the market cycle, I like our prospects.

Property and Casualty Operations have managed through two years of softening rate and we are well positioned to stay the course. We continue to refine our data driven approach to underwriting, we continue to optimize our portfolio of shift in our mix to maximize risk adjusted returns. We continue to sell more to every customer by cross-sell and we continue to investment in our people and infrastructure to further sharpen our competitive edge.

In short, we continue to execute on a strategy that guides us through the softening market and positions us to be in great shape when the market turns up. Now let's turn to a few of our key operating metrics starting with premium. Net written premiums were down 3% to $1.6 billion for the quarter and 4% to $6.8 billion for the year. Standard lines decreased 11% for the quarter and 9% for the year, while Specialty lines were up 4% for the quarter and 2% for the year. Overall, our premium volume reflects a disciplined response to rate pressure on our renewable and stiff competition for new business. This is not to say, we are hunted and down; selective growth is the key dimension of our overall strategy or improvement of profitability of our portfolio, and our diversified portfolio is a major advantage in this regard.

In Specialty, we continue to find niches and shift our book towards most profitable small and mid-sized risk. In Standard, which tend to be on the leading edge of a softening market, selective growth is more challenging. We have a strong franchise in middle market construction; we are building similar positions in our targeted industry and also sustaining our focus on small business in the small and the middle market. Overall, we continue to maintain an active, intelligent presence in the market and we continue to see opportunities for profitable underwriting.

Now let's turn to rate and retention. For our business as a whole, average rate decreased by approximately 5 points in the fourth quarter and 4 points for the year. In Standard and Specialty lines, average rate changes were in line with the overall book. As for our retention, Property & Casualty

Operations came in at approximately 81% for the quarter. Standard and Specialty were in the same range. For the year, Standard lines retention was 79%, Specialty line was 83%. These figures are consistent with a normal level of turnover and a quality book of business. Overall, our rate and retention figures reflect our patient intelligent approach.

In addition to focusing on smaller and mid size accounts, which tend to be less price-sensitive, we have built our business around higher value products and services that give our customers a reason beyond price to stay with CNA.

Another key measure of our renewal book relates to quality. We continue to track the book use in a measure we call renewal efficiency. This is the spread between the incurred loss ratio of renewed business versus non-renewed business. Renewal efficiency and other measures tell us that our underwriters continue to retain the right business.

Now let's turn to new business in cross-sell. We wrote approximately $269 million of new business in the fourth quarter and $1.2 billion for the year. This represents approximately 17% of total production for the quarter and 18% for the year. Overall, our new business continues to be right where it should be than where it... we said it would be under current market conditions. With all our competitors working very hard to hold on to their quality renewals, writing new business is more challenging than ever and requires a disciplined, data driven strategy. I already mentioned our quality metrics for renewal business; we have similar measures for new business quality, such as variance demand for new and renewal pricing.

Cross-sell continues to benefit new business quality and volume. For the year, cross-sell premium amounted to $458 million, approximately 38% of our total new; that makes more than $1.5 billion of cross sale business in the last three years, that otherwise would have been left on the table.

Net loss ratio; our fourth quarter net calendar year loss ratio was 67 versus 68 in the prior year period. The Standard lines loss ratio was 71, while Specialty line was 63. The fourth quarter loss ratio benefited from approximately three points of favorable development in Standard lines and three points in Specialty lines. There is more information on the impact of the development on page 10 of our financial supplement. On a full year basis, P&C Operations' net calendar year loss ratio came in at approximately 65, a two-point improvement over prior year, largely driven by favorable development of 1.8 point.

Turning to accident year, the net of accident year loss ratio for Property & Casualty Operations was up approximately three points to 67. This increase reflects our recognition of the change in the rate environment and we also had the impact of a few specific losses. These factors underscore the importance of our strategies for protecting loss ratio. I've already mentioned the few of them; segmentation, data driven underwriting and higher value of products and services. To these, I'd add the following. A disciplined set of underwriting controls, referrals and audit, ongoing improvement of our predictive modeling tool, the claims operations that directs routine claims to an express center, while more complex claims go to our experienced to justice, and finally we continue to adjust our mix to optimize total profitability. Our loss ratio is our most important operating metric and we will continue to refine our strategies to protect it.

Now let's turn to combined. In the fourth quarter, we came in at about 98%, our eighth consecutive sub-100 quarter and one point better than the prior year. For the year, our combined ratio was under 95%, 94.8%, the best full year performance since I joined CNA in 2001. Tender lines came in at approximately 100%, specialty came in under 90%. Our combined ratios benefited from the favorable development I mentioned a moment ago, but this was largely offset by the higher accident year loss ratio.

We recognize the challenge contained in these results. In particular, further improvement on the Standard side remains a key priority. We will continue to shift our Standard portfolio towards small business, small and middle market, industry-specific program business and other attractive segments. Meanwhile, we will continue to grow selectively and have profitable Specialty business. We will also continue to squeeze out expenses, process and IT efficiencies are key drivers of our small and middle market strategies, including endorsement and renewal process and upgrade this year that will improve service and reduce cost.

On the claims side, we have already made substantial improvement in service and efficiency, with more opportunity for improvement in '08 and beyond. These and other measures to come even more urgent going forward from a... for a disciplined underwriter in a softening market, pressure on the expanse ratio comes with the territory.

Before I wrap up, I'd like to comment briefly on the outlook for 2008. The market is getting tougher, but we continue to manage through and build capabilities that will serve us well, regardless of market conditions. Segmentation has already shaped our business portfolio in Specialty and Standard and it continues to sharper our competitive edge. In our middle market book for instance, we continued to segment and sub-segment by industry, accounts size, geography and gradation of risk. We have dedicated underwriters by segment and our distribution strategies are even more closely in line with our segment appetite. With our predictive modeling tools which directly enable our segmentation strategy, we continue to manage additional sources of internal and external data. And the same thing, our segmented specialized claims operation enables us to apply the right level of efficiency and expertise to individual claims.

Overall, without underestimation... underestimating the pressure of the soft market, I like our outlook and feel we are well positioned for the challenges of the market cycle. In summary, Property & Casualty Operations had a very good year. We feel very good about our performance. We continue to improve our fundamentals and we expect another solid year in 2008.

Operator, we are now available for our Q&A.
Question And Answer

Question and Answer

Operator

[Operator Instructions]. We'll go first to Bob Glasspiegel with Langen McAlenney.

Bob Glasspiegel
Langen McAlenney

Good morning. I was wondering if you guys could give us a little bit more color on the mass tort reserve increase in the fourth quarter and also just on the life year-over-year deltas?

Jonathan D. Kantor

Yes, I'll take that this is Jon, Jon Kantor. Really good news, bad news story I'd say on mass tort. Our frequency is decidedly down, pendings down by 30%, newly reported down by over 40%, severity is down. The bad news is defense costs really are rising much more than indemnity cost, as indemnity costs come down, defense cost are rising, but there's actually a good story embedded in that. Because what that's telling us is corporate defendants are defending more of these cases. They're trying more cases; it is expensive in the short-term. But I believe much less expensive in the long-term when you look at excessive where many of the corporate defendants rolled over, the result was a 30-year claimed debacle and I don't think the corporate America intends to repeat that mistake. So I think... I'd say that's really what it's coming from. In general, we've had a number of small adjustments in the context of our annual account-by-account review, but that would be the one theme I would pick out of it.

Bob Glasspiegel
Langen McAlenney

Is this the pay as you go on, on this just a report you will have to upset that?

Jonathan D. Kantor

I don't think so, our gross reserves are now up to a pretty nice level, $293 million. We have pretty good re-insurance on that. Our growth survival ratio, I'll take one year as 4.4, I'm doing that because there are a couple of large --.

Bob Glasspiegel
Langen McAlenney

John, just to cut you, I was asking on legal defense not on the overall reserve?

Jonathan D. Kantor

What's the question then?

Bob Glasspiegel
Langen McAlenney

Is LAE, on legal defense is that sort of pay as you go or is that you got to reserve it up for the future, defense cost booked in the reserve?

Jonathan D. Kantor

It's booked in the reserve.

Bob Glasspiegel
Langen McAlenney

Okay, so it's not paid as you go on the defense LAE component?

Jonathan D. Kantor

That is correct.

Bob Glasspiegel
Langen McAlenney

Okay, I guess I'll follow up on that later than. Now go ahead, give me your survival ratio story too, I'm interest in it.

Jonathan D. Kantor

Its 4.4 on a gross basis, we have $293 million growth reserve on net basis, the net reserve is $205 million, survival ratio is 3.7. Now I'm picking a one-year survival ratio because we've had some large settlements which would distort the three year, loss in three-year survival ratio goes 3.3 and 3.0 gross net respectively. But as I said, I mean I think what we are... we are pretty well into our carried reserve is pretty well into our actual range and we're not... we're encouraged by the fact that the frequency and the severity are down, frequency particularly.

Bob Glasspiegel
Langen McAlenney

Okay. Then on the life side?

D. Craig Mense

This is Craig, Bob. You wanted some more color on the Life side?

Bob Glasspiegel
Langen McAlenney

Yes.

D. Craig Mense

Relative to the $17 million loss?

Bob Glasspiegel
Langen McAlenney

Right.

D. Craig Mense

You'll recall, in the Life Group run-off we had a biotical settlement business.

Bob Glasspiegel
Langen McAlenney

Right.

D. Craig Mense

And, just, it was a debt benefit revenue for this quarter was the lowest it's been for seven years, only $2 million, normally it averages $10 million to $15 million of debt benefit revenue. And then the pension deposit business that I referred to there is, we do have a product that we sell to large institutional pension funds that guarantees the return on this S&P 500 plus 25 basis points and our operating income there is derived from the net investment earnings in excess of the hedge cost. Our investment strategy there is to hedge the index performance. As well as, again, it's... so our earnings are, whatever we earn in excess of the hedge cost and the 25 basis points guarantee. So and just the market conditions in the fourth quarter led to operating loss on the product, which is really on a second one we've had in the history of product, it was like $3 million loss which compares in the prior quarter to $9 million earnings impact.

Bob Glasspiegel
Langen McAlenney

So if all stays high, that will be a ongoing pressure, perhaps a little mass --.

D. Craig Mense

No, I think is a small amount, I mean, me remember it's an Index 500 products that were gaining the investors, the return on the Index 500, is that, if there is pressure on the 500, that goes to the contract holders.

Bob Glasspiegel
Langen McAlenney

No, still about volatility, the hedging cost would be higher if the market is more volatile, no?

D. Craig Mense

No, not really.

Bob Glasspiegel
Langen McAlenney

Okay. Last question, it looks like if I map up your page 6 last quarter from page 7, just to see where you pumped your subprime up, it seems likes it's in the 06 year and I just want to make sure, confirm that, that's sort of purchases rather than downgrades to fill into that bucket?

D. Craig Mense

They were purchases.

Bob Glasspiegel
Langen McAlenney

Okay.So the 224, to 473 or 508 I am going to show whether that was fair value or market a year ago... quarter ago but that would be mainly purchases.

D. Craig Mense

They are mainly purchases and as I said, those would be... we saw attractive opportunities in very short duration securities to get a very attractive yield and very high quality.

Bob Glasspiegel
Langen McAlenney

Thank you very much.

Operator

[Operator Instructions]. We will go next to Chris Neczypor with Goldman Sachs.

Christopher Neczypor
Goldman Sachs

Hi, good morning. Apologies if you have already addressed this, as I had to jump off the call for a minute. But could you just discuss how you are thinking about CNA's exposure to the fall off in the mortgage crisis from a D&O and an E&O perspective? What types of business you guys typically ensure for in that market and then what sort of claims you've seen to date? Thank you.

Jonathan D. Kantor

Hi, this is Jon Kantor again, I'll be happy to address that. The exposure is going to be concentrated in the financial institutions book, where CNA was really not a very big player at all. Last year CNA wrote $72 million of premium for financial institution, which was 2% of our specialty book. And as a result, at 12.31, we had only 16 claims in financial institutions. The other point would be within financial institutions, we underwrote pretty carefully. Post-Enron, we made conscious decision not to write E&O on investment banks, or money centered banks and that the only D&O on them we would write would be A side. And we've reviewed that again in light of recent events and the exceptions to that rule are extremely rare. So at 12.31, half the claims that I mentioned are actually A side D&O policies, which as you know seldom pay anything.

Also in general, we wrote high excess and for low limits so that on the open claims that I mentioned, the average attachment point that is the underlying insurance with the retentions is over $120 million. In addition, the limits are on non-A side claims average about $8 million. So that's the financial institutions book.

There are three other potentially exposed areas, none of which we think are going to be material, but I'll mention them. The first is the non-financial institutions D&O and E&O, where we have just a couple of claims. And significantly, here we avoided homebuilders. There is a very minor amount of premium that are, that very few exceptions to that rule. The second area is mortgage broker E&O, but there we stopped writing mortgage brokers in April 2007 and I think the gross premium in 2007 for mortgage brokers was about $1 million. The subprime phenomenon has had no meaningful impact on the book. The third part of this was the surety, which is of course as you know we have a publicly traded company, CNA Surety, which we own 64% of. There have been no losses to-date there and we really don't see this becoming an issue, the sub division bonds or the... when a sub division project gets halted, the municipality has the right to call the surety to complete the infrastructure, but, MS never do it because they don't like to have infrastructure completing when there's no tax base to support it.

In any event, the loss ratios on those books are traditionally in the low single-digits and I don't see that as becoming an issue. I should let you know, in A side D&O, just folks are on the same page. A side D&O is really a situation that where the policy will get tapped only where you have derivative claims, where those claims are not under the particular state law allowed to be indemnified by the company or you have a bankruptcy situation. So in our view, if you want to construct a worst case scenario, the... our A side exposure will get tapped only, I believe, where there's a massive wave of derivative claims or a massive wave of bankruptcies deriving from the subprime crisis. We think that's a remote contingency.

Christopher Neczypor
Goldman Sachs

Great thanks for the color.

Operator

[Operator Instructions]. We'll go next to follow-up with Bob Glasspiegel with Langen McAlenney.

Bob Glasspiegel
Langen McAlenney

So. Sort of where the expense ratio may drift up into '08 and clearly the message from Wall Street is to know rate bad business to keep the expense ratio down and let that go up, but how much tolerance do you have on that, on that ratio?

D. Craig Mense

Bob, this is Craig. And I'll let... I am sure, Jim's team might want to have something to say on that too. We don't have a particular tolerance or we haven't set some floor or ceiling that we'd like to go up. I think that... that we should take from our comments are that we're... we're mindful of the pressure from top line on the ratio itself, we are also mindful of making sure that we are making long-term decisions about long-term health of the business. So we're going to continue to make investments in technology and people and not of... we don't want mortgage in the future, no pun intended and so we'll be... but have given all that, we're going to aggressively manage expenses to keep it in a reasonable range, but I don't have a number to give you necessarily, I think you can expect us to be as stock pullers we are, and have been in the past and we'll continue to be thoughtful about it. Jim talked about how he had acted in the third quarter that try to get ahead of the curve on that and you can expect us to keep doing that, but it's going to be tough with the market pressure and with our desire to not write improper business. We'll be less focused on the ratio than we are with the bottom line NOI numbers, I guess may be is a shorter way of answering that question.

James R. Lewis

And I think that's an excellent way to answer it. This is Jim Lewis, Craig is that we do not have a set number but we know that, with what we understand from a top line pressure, whether that be read or what we are seeing with new business and the like there of that there is going to be pressure on the top line. We did address that within the P&C Operation in the third quarter, when we reorganized our P&C Operation. We flattened the organization structure, eliminated a layer of management which was regions that we had in place, but now it's just a home office and a branch structure. At the same time, we also right sized the organization based on what we were seeing is as far as top line drop through the third quarter and what we're also anticipating early into '08. So, there will be pressure on expense, we're obviously very mindful of this and we are constantly looking at ways to improve the overall operation.

We do still want to invest in places that impact the bottom line for the future, but as we look at doing it and I think there's still... it's been that we can get and be in a lot more efficient. So we're taking a look at our middle market part of our book, doing an end-to-end analysis of process and efficiency. We're going to get efficiencies in our small business side of our operation. We'll have the ability for an automated renewal capability for endorsements and renewals on all of our small business in the second quarter and quite frankly, that's going to be a significant benefit for us on the expense side and the efficiency within our small business arena. And we're also taking a look at our claims operation from an end-to-end process in and how we really do business so that we become more efficient. And overlaid on that then we'll be as we've made our end-to-end processes more efficient, we'll be also then to overlay technology to help drive the additional expense savings.

Bob Glasspiegel
Langen McAlenney

Thoughtfully answered. One other quick follow up. Craig, where are you on capital going into '08 and the top line is going to be contracting more, I suspect it will be generating more excess capital. The dividend has been sort of primary use of excess capital as buyback at all the consideration under played for '08. I recognize the float issues and liquidity but --?

D. Craig Mense

I think that's important to consider, in terms of float issues, which... and liquidity, which we think a buy back would be certainly... if they would hurt the stock. So we don't think that's really necessarily at this point in time not something that's high on the list of option for us. We do think that we have a fair amount and a significant amount of excess capital. We don't have any particular and specific plan for that right now to share with you. One thing we have done with it given our improved flexibility is then to get some debt that matured in January, $150 million which we paid off, there is more debt that comes due in... not until December. So we are going to pick the right spot, the right opportunity spot in the market to refinance or to not. So we do have significantly enhanced flexibility in the capital side from this year. Then we have been focused more in the immediate term with just improving the cash at the holding company level; so we can improve the number of options we can consider going forward.

Bob Glasspiegel
Langen McAlenney

Today's sharp correction wouldn't change the dynamics of the decision materially. The stock's down $4.30. I mean at some price, maybe buyback becomes quite economically satisfying?

D. Craig Mense

It is, I mean, you are right, it is. Really at the price it was before that is economically satisfying. I think we're just mindful and a little concerned about the impact... the negative impact that will have on float.

Bob Glasspiegel
Langen McAlenney

Got you

D. Craig Mense

Again that may not be the right way to get money to shareholders.

Bob Glasspiegel
Langen McAlenney

Okay, thank you.

Stephen W. Lilienthal

Hey Bob, this is Steve Lilienthal. I didn't want to let you go without maybe just picking up another comment on this expense question. One of the things I just wanted to remind you is that we at CNA, have truly demonstrated a willingness and an ability to deal with expense issues over the past couple of years, not just the recent restructuring and resizing that Jim did in the third quarter. I mean, this has been a regular part of our culture, and we are added all the times. That's the first thing. The second thing, we look at the expense initiatives, an expense issue is not something that you can expense your way to success. I mean you can certainly find yourself expense into a competitive disadvantage. But we don't look at that as to be on and end all, we look at as very important part of our business strategies. But as Craig mentioned and Jim mentioned, we are in a... we, we look to and our... we really need to make strategic investments going forward, particularly in the predictive modeling area and some of our claims infrastructure.

Yes and the last point I would want to... and frankly, we would prefer to be dealing with what we look to be a short term issue on the expense side than a longer term issue on the loss side. So to rebuild or to build up a book of business that we would feel but not meet the hurdle rates or deliver the sustained profitability that we have delivered over the past several years, we think would be... would be a long-term problem and something that would be extremely difficult for us to work out of, and undoing all the work that we have done till last couple of year. And the very last point I would make is that, if you look at all of our peers, the people you compare us to, you'll find out that we stack up really, really fine based on outside data that serves that we are right at and right in the neighborhood of all of our major competitors, so.

Bob Glasspiegel
Langen McAlenney

Fair answers. Thanks Steve.

Operator

We'll go next to Richard Greenberg with Donald Smith and Company.

Richard L. Greenberg
Donald, Smith & Company

Bob just answered... asked my question on the stock buy back, but we would be, just to say, we would be very supportive of that. I don't see what you possibly can invest in it, your stock is currently at 75% of book value, I don't know what could provide a better return and flow, there is no real academic evidence that flow matters in pricing a stock and kind of, who cares, if you're buying something that is so cheap and under the underlying value, that's what's really important. You're building long-term book value and long term shareholder value. So that would just be the point there.

Secondly, just, I think I need a little bit more clarity on your evaluation of your securities because it does appear that, for example, on your subprime portfolio, you're not really relying on the ABX index or into pick one specific example on your Alt-A or if you look at page 7, in 2007, for example, on the AAA, you're evaluating your, the book value is basically equivalent to the fair value, actually you're showing a higher fair value and when you look at some people that have done some really thoughtful analysis on this; somebody like Bill Acquin at [indiscernible] and his recent work show that, 2007 vintage would have at least an 11% hit is that valuation, it could as high as 40%. So I think if you just clarify little bit, how you do or value your various securities; that would be helpful.

Stephen W. Lilienthal

Alright Rich, I appreciate your comments about the stock as well and understand that we hadn't really thought about the buy back at the level... the level we've seen this morning, so, to make one comment. But as far as our pricing, you should know that all of our pricing is third party. It's a majority of it is from IDC and not a bit is in internal pricing. So these are market prices and market pricing and we are very mindful of making sure that we have both accurate and of going to sources that are very historical choices that we found to be very credible.

Richard L. Greenberg
Donald, Smith & Company

So, you can't get market pricing on all of these Alt-A securities, for example?

Stephen W. Lilienthal

Yes.

Richard L. Greenberg
Donald, Smith & Company

Okay.

Stephen W. Lilienthal

And you got to look really at the collateral that we're holding relative to ABX.

Richard L. Greenberg
Donald, Smith & Company

Right, okay, that's great. And then we really do appreciate this... the breakdown you guys have done and all this increased disclosure. Thanks a lot

Stephen W. Lilienthal

Welcome.

Operator

And we have no further questions. I would now like to turn the call back over to Nancy Bufalino for any additional closing remarks.

Nancy M. Bufalino

Thank you, Dana and thank you all for joining us today.Once again, I call your attention to the disclosure containing forward-looking statements and non-GAAP measures in the earnings release. Taped replay of today's conference call will be available for one week immediately following until February 18th. Please see the earnings release for replay details. We appreciate your participation today and thank you again. Operator: That does conclude today's conference. And the replay of this call will be available to you by dialing 888-203-1112 or 719-457-0820 and entering replay passcode 3629040 followed by the # sign. We thank you for your participation and you may now disconnect.