S&P Capital IQ

CONTENTS

The Hartford Financial Services Group, Inc. NYSE:HIG

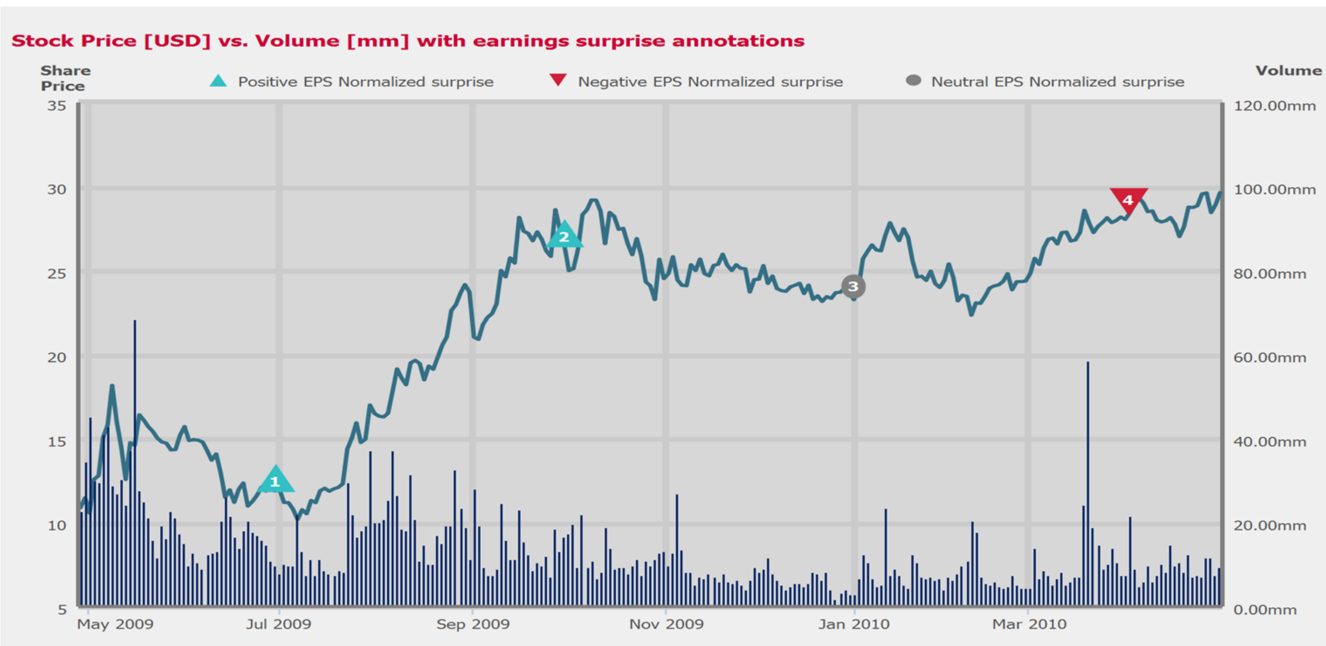
FQ2 2010 Earnings Call Transcripts

Thursday, August 05, 2010 2:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2010-			-FQ3 2010-	-FY 2010-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.77	0.92	▲19.48	0.83	2.38	3.73
Revenue (mm)	5556.23	3336.00	▼(39.96 %)	3966.56	18564.59	17863.42

Currency: USD
Consensus as of Aug-05-2010 12:34 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2009	1.16	1.90	▲1 63.79 %
FQ3 2009	1.42	1.56	▲2 9.86 %
FQ4 2009	1.51	1.51	●3 0.00 %

FQ1 2010	0.25	0.14	(44.00 %)

Call Participants

EXECUTIVES

Christopher John Swift
Chairman & CEO

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

Gregory G. McGreevey
Former Chief Investment Officer, Executive Vice President and Member of Office of the Chairman

Juan Carlos Andrade
Former President and Chief Operating Officer of Property & Casualty Operations

Liam E. McGee
Former Chairman

Richard Costello

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JP Morgan Chase & Co, Research Division

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FBR Capital Markets & Co., Research Division

Thomas George Gallagher
Crédit Suisse AG, Research Division

Presentation

Operator

Good morning. My name is Ginger and I will be your conference operator today. At this time, I would like to welcome everyone to The Hartford Second Quarter 2010 Earnings Conference Call. [Operator Instructions] Thank you. Mr. Rick Costello, you may begin your conference.

Richard Costello

Thank you, Ginger. Good morning and thank you for joining us for the Hartford's Second Quarter 2010 Financial Results Conference Call. Our earnings release and financial supplement were issued yesterday. The slide presentation for today's call is available on the company's website at thehartford.com.

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 Juan Andrade, President of Commercial Markets; Dave Levinson, President of Wealth Management; Greg Mcgreevey, Chief Investment Officer; and Alan Kreczko, General Counsel.

Turning to the presentation on Slide 2, 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 2010 quarterly reports on Form 10-Q, our 2009 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 second quarter of 2010 and in the press release we issued yesterday, both of which can be found on The Hartford's website at www.thehartford.com.

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

Liam E. McGee
Former Chairman

Thanks, Rick. Good morning, everyone, and thank you for joining us today. Before we get started, I want to welcome Dave Levinson. Last month, as you know, I asked Dave to lead Wealth Management and as we shared with you in April, we see exciting opportunities for this business.

The Hartford performed well in the second quarter. First, we reported good core results, with healthy top line momentum in many of our businesses. Second, we saw significant improvements in the investment portfolio. And third, we are well underway executing the go-forward plan we outlined in April.

As I said, The Hartford reported good overall results in the quarter. Given the economy, the volatile equity markets and as you already know, issues specific to the P&C and life industries, I was pleased that we navigated well through a bumpy quarter. We earned $76 million of net income compared to a net loss of $15 million in the second quarter of 2009. Core earnings were $92 million in the second quarter and included higher-than-expected catastrophes, a DAC unlock, an annual asbestos reserve charge, goodwill impairment and favorable prior-year reserve development in ongoing P&C.

When you account for these items, adjusted core earnings were about $0.92 per diluted share. We believe this figure demonstrates the underlying earnings power of the company. Chris will discuss how we get to that number in detail later in his remarks.

Book value per share was up 6% sequentially to $41.29. And with the market volatility we saw in May and June, I am pleased with the continued strength of our capital position. Revenues, excluding net realized capital gains and trading securities, grew 3% year-over-year. And we saw good top line momentum in many of our key businesses.

In P&C Small Commercial segment, written premium grew 3% over the prior year, reflecting positive renewal pricing and a 9% increase in new business policy count. In P&C Middle Market, price competition is intense, and we are balancing growth and profitability. So we were pleased that pricing on renewals was flat. And policy count retention increased 2% over the prior year. Chris will talk more about Group Benefits later in the call but results there were below our expectations. We see some near-term challenges in this business and are working hard to address them.

In Wealth Management, sales and deposits increased in many businesses. Retirement plan deposits increased 12% over the prior year. Mutual fund deposits were up 11%, and Life insurance sales grew 8%. Second, over the last year, we have seen significant improvements in the investment portfolio. In the second quarter, we had a 13% increase in net investment income, excluding trading securities, driven by strong partnership returns. Another positive sign was that net unrealized losses declined by more than 50% since March 31 to $1.5 billion. We are also seeing favorable trends on impairments, which declined again this quarter. Barring a severe economic or market reversal and given the actions we've taken to date, we believe the worst is behind us on impairments. Over the next several quarters, we expect to see credit losses similar to those we've experienced in the first half of the year.

Given the recent interest in municipal bonds, I want to provide some background on our $12.5 billion portfolio. We feel good about this portfolio given its broad diversification and high average credit quality of AA-. We are heavily weighted toward general obligation and essential service revenue bonds that are supported by clearly defined and dedicated tax or revenue sources. We have also reduced exposure to municipalities in areas of particular economic stress. As Rick said, Greg is here for the Q&A session to answer questions you may have on the portfolio.

Finally, I want to provide an update on the company's strategy. We're making good progress executing on the plan we outlined in April and are seeing a number of encouraging signs. On July 1, we completed the transition to a new organizational structure. Leadership of the Commercial Markets and Wealth Management business unit is in place. We also have a number of very good candidates for the Consumer Markets role and expect to have that position filled in the early fall.

Now as I mentioned earlier, I'm pleased to have Dave Levinson lead Wealth Management. In his 15 years at The Hartford, he has a broad range of experience across Wealth Management, which along with his strategic vision and bias for action, are among the key reasons I selected him for this role. I have charged him with accelerating the profitable growth of Wealth Management, working within the strategy we announced in April. I can tell you that Dave is moving quickly and decisively to identify the best individual and collective opportunities for these businesses.

I've also asked Dave to review the Annuity business, including the performance of Personal Retirement Manager. The new product is now broadly available in the marketplace and the next few quarters will be critical in determining its ultimate success. As we said in April, annuities with an appropriate balance of risk and return are an important part of The Hartford's Wealth Management business. We are committed to the Annuities business and we continue to invest in product, distribution and marketing going forward. And finally, I'm excited about our unique potential to profitably grow in the Wealth Management business.

In Commercial markets, we're optimistic about our go-to-market strategy. I'm pleased with the early results coming from the combination of our Group Benefits and Commercial P&C businesses. Together, the efforts of these two sales teams have already built a solid pipeline, with close to 1,000 new opportunities, a significant percentage of which we have already quoted. Our early joint efforts have generated several million dollars in sales to date. Juan and his team are optimistic about using this collaborative business model on the full year sales cycle in 2011.

And consistent with that, we're implementing additional sales tools to drive the sustained success across this organization, which include: Cross-train the P&C and GBD sales organizations on each other's products; launching new compensation, incentive and recognition plans to align individual and agency objectives with this strategy; new marketing materials that better articulate to our customers the value proposition of the combined Commercial Markets business; and we have established a set of metrics that will measure the success of our sales teams.

The Consumer Markets team is also executing on its strategy. In auto and homeowners insurance, our focus on the 40-plus age group is resulting in a higher percentage of preferred business. As an example, in the agency channel, preferred new auto and home business as a percentage of the total, has increased by more than 7% over the past six months. The team is also off to a fast start in creating new affinity relationships, as we are already in conversations with several large potential partners. This was important, since there is generally a long sales cycle for affinity relationships. We're optimistic about the potential for future top line growth from this strategy and the value for both us and our partners.

As we also discussed in our April investor meeting, we are committed to simplifying The Hartford and making the company more efficient. Our first important step was to bring together the company's service operations into one enterprise organization. This will allow us to share resources and best practices, further enhance customer service and drive efficiencies. Our ultimate objective is to give customers a one Hartford, one brand experience.

Now before I close, I want to comment briefly on the economy. We continue at The Hartford to anticipate a slow and choppy economic recovery. Recent GDP and payroll data has been consistent with this view. We believe the steps we have taken over the last several months and will take in the future months leave us well prepared to profitably grow.

To conclude, The Hartford reported good results in the second quarter, with healthy top line momentum in many of our businesses and an increase in book value. We saw significant improvements in the investment portfolio and we are well underway executing on our go-forward plan.

With the first half of 2010 complete, I am fully confident in the future of The Hartford and in our ability to meet the 2012 financial targets we laid out for you in April.

Now, I'll turn it over to Chris to talk about the quarter in more detail. Chris?

Christopher John Swift
Chairman & CEO

Thank you, Liam. Good morning, everyone. Let's begin on Slide 4. As Liam mentioned, net income for the second quarter was $76 million. Reported core earnings were $92 million or $0.17 per diluted share. Second quarter results were very noisy. To help better understand the company's core earnings strength, I'd like to discuss our calculation of adjusted core earnings, which we estimate at $460 million or $0.92 per diluted share.

Our estimate of adjusted core earnings excludes five items: The DAC unlock; higher-than-budgeted catastrophe losses; a goodwill impairment; a second quarter asbestos reserve charge; and net positive prior-year development in P&C ongoing operations.

Let's spend a few moments looking at these items in greater detail. The DAC unlock charge to core earnings was $168 million or $0.34 per share, resulting from global equity market declines in the second quarter. To put this into perspective, since The Hartford began using reversion to the mean for our return assumptions, we've had positive DAC unlocks totaling about $750 million through the first quarter of 2010. These unlocks were primarily driven by the 47% rise in the S&P over that period of time. So with the markets down 12% in the second quarter, you can see that the DAC unlock charge was proportional to the market move.

This was also an unusually high catastrophe quarter for The Hartford, with pre-tax losses of $229 million. On an after-tax basis, it was $0.18 higher per share than our budget. These losses were primarily driven by the severe hale and wind storms in the Midwest and are in line with others in the industry. While the second quarter was very active, potential fee management remains the strength of The Hartford. Although higher than budgeted, the losses we experienced were within the expected range of volatility for these types of events.

We also took a $110 million after-tax charge in the second quarter to increase asbestos reserves. This equates to about $0.22 per share. The charge follows the company's annual review of its asbestos exposures and was driven by increased severity in loss adjustment expenses, including litigation costs. These factors are generally consistent with the broader industry trend.

In contrast, reserves in our ongoing operations developed favorably during the quarter. In general, we saw positive reserve development across our liability line, primarily for accident years 2007 and prior. In total, net prior-year reserve releases in ongoing operations were $97 million after tax, a benefit of $0.19 per share. Even after these releases, our reserve position remains strong, with carried reserves higher than our actuarial indication and consistent with prior reserve positions at the end of 2008 and '09.

Finally, we wrote off most of the goodwill associated with Federal Trust Bank. This resulted in a $100 million impairment charge or about $0.20 per share. We acquired Federal Trust in the second quarter of 2009 in connection with the CPP investment. GAAP accounting calls for annual goodwill testing, