S&P Capital IQ

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The Hartford Financial Services Group, Inc. NYSE:HIG

FQ1 2011 Earnings Call Transcripts

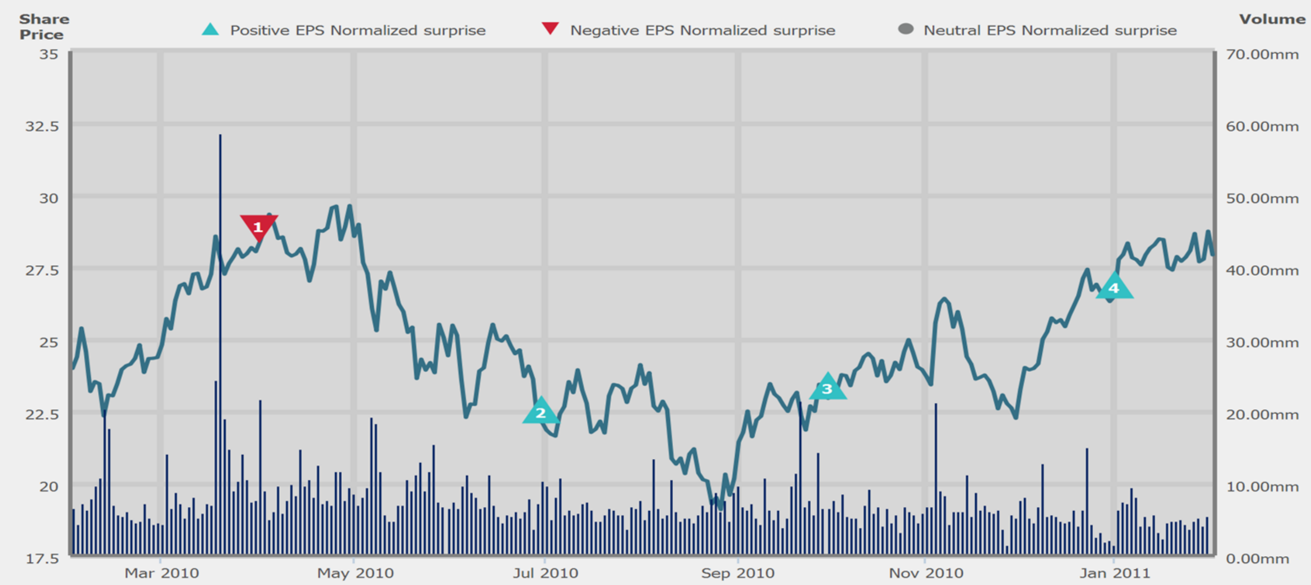
Tuesday, May 03, 2011 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2011-			-FQ2 2011-	-FY 2011-	-FY 2012-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.95	1.16	▲22.11	0.95	3.90	4.04
Revenue (mm)	6052.63	6308.00	▲4.22	6031.01	24675.66	24305.06

Currency: USD
Consensus as of May-03-2011 10:30 AM GMT

Stock Price [USD] vs. Volume [mm] with earnings surprise annotations



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ1 2010	0.25	0.14	▼1 (44.00 %)
FQ2 2010	0.77	0.92	▲2 19.48 %
FQ3 2010	0.93	1.43	▲3 53.76 %

FQ4 2010	0.95	1.06	▲11.58 %

Call Participants

EXECUTIVES

Andre A. Napoli
Former Executive Vice President and President of Consumer Markets & Enterprise Business Services

Andrew J. Pinkes
Former Executive Vice President of P&C Claims and President of Heritage Holdings Inc

Christopher John Swift
Chairman & CEO

David N. Levenson
Former Executive Vice President and President of Wealth Management

Liam E. McGee
Former Chairman

Lizabeth H. Zlatkus
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Presentation

Operator

Good morning. My name is Tierra, and I will be your conference operator today. At this time, I would like to welcome everyone to the Hartford Financial Services Group Inc. First Quarter 2011 Earnings Conference Call. [Operator Instructions] I would now like to turn the conference call over to your host, Mr. Rick Costello. Sir, you may begin.

Richard Costello

Thank you, Tierra. Good morning, and thank you for joining us for The Hartford's First Quarter 2011 Conference Call. The earnings release and financial supplement were issued yesterday and the slide presentation for today's call is available on the company's website. Chief Executive Officer, Liam McGee; and Chief Financial Officer, Chris Swift, will provide prepared remarks this morning, and we will finish with Q&A. Also participating on today's call are Doug Elliot, President of Commercial Markets; Andy Pinkes, who served as President of Commercial Markets through last month; Dave Levenson, President of Wealth Management; Andy Napoli, President of Consumer Markets; Greg McGreevey, Chief Investment Officer, Liz Zlatkus, Chief Risk Officer; and Alan Kreczko, General Counsel.

Turning to Slide 2 of the presentation. Please note that we will make certain statements during the call that should be considered forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These include statements about The Hartford's future results of operations. We caution investors that these forward-looking statements are not guarantees of future performance and actual results may differ materially. Investors should consider the important risks and uncertainties that may cause actual results to differ, including those discussed in our press release issued yesterday, our quarterly report on Form 10-Q for the first quarter of 2011, our 2010 annual report on Form 10-K and other filings we make with the Securities and Exchange Commission. We assume no obligation to update this presentation, which speaks as of today's date.

Today's discussion of The Hartford's financial performance includes financial measures that are not derived from Generally Accepted Accounting Principles or GAAP. Information regarding these non-GAAP and other financial measures, including reconciliations to the most directly comparable GAAP measures, is provided in the Investor Financial Supplement for the first quarter of 2011 and in the press release we issued yesterday, both of which can be found on The Hartford's website.

Now I will hand the call over to The Hartford's Chairman, President and CEO, Liam McGee.

Liam E. McGee
Former Chairman

Thank you, Rick. Good morning, everyone, and thank you for joining us. Before I get started, I really want to welcome Doug Elliot to The Hartford. Doug joined us at the beginning of April as President of Commercial Markets and, as you know, he was most recently with Hartford's Steam Broiler, where he was President and Chief Executive Officer. Now as you all know, Doug has a strong and broad P&C industry background. He ran the commercial business at Travelers several years back and has great relationships with the agent and broker community. He is off to a fast start and we're really excited to have him at The Hartford.

I would also like to thank Andy Pinkes and the entire Commercial Markets team for continuing to deliver solid results for the last 6 months.

The Hartford reported another strong quarter last evening, building on our solid momentum in 2010. In the first quarter, net income increased 60% year-over-year to $511 million or $1.01 per diluted share. Core earnings were $588 million or $1.16 per diluted share, an 8% year-over-year increase.

We're pleased with the progress the company is making. As our results over the past 5 quarters demonstrate, we're building a track record of consistent performance from both an operational and financial perspective. This is particularly noteworthy given the quarter's tragic events in Japan. Our thoughts and prayers obviously remain with the Japanese people. Our 200-plus employees in Japan and their families are safe, and our team there is doing a tremendous job serving our customers. And I thank them for their dedication.

Importantly, even at the worst of the market's reaction to the crisis in Japan, our hedging programs performed well and as designed. Previously, the company did not have the tools needed to dynamically manage the various market exposures in Japan on a daily basis. We have completed the development of these tools and they were effective during the market volatility that followed the earthquake.

I'm pleased with the progress the team has made on developing a more comprehensive tail hedge for Japan. The tail hedge will limit The Hartford's downside risk under severe capital markets conditions, while preserving some of the upside should markets improve. The tail hedge will take advantage of the company's existing macro hedge positions, and the implementation costs will be reasonable. We remain very confident that the risk in Japan is manageable.

Our Commercial P&C business had a very good first quarter. We're benefiting from The Hartford's competitive advantages in underwriting, product and distribution, as well as increasing U.S. business activity. P&C Commercial written premiums grew 9%, which was better than we expected, and was driven by strong retention and improved renewal written pricing, combined with economic exposure increases.

We also continue to see strong results from the integration of our Group Benefits and P&C Commercial sales teams. Their joint sales efforts generated more than $40 million of incremental premium in the first quarter.

Now Chris will talk in more and detail about our GBD performance, which remains challenged. But our experience has been similar to the broader industry trends.

In Consumer Markets, the team is focused on its strategy of profitably growing AARP, adding new profitable affinity partners and repositioning the agency business to a more profitable target customer. Disciplined pricing in underwriting are driving improvement in the current accident year combined ratio and we're pleased with this outcome. But on the other hand, the resulting impact to the top line, frankly, was larger than we expected. Chris will walk you through the drivers and our plan to address the decline.

We're in very active discussions with several affinity partners and plan on signing at least one additional new partner in the second quarter. We also launched our marketing outreach to members of the American Kennel Club, an affinity partner we announced last quarter. Including AKC, we expect to have the ability to market to more than 5 million new affinity members by the end of the second quarter. Our goal is to generate about $200 million in written premium in 2013 through new affinity partnerships.

Now before I turn to Wealth Management, I want to address the devastating storm activity we've seen in April. Our claims teams are on the ground working with customers. Based on the level of storm activity we have already seen, catastrophe losses in the second quarter may exceed last year's second quarter total of about $200 million.

In Wealth Management, retirement plans, non-proprietary mutual funds and Life Insurance reported double-digit sales growth. Our strategy of combining innovative product development with a focus on broadening distribution is generating good results.

In product innovation, we recently added the life industry's first longevity rider, which allows policyholders to begin receiving payments at age 90. So in conjunction with our popular Life access rider, we can now offer protection against all of the customers' major concerns: premature death, getting sick or outliving one's assets.

The team is also working diligently towards the launch of the next offerings in our suite of variable annuity products. We were optimistic that we would be able to go to market as soon as this week, but our launch was delayed. The innovative nature of the new product features has led to extended conversations with regulators, which are ongoing.

We are committed to the Annuity business and to developing a suite of products that offer attractive benefits for consumers, with an appropriate risk return profile for The Hartford. Since Dave Levenson took leadership of Wealth Management in July, the team has been investing in the Annuity business, adding top talent, spending time with distribution and revitalizing the product development efforts. And I'm excited about our pipeline of potential new products.

So we are executing on the strategy we outlined last April and are operating with a much improved investment portfolio and capital position. In the first quarter, we took an important capital management action by doubling the dividend. And since the first of the year, we've been pleased to see 3 rating agencies upgrade our outlook.

We are committed to prudent capital management. We are evaluating potential capital management actions and are beginning to have discussions with our key constituencies.

In an environment of global financial and political uncertainty, the first quarter's results are a good start to the year. The team and I are focused on executing the strategy with the goal of delivering sustained, profitable growth.

I'll now turn the call over to Chris. Chris?

Christopher John Swift
Chairman & CEO

Thank you, Liam. Good morning, everyone. Let's begin on Slide 4.

As Liam mentioned, we feel very good about our first quarter results. Net income was up strongly over prior year at $511 million or $1.01 per diluted share. Core earnings were $588 million or $1.16 per diluted share. At the end of the first quarter, book value per share was $45.93; this was up 18% over prior year, and 3% during the quarter. Diluted book value per share, excluding AOCI, continued to decline, up 2% in the first quarter to $43.09. Core earnings return on equity, excluding AOCI, for the trailing 12 months was 9.1%.

Now let's move to Slide 5 to discuss 2 of our key financial metrics, adjusted core earnings and the expense efficiency ratio. Adjusted core earnings were $494 million, a 9% increase over the first quarter of 2010. This calculation excludes two first quarter benefits, a DAC unlock of $61 million, strong growth in U.S. equity market and yen weakening more than offset the decline in Japan equities. In Property & Casualty, net prior year reserve releases of $33 million.

Our strong first quarter results benefited from partnership returns, healthy equity markets and better-than-expected top line growth in P&C Commercial. We're also seeing strong margin expansion in Consumer Markets, reflecting the pricing action we have taken. This was offset somewhat by a higher non-cat [catastrophe] weather in both consumer and commercial lines, and increased loss cost in GBD.

Turning to the expense ratio, we've restated the 2009 measure to reflect primarily the completion of the sale of Specialty Risk Services, The Hartford's third-party claims administrator. Due to the nature of the TPA business, SRS operated with a relatively high expense ratio. So the sale lowers The Hartford's expense ratio, but without the corresponding bottom line impact. The new restated baseline for 2009 is 18.5%.

A significant number of expense projects are underway at the company. We are implementing over $200 million in run rate expense reductions, which will contribute to achieving our goal by the end of 2012.

Now let's move to a more detailed discussion of our business results, beginning with Commercial Markets on Slide 6. P&C Commercial lines performed well in the quarter, with written premiums up 9%. This was the third consecutive quarter of written premium increases. We saw economic exposure growth in improving pricing in the marketplace. Our standard commercial renewal price increases were 3%, up from 1% in each of the quarters in 2010. Retention was strong across standard commercial businesses. New business levels were up modestly, reflecting continued underwriting discipline. In terms of profitability, current accident year cat losses were 3 points on the combined ratio. The primary driver was winter storm activity.

P&C Commercial reported a 94.9% ex-cat current accident year combined ratio. This reflects elevated non-cat property losses, as well as underlying losses that were slightly higher than earned pricing increases. Pricing and loss cost trends remain within our expectations. As a result, we are maintaining our full year combined ratio guidance.

In Small Commercial, we grew policy count by 5% over prior year, while achieving targeted rate increases. This reflects our outstanding market position, pricing model sophistication and new product introductions. In Middle Market we had solid retentions, while exposure growth was also positive. Pricing in Middle Market turned positive in the first quarter with 2 points of rate on renewal pricing. New business premiums were up 6% year-over-year. We are maintaining our full year written premium growth guidance of 3% to 6%. We are encouraged by increasing pricing and favorable exposure growth we saw in the first quarter.

To the extent that these trends are sustained, we would expect to be near the top of our full year guidance range.

The Group Benefit business remained extremely competitive. Fully insured premiums declined 2% year-over-year, and first quarter sales were down 18%. We continue to exercise the appropriate pricing discipline on both new and renewal business. Elevated claim incidences and long-term disability, again, impacted the bottom line. We are taking selected rate actions on renewals, zeroing in on the accounts that need price increases. As the economy continues to improve and our pricing actions earn in, we expect the loss ratio to improve. This will take time and the loss ratio will likely remain in the high 70s through this year.

In summary, it was a strong quarter for Commercial Markets, with P&C Commercial lines reporting 9% premium growth and solid underwriting profitability. The Hartford's competitive advantages in product, pricing sophistication and distribution continue to drive disciplined growth.

Now let's turn to Slide 7 for Consumer Markets. We continue to improve profitability in Consumer Markets by increasing pricing and refocusing our book on targeted customer segments. We saw an improvement in first quarter ex-cat, ex-prior year combined ratio, which is evidence we're on the right track. On the top line, our pricing increases continue to impact written premiums. Competition remains intense and with the economy in its current state, there is greater price sensitivity among consumers.

In the first quarter, written premiums declined 6%. New business levels were soft and retention was down 2% year-over-year. We are taking a number of steps to improve new business flow. We are increasing marketing efforts in the most productive regions, refining rate actions and streamlining the underwriting and sales process. We should see new business growth in the second half of 2011. Even with these actions, we now expect written premiums to decline between 2.5% and 5.5% for the full year 2011.

Overall, Consumer Markets had a mixed quarter. We saw improvement in the ex-cat, current accident year underwriting margin, but our top line results were disappointing. We are on the right track in executing our strategy.

Now let's discuss Wealth Management results on Slide 8. Excluding the impact of the DAC unlock, first quarter core earnings were up 24% over prior year. The trends that contributed to margin expansion in 2010 continued, rising equity markets, healthy investment income and top line growth in our non-VA businesses. First quarter core earnings for Global Annuity, ex-DAC unlock were $169 million, a 30% increase over prior year. Assets under management were $151 billion were largely unchanged from year end as rising equity markets offset net outflows.

This quarter's 5% rise in the S&P reduced the value of living and death benefit guarantees, and contributed to a higher surrender activity.

Our new net flow guidance incorporates the impact of increased account values and higher lapses. We are adding an additional $1.5 billion of outflows to our full year guidance. In addition, we are increasing our

ROA guidance for Global Annuity by 4 basis points to reflect the strong investment income we saw in the first quarter.

The Life Insurance business posted another solid quarter. Ex-DAC unlock, core earnings were $55 million. This is up 12% from prior year, reflecting higher investment income, which was partially offset by elevated mortality.

Individual Life sales were up 13% over prior year, driven by higher sales in our independent distribution channel. The Monarch program we introduced in 2010 continues to be a source of growth. 600 Monarch agents, among the largest independent producers in the U.S., generated about 16% of total Individual Life sales in the first quarter.

Retirement plans continues to build on strong sales momentum. First quarter deposits were $2.9 billion, up 12% over prior year. This brings retirement plan's AUM to a record $55 billion. Sales of $1.4 billion were up 24% over prior year. We're seeing good growth in 401(k) sales and increasing traction in the tax-exempt and Middle Market segments. While still modest, sales through our P&C agents more than doubled over prior year to $76 million.

Ex-DAC unlock core earnings were $17 million, up 70% over prior year. Key drivers include higher AUM, stronger investment income and expense discipline. We continue to build scale without adding additional operating expenses.

Non-proprietary mutual fund AUM had a record $60 billion, helped by equity market appreciation and strong net flows of $1 billion. Retail mutual fund sales were up 15% over prior year. Core earnings of $27 million were in line with prior year.

The Hartford mutual fund posted excellent performance again, with 68% of the retail funds outperforming their Morningstar peers during the first quarter. Mutual funds sales rose steadily and we expect this momentum to continue. As a result, we are increasing our full year guidance for deposits and net flows in our non-proprietary mutual funds by about $0.5 billion.

In summary, our Wealth Management business had a strong first quarter with healthy sales momentum and improving profitability. Before we move to the next slide, I want to highlight our investment performance in the first quarter, which was a significant driver of the company's strong results.

Net investment income on limited partnerships and other alternative investments was $100 million pretax in the quarter, which reflects an annualized rate of return of 21%. While we are very pleased with this quarter's results, we expect the remainder of the year to be closer to our long-term expectations of 8%.

Higher interest rates led to an improvement in the portfolio of new money yield, which was 4.23%. We expect a gradual improvement in fixed income portfolio yields over time, provided we don't see a substantial decline in interest rate or spreads.

Impairments in addition to the mortgage loan loss reserves remained low at $58 million in the quarter. Tighter credit spreads drove more than $400 million of improvement in our net unrealized loss position, and we ended the quarter with a net loss position of $161 million.

Turning to Slides 9 and 10, let's review improvements in statutory surplus in the first quarter. In aggregate, U.S. statutory surplus was up about $400 million. P&C generated $400 million of capital. The sale of SRS contributed about $150 million, credit related impacts were positive $100 million, spread tightening and mark-to-market assets more than offset impairments and net trading losses. Non-annuity Life businesses generated $100 million of surplus. Net dividends to the holding company were $350 million. This includes the net proceeds from the sale of SRS. Holding company resources increased to $2.2 billion at the end of the quarter. VA-related impacts were essentially surplus neutral during the quarter. The details of the VA surplus changes are on Slide 10. As Liam mentioned earlier, we are very satisfied with the hedging programs performance following the earthquake and tsunami in Japan.

Turning to Slide 11. As you would expect, strong equity market returns drove significant improvement across all U.S. Net Amount at Risk measures. In Japan, NAR has also declined. Yen weakening, particularly against the euro, was enough to overcome a 6% decline in the Nikkei. The reason why the impact of the Nikkei decline on surplus was so modest, is that only about 20% of the separate account assets are invested in Japanese equities. The balance of the assets are allocated roughly, 40%, global bonds; 20%, global equities; and 15%, Japanese fixed income. To clarify this for investors, we've included new disclosures on Page 68 of the first quarter 10-Q.

Before I leave Slide 11, I want to provide an update on our risk management progress in Japan. Importantly, we now have the full set of analytical tools and models necessary to implement and manage a dynamic multi-Greek hedging program for our Japan VA risk exposures. These enable us to rebalance hedge positions daily and to model economic, GAAP, statutory surplus impacts under different capital market scenarios. These capabilities are similar to the ones we used to manage the GMWB hedging program in the U.S., with the added complexity of multi-currency inputs. We are using these tools to implement a comprehensive tail hedge program for Japan. The objective is to limit The Hartford's actual cash claim payments over the lifetime of the block to a manageable amount in the context of the company's capital resources, under severe capital market scenarios. At the same time, the tail hedge will preserve some of the upside potential in the VA block should markets continue to improve.

This approach will also work to limit short-term statutory surplus declines and tail events to acceptable levels in support of our long-term capital management objectives. We've consistently said that we are not managing our Japan VA exposures to eliminate point-to-point surplus volatility. That has not changed. We are currently holding hedge assets in our U.S. insurance companies for the entire Japan VA exposure. As a result, although we intend to develop hedging capabilities in Japan, initially you are likely to see more pronounced U.S. statutory surplus volatility when capital markets are volatile.

Our existing macro hedge protection is consistent with the design of the tail hedge program. Therefore, we will supplement the macro hedge with the mix of capital market instruments, beginning in the second quarter.

As we have discussed previously, putting an incremental hedge protection will cost statutory surplus and capital impacts along with DAC impact. The actual impacts will depend on a number of factors, including timing of implementation and capital market conditions at the time we purchase protection. In any event, the impact will be modest in the context of the company's balance sheet and capital resources.

As we move forward with the implementation of the program, we will update investors about these impacts and other details about the Japan VA block's overall performance. A more comprehensive hedging solution in Japan is an important consideration in developing our capital management program. So I'm pleased with our progress on that front.

We've also received positive news recently from 3 of the rating agencies, who completed their annual reviews of The Hartford during the first quarter. All of the reviews included upgrades of The Hartford's rating outlook to stable. The transition to stable ratings across the board is an important step. In addition, in the first quarter the company grew statutory surplus in its Life and P&C operations.

Holding company resources have also increased. All of these are important steps towards potential capital management action, which we continue to evaluate and discuss with our key constituencies.

With that, I'll turn the call over to Rick.

Richard Costello
Thank you, Chris. [Operator Instructions] Tierra, you may now open the call to questions.

Question and Answer

Operator

[Operator Instructions] Your first response is from Andrew Kligerman with UBS.

Andrew Kligerman
UBS Investment Bank, Research Division

First is around rate increases. Maybe you could help out, Liam or Chris, on the group business. How much rate increase are you getting? I know Chris had mentioned the loss ratio would be around 76% to 79% this year, but where does it take you next year on the loss ratio? And then the same question around the Commercial Property Casualty, could you give us a little color on where that 3% overall rate increase is coming? I think I heard Middle Market is getting 2%. How much are you getting in Small Commercial? How much are you getting in large and specialty? Maybe a little color around that.

Liam E. McGee
Former Chairman

Andrew, I'm going to ask Andy Pinkes with Doug to take both of those questions.

Andrew J. Pinkes
Former Executive Vice President of P&C Claims and President of Heritage Holdings Inc

It's Andy Pinkes. Let me start with Group Benefits. As you noted, it is a competitive environment in the benefits space right now and we are being rigorous with regard to our approach to pricing, managing our portfolio's profitability in total. As we've talked about in the past, really, price for us is evaluated on a case-by-case basis. We really use our pricing and scoring models to segment our book and really look at our book across the portfolio, to look at where we really need price and where can we give up price in terms of how we behave in the market. So it's not a one price, one increase across the portfolio. So we're being very disciplined in that approach. We're being competitive, but it's no doubt, competitive out there. You saw our sales come off about 18% in the first quarter. We are willing to walk away from newer renewal business that does not meet our expectations. That said, we're taking it one month, one quarter at a time. We're confident that we're making sound pricing decisions and we're going to continue to be thoughtful in our approach. I think as you know as well, really, only a portion of the book, really renews annually since our pricing actions were initiated in the middle of 2010, those rate increases are going to earn in over the contract periods, which in some cases will be multiple years. Turning to the P&C...

Andrew Kligerman
UBS Investment Bank, Research Division

Wait, wait, Andy, so net-net, can you give me a bottom line on overall what you're doing and whether you feel comfortable that, that 76% to 79% range of loss can come down next year?

Andrew J. Pinkes
Former Executive Vice President of P&C Claims and President of Heritage Holdings Inc

In our guidance, we are keeping our guidance. We believe that as the economy improves and as price earns in, we will continue to see some improvement. And over time, we'll see that ratio come down.

Andrew Kligerman
UBS Investment Bank, Research Division

So you're not going to give me the rate increases then on average?

Andrew J. Pinkes
Former Executive Vice President of P&C Claims and President of Heritage Holdings Inc

Yes. I think, quite honestly, it is so segmented, that to give a number would not be useful. The reality is we're taking a segment that encroach across our book. So on the P&C point, what I would say to there is that, we are, first, very strong execution by our team in that market. Lots of focus on profitability and price in keeping with our market. I think in terms of what we're seeing, we've had a consistent track record of using, again, our pricing and scoring capability in the Small Commercial space to continue to appropriately take price in that market. The Middle Market space is certainly a more challenged space and has, what I can say, gone positive really for the first time in some time in terms of price. And so we're very encouraged by that. In some of the specialty businesses, there continues to be challenge and still some negative pricing there. But that's a transactional business, it's a lumpier business. But we're continuing to compete there and feel good about that business.

Andrew Kligerman
UBS Investment Bank, Research Division

Got it. And then, Chris, just quickly on the expense ratio at 17.6% in the first quarter. I just want to fine tune my number. Where do you expect that to get to by the end of '12? Is it 100 from there or 100 bps from there down?

Christopher John Swift
Chairman & CEO

Yes, exactly, Andrew. I mean, we still have the 200% overall goal, and all we've done is adjusted the starting point. So 200% remains the same. We have 100% to go roughly.

Operator

Your next response is from the line of Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Let me ask a question and then I'll let Ed Spehar ask a question on the Life side. I guess the question for me was on the accident year loss ratio and the consumer business, in the Property Casualty side, which I know you've been working on profitability there, but it was quite a dramatic increase when I would have expected any improvement to be a bit more gradual than that. Can you talk to that kind of quarter-over-quarter increase or improvement?

Liam E. McGee
Former Chairman

Andy Napoli, who runs our Consumer Markets, will take that question.

Andre A. Napoli
Former Executive Vice President and President of Consumer Markets & Enterprise Business Services

Hi, this is Andy. Yes, we feel really good about our progress here. I think, when you go from a Q4, fourth quarter to first quarter comparison, we have to note upfront that there's a significant amount of seasonality. The fourth quarter tends to be much higher than any other quarter in the year. So probably the more relevant comparison point is from Q1 of last year to Q1 here, where we observed a pretty significant improvement there of about 2.6 points. So, really, the big driver there was earned pricing, continue to earn its way into the book as expected and we expect that to continue. Bodily injuries severity was less than expected, offset a little bit by increasing physical damage frequency, particularly in glass and towing. One might expect gas price increases to put some degree of downward pressure on frequency, but we'll see how that plays out.

Edward A. Spehar
BofA Merrill Lynch, Research Division

Okay. Chris, this is Ed Spehar. Just a question on statutory. The Hartford Life statutory earnings of $100 million, it looks like in the quarter. Is that a normal level or is that a little lighter than you would anticipate? Assuming that the markets go up in line with your pricing assumptions.

Christopher John Swift

Chairman & CEO

Ed, thanks for the question. I would say what we put on that slide is a combination of statutory and other non-statutory income related items. If you look at purely a blue book and see statutory net income, you'll see something higher in the $400 million to $500 million range, offset then by things that don't go through, income on the statutory blanks. So I wouldn't say the $100 million is an appropriate run rate for statutory net income for the Life company.

Edward A. Spehar
BofA Merrill Lynch, Research Division

What would you say, if we sort of think about that kind of dividend-able funds or cash flow from the Life company on an operating gain basis, after-tax number. What would be closer to normal in your view? Annual number or...

Christopher John Swift
Chairman & CEO

I would be happy to try to help you. But I think it's also important to say that we don't, really, our current tentative plan is not to take any money out of the Life company this year. I mean, we continue to build capital and surplus and we feel good about that. We don't have that much dividend-able capacity. I think we've disclosed in our 10-Q. So whatever the normalized, I'll call it, operating income, and I would put it roughly around $600 million to $800 million of, I'll call it, blue book statutory income. But just know the dividend limitations we have there.

Edward A. Spehar
BofA Merrill Lynch, Research Division

Right. That's an after-tax number though, $600 million to $800 million, right?

Christopher John Swift
Chairman & CEO

Correct, correct.

Edward A. Spehar
BofA Merrill Lynch, Research Division

Then one other statutory or book stat and GAAP, can you give us any sense of what the statutory and GAAP book value would be for the Japan VA business?

Christopher John Swift
Chairman & CEO

We could think about that and talk to you about it. But I don't have that number handy right now.

Operator

Your next response is from Suneet Kamath with Sanford Bernstein.

Suneet Laxman L. Kamath
Sanford C. Bernstein & Co., LLC., Research Division

I had a quick follow-up to Ed's question and then have a separate question. So, Chris, what explains the difference between the 400 to 500 of "blue book" stat earnings and then the 100 number that you mentioned. You said that it was offset by other items? Can you just, quickly, just walk through what some of those other items might be?

Christopher John Swift
Chairman & CEO

It's just really the unrealized hedge impacts, mark-to-market that go through the direct charge to surplus as opposed to P&L. And just to be clear, I think I said $600 million to $800 million of normal Life company statutory earnings, that's down from prior years, primarily due to Group Benefits business, that's still in Life's legal entity, having lower statutory surplus generation.

Suneet Laxman L. Kamath
Sanford C. Bernstein & Co., LLC., Research Division

Okay. Got it. Then, my other question was on the variable annuity product launch. I think there was a comment made earlier about perhaps the approval process taking a little bit longer with the regulators. Just wondering if you could provide any more detail in terms of what's really the issue there.

Liam E. McGee
Former Chairman

Suneet, I'm going to ask Dave Levenson, President of Wealth Management, to handle that.

David N. Levenson
Former Executive Vice President and President of Wealth Management

I would just say that, given the distinctive and innovative nature of the new products, it's taking more time than we anticipated to get through the regulatory process. That said, our annuity franchise goes much deeper than any one single product. As I mentioned on previous calls, we are working toward an all-weather, rational portfolio of products in 2012. We have other products already in the lab that we expect to launch this year. And overall, I'd say that we remain confident about our proportionate goal of $5 billion in sales in 2012.

Suneet Laxman L. Kamath
Sanford C. Bernstein & Co., LLC., Research Division

Okay. Then just one quick follow-up. So is it fair to assume, given the regulators are taking a little bit more time with this product, that the innovative product design, I mean, is something that does not exist today in the marketplace?

David N. Levenson
Former Executive Vice President and President of Wealth Management

I think that is a fair assumption, yes.

Suneet Laxman L. Kamath
Sanford C. Bernstein & Co., LLC., Research Division

Okay, terrific.

Operator

Your next response is from the line of Chris Giovanni with Goldman Sachs.

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

Two questions, one on the commercial property side. I wanted to see if you guys can comment at all on the reserve releases you guys had there, which seemed modest, maybe relative to some of the other peers. And then any preview in terms of 2Q annual asbestos review?

Liam E. McGee
Former Chairman

Andy Pinkes will take that.

Andrew J. Pinkes
Former Executive Vice President of P&C Claims and President of Heritage Holdings Inc

Chris, Andy Pinkes. Let me start with prior year development. So, really, the way I think about that is our reserve position remains strong. I think as you know, our carried reserves continue to be greater than our actuarial indications. We have a very robust reserve process and our reserving actuaries are reviewing the P&C Commercial reserves, monthly and quarterly, using the most current claim data and taking actions where appropriate. So really that's the baseline I would say that we head into any particular period with. That said, there's no doubt the last couple of quarters and as you noted this quarter, have had smaller releases. I would say that the pace of it all, of those prior year releases, will really be determined throughout the year as a result of that reserving process as we move forward. And yes, we are in the midst of our ground-up annual asbestos review. That's a second quarter operation. And so we're in the middle of it and we'll report out to you at the end of the second quarter.

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

Okay. And then one quick one on regulatory items. The CEO of one of your competitors last week had comments saying Washington keeps excluding the industry from some of the heavier regulations. So I wanted to see if you guys could just could provide some color on comments you guys may be having on the regulatory front?

Liam E. McGee
Former Chairman

Well, Chris, this is Liam. As it relates to Dodd-Frank, I think, generally the outcome so far, understanding and acknowledging there's a lot more to be done and to be defined, have been generally constructive for the industry. There's more to go and I'm not sure we can make a definitive statement until we kind of get through the entire process.

Operator

Your next response is from the line of Jimmy Bhullar with JPMorgan.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

I just have one question, a few of mine were already asked. But on -- you mentioned evaluating capital management initiatives. So I wanted to see if you could either give us some idea on the timing of when you would announce something or the timing of when you would know what the various -- the timing of when you would actually know what you're going to do and share that with the market. And then also, just related to that, what are the things that you are considering in terms of capital management and how would you view share buybacks versus retiring awards?

Liam E. McGee
Former Chairman

Well, a couple of general comments, Jimmy. Thanks for the question first. The 11% target, if you will, is really, was always meant to be an indication that this management team is very serious about managing a capital and using our capital as efficiently as possible. Secondly, we're very intent upon getting the relationship between our average cost of capital and our returns in the right position. Today, they're not. And so we took the first action, the dividend as you know last quarter. As we suggested then, Jimmy, we will now begin or have begun to consider a variety of potential actions. As you recall, last quarter I talked about, it could be for the dividend actions, it could be share or warrant repurchases, it could be risk mitigation and it could be a variety of other things. All I would say at this point in time is that we are in conversations and beginning some conversation with other constituencies around a variety of things we may consider. I'm not really prepared to give you a timing right now, but I can -- rest assure, as we make those decisions we will let the market know immediately.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

And then, maybe another one, just on your margins and the personal lines of business. It seems like you had pretty good severity frequency trends, especially in the auto business. If you could just talk about whether you see it as a secular trend or is it more related to fuel prices being high and like, what you're seeing in terms of frequency, severity in personal lines?

Liam E. McGee
Former Chairman

Jimmy, Andy Napoli will take that one.

Andre A. Napoli
Former Executive Vice President and President of Consumer Markets & Enterprise Business Services

Jimmy, yes, I mean, for auto, we expect baseline frequency will increase as the economy improves and miles driven increases. But I think what we have going for us is a pretty significant mix shift to a more preferred mix of business will largely offset that impact. In terms of severity, we expect that to increase moderately in '11, maybe a little bit below the long-term historical average. So you blend that together into a loss cost pic, we expect loss cost for us to be somewhat flat for the year.

Operator

Your next question is from the line of Mark Finkelstein with Macquarie.

A. Mark Finkelstein
Macquarie Research

I guess if I could, can I just expand on, Chris, your comments on the tail hedge. I mean, it sounds like you've done the analytics on the Japan VA block. It sounds like you're, at least, have set a strategy. I guess, just in terms of some of the details or at least the framework for how to think about it. I mean, I guess, how much volatility in Japan capital will this tail hedge allow or even U.S. capital for the reinsured block? And can you just give us any sense at all in terms of what kind of a cost we should be thinking about and what are the implications, particularly on the DAC balance of $1.6 billion?

Christopher John Swift
Chairman & CEO

Mark, it's Chris. Happy to try to respond. Yes, I would say that we have a good framework, a good strategy, a good, I'll call it, definition of what we're trying to accomplish from a number of different points of view. But at least, which is unimportant is sort of the deductible or the amount of risk that we still want to retain versus what we're going to ship off to the market. So what I -- we just can't share with you right now, because we just don't physically know, just as we build positions, what's the impact on, completely on statutory surplus and capital and DAC. Obviously, from baking those into the EGP streams. I think one point of clarification, I would like to point out to you, all these hedging instruments will be in U.S. legal entities, not on the Japan illegal entities. I think you and I have talked with others that we have about $1.2 billion, $1.3 billion of statutory capital in Japan, that's sort of unaffected by this. So all the hedging instruments, at least initially, will be put into the U.S. legal entities. And then over time, we might build out a more direct hedging program in Japan, too. But I think we'll know more as we build the positions here during the second and third quarter and we'll keep you posted on the impacts on statutory and GAAP.

A. Mark Finkelstein
Macquarie Research

Okay. I guess, just a follow-up on Consumer Markets. I guess, how should we think about a pricing strategy? I mean, you're continuing to push rate, the PIF count continues to decline. It feels like maybe the market isn't kind of taking the rate increases. Is there any shift in how you're thinking about rate in the consumer markets in terms of stabilizing PIF, and when do you see that PIF count stabilizing?

Andre A. Napoli
Former Executive Vice President and President of Consumer Markets & Enterprise Business Services

This is Andy. Good question. As the year progresses, especially in auto, we expect our recent price increases to moderate. And homeowners, I think, there's going to be continued upward pressure on homeowners pricing. But auto is obviously a big driver here. As the pricing moderates throughout the year, we expect new business growth to turn positive in the second half of the year and retention to start increasing moderately by the end of the year.

Operator

Your next response is from the line of John Nadel with Sterne Agee.

John Matthew Nadel
Sterne Agee & Leach Inc., Research Division

A couple of quick ones. Just following up on Jimmy's question in a slightly different way on the capital management issue, Liam. Just maybe you can frame for us, if you -- if The Hartford did not, between now and the end of 2012, deploy capital in a buyback of stock or warrants or other. What's the differential as you look at that 11% ROE objective. What would it be, if you're not able to deploy at the same level that you're expecting embedded in the guidance?

Liam E. McGee
Former Chairman

John, thanks for the question. Let's take a couple of steps back away. As I said to Jimmy, this team is very focused on managing and utilizing our capital as efficiently as possible. That's what the 11% target is all about, as well as lowering our average cost of capital and getting ROEs to exceed them. If you recall, the 11% target, if you will, is really for the tail end of 2012 to be at that rate. So we do have some time to get there. I'll reiterate what I said, and I think Chris has said consistently as well, is that it is -- it is through a combination of both the high single-digit earnings that we're targeting, which includes that efficiency improvement that Chris just discussed, and we're very confident we will achieve, as well as we believe we will have a variety of levers to pull either individually or collectively around capital management. So as we make those decisions and as I made clear in my remarks and we've been consistent on this, we're considering all those things. We're in conversations or beginning conversations with some constituencies around potential actions, and we'll let the market know that. Chris, I'll turn it to you in terms of John's other questions about the calculation.

Christopher John Swift
Chairman & CEO

John, I think I understand what you're trying to calculate. I think the simple answer is it just really depends, right? I think it would be unfair to put out any sort of with and without type of calculations right now, because there's a lot of moving parts in our balance sheet that we just need to go through, with some accounting changes that we'll have to implement. So it's really just very imprecise to even do it with and without calculations. I just prefer not to speculate at this time.

John Matthew Nadel
Sterne Agee & Leach Inc., Research Division

Okay, understood. I guess, just a quick follow-up then on the activities you're contemplating with respect to the Japan tail hedging. It sounds like we've got some incremental cost coming, I think in your words, Chris, manageable costs. But are those costs expected to be part of core earnings and does that then -- is that something that we need to contemplate as we think about EPS estimates relative to your guidance as we look out?

Christopher John Swift
Chairman & CEO

What I would just characterize, the incremental cost, directionally, and Liz Zlatkus is here too and she can give you more details of the final warrants on the program. But I think what we're targeting is, you think in terms of about 1/3 more protection that we'll build over a period of time here. As we build it, and again, depending on the form, the nature, price levels, we will incrementally include those in our EGP streams going forward. So I would say that the programs' cost, at least from our normal core earnings reflection will be reflected in EGPs over a longer period of time. The mark-to-market and positions will still be below the line, consistent with our current practice and I think, John, you see all the pieces and then you could put it together and make your own determination.

John Arthur Hall
Wells Fargo Securities, LLC, Research Division

That's great. That's very helpful.

Operator

The next response is from the line of Darin Arita with Deutsche Bank.

Darin C. Arita
Deutsche Bank AG, Research Division

I was hoping to stick with Japan, and if you can give us a sense on what types of hedges that you're planning to put on to supplement the macro hedge? And then also, how we should think about the accounting effect of this?

Liam E. McGee
Former Chairman

Darin, I think on the hedges, I'm going to ask Liz just to give a little bit of details and then, after you hear that, then follow-up on the specific accounting implications of really what you mean, because I don't think I understand fully what you mean, the accounting implications. So, Liz?

Lizabeth H. Zlatkus
Former Chief Risk Officer and Executive Vice President

So, first of all, I'm just going to sort of reiterate how we're thinking about this hedge. We feel that our current hedge today has worked very well. It's minimized our losses for statutory, it's allowed us to go through the market turmoil during the quarter and fare very well, and it's also allowed us to benefit from improved market conditions. Going forward, as Chris said, we're going to have a more comprehensive approach that's going to look at economic cash flows. So regardless of where the risk sits, we're going to be able to feel very confident that we can manage the claims level after our deductible to a manageable amount. And yet, we'll still be able to share in the upside. As Chris said, about 1/3 more coverage overall. And it will depend on, certainly, from options versus futures, we'll make that determination depending on levels of implied volatility. On average, I would tell you that we're very well protected on the currency side, so it would be more on the equity and interest rate protection that we'd be adding. And all in, again, I think it's a very, very good approach because it really gives us confidence we can manage our risk to acceptable levels and again, still share in the upside.

Darin C. Arita
Deutsche Bank AG, Research Division

I guess on the accounting, I was thinking in terms of, if we're going to still have the mark-to-market go through this, show up as the way it does. I'm wondering, how that will -- what sort of volatility that might introduce, given the mark-to-market of these assets versus how the liability is set up?

Liam E. McGee
Former Chairman

That's a great point and that's what we've alluded to and foreshadowed in our prepared remarks, is that given that the liabilities for Japan aren't mark-to-market, we have the one-sided mark gains or losses on the asset side that would be flowing through the, I'll call it, the U.S. books on statutory GAAP basis flowing through consolidated. So you're right, but that's just the nature of the accounting model, Darin.

Darin C. Arita
Deutsche Bank AG, Research Division

Okay, understood. And then, I guess, turning more towards the U.S. Annuity business. We're seeing surrenders go up quite a bit here. I'm just wondering if you're noticing any particular trends on policyholder behavior and the types of people lapsing, and how it might relate to the account value in or out of the money.

David N. Levenson
Former Executive Vice President and President of Wealth Management

So, Darin, this is Dave Levenson. So lapses did increase to 14.4% in the first quarter, that is up from 12.8% in the fourth quarter, and that compares to, I guess, a normal range of 10.5% to 11.5%. So we have seen an uptick. I guess, I would relate the uptick to 2 specific things. One is a general aging of the book. Right now, we've got about 57% of our policies that are outside of the CDSC period. But more relevantly, I would say that as the markets are going up, more contracts moving from in the money to out of the money. And as a result, that is causing the lapses to go up. But, I guess, the upside of that is as markets go up, net-net, that is good for the organization. And we're also seeing about 40% of our lapses come from in-the-money contracts, so we are seeing an NAR reduction.

Operator

The next response is from Thomas Gallagher with Crédit Suisse.

Thomas George Gallagher
Crédit Suisse AG, Research Division

One quick follow-up on Japan, then another one on the tax rate. So, Chris and Liz, is the right way to think about this, that you're willing to absorb more statutory capital volatility because you have, in your estimation, and probably the rating agencies' estimation, more than enough risk-base capital. So when you evaluate this, you're looking at the cost of holding on to more capital potentially versus the cost of paying up in the capital markets. And then right now you view self-ensuring as the better option and then buying the very deep out-of-the money protection as what you're implementing here. Is that a fair characterization or not on the Japan side?

Christopher John Swift
Chairman & CEO

Tom, it's Chris. I would say precisely. Again, we've always said we're balancing the economics. We're running the plays on the economic basis that will balance GAAP capital, statutory implications, and that's exactly the design that Liz and the team have come up with based on our framework.

Thomas George Gallagher
Crédit Suisse AG, Research Division

Okay. And presumably, Liz, this is going to be a multiyear hedge program that more closely matches the duration the of the liabilities, is that in theory the way we should be thinking about this?

Lizabeth H. Zlatkus
Former Chief Risk Officer and Executive Vice President

Yes, absolutely. But that doesn't necessarily mean all the instruments will be multiyear, because you can always roll them. So we'll be looking at, like I said, at implied volatility levels and price points. But how you should think about it is, if you -- eventually stat will equal cash flows, right? So we're looking at it comprehensively on a cash flow basis, ultimate cash claims cost, limiting that to an acceptable level, irrespective of the risk factors. So you could be putting on, if rates move more, you'll put more rate protection on, or if equities, you'll do that. So it is to look at the long-term claim patterns to your point.

Liam E. McGee
Former Chairman

Tom, I would also just add, again, with the discussions we have with Liz. Remember, the most important part of the exposure period is until annuitization also. So that a lot of the design in the hedging instruments x interest rates, which is a longer-term matter, is really FX and equity in the short term prior to people's election on annuitization is the primary focus of the program, also.

Thomas George Gallagher
Crédit Suisse AG, Research Division

And has the reaction from the rating agencies been -- did they understand that you're better matching the economics? Are they willing to let you have more statutory capital volatility and not make you hold on to more capital? Or is there the understanding that you're going to have to run it at a higher RBC, just because this is inherently going to create more, at least short-term, statutory capital volatility?

Christopher John Swift
Chairman & CEO

Great point. And like as Liam said, we're early in those discussions and those are important dialogues that will begin to happen.

Thomas George Gallagher
Crédit Suisse AG, Research Division

Okay. Then last question, can you just comment on what the tax rate you're using to calculate core EPS and what should we be modeling for the balance of 2011?

Christopher John Swift
Chairman & CEO

I would just point you to -- it's a little lower this quarter just because net income is a little lower. Nothing's really changed from an, I'll call it, an actual calculation side or the amount of preference items we have, Tom. So think in terms of 22% to 24% effective tax rate going forward.

Richard Costello

This is Rick Costello. We don't want to run too long given that we've got another industry call beginning at the top of the hour. So I'd ask that we take one more question and then we'll conclude.

Operator

Your final response is from Eric Berg [ph] for RBS Capital.[ph]

Unknown Analyst

Chris, I know we've sort of said along here that the statutory capital volatility will increase as a result of your layering in more hedges prospectively. But why is that? And the reason I ask is as follows: My understanding is that you're currently booking reserves under this -- for these GMIB and GMDB benefits in Japan under U.S. statutory capital rules, namely what they call C3 Phase 2 and VA CARVM. This is something approaching, but not actually a mark-to-market. It's something like that, the so-called CTE approach. You're now going to layer in the use of additional derivatives that under statutory accounting will be mark-to-market. So it feels like, if anything, you will be supplementing your existing mark-to-market of liabilities with the introduction of new hedge assets that will also be mark-to-market, a move that I would think would lower statutory capital volatility, not increase it. Can you sort of set me straight on this? Because I was not able to follow the discussion as to why statutory capital volatility will increase.

Christopher John Swift
Chairman & CEO

Two, we could go on to a lot of detail offline on this, but I'd like you to think about, remember, it's Japan risk that is seated into the U.S. entity. So we have some basis risk there. It's not all of it. It's not all the income that's coming into the U.S. It's really the application of AG43 and VA CARVM and all that. There's a lot of technicalities that will create some initial, I'll call it, capital consumption that you'll have to assume and consume when we put in these positions, and then there is just volatility in how you run your AG43 models here going forward. Remember, we have an onshore program. We don't see this as offshore captives and we have actual surplus in our White River Re entities, back all these programs. So our U.S. program is just subject to a little bit more volatility the way we approach it.

Unknown Analyst

Okay, I'll definitely circle back to you.

Richard Costello

Thank you. And if there are no further questions at this time, it is 10:06. This concludes The Hartford's First Quarter 2011 Earnings Call. Thank you so much, all, for your participation and we do look forward to seeing you soon. Thank you.

Operator

This does conclude today's conference call. Ladies and gentlemen, we thank you for your participation. You may disconnect at this time.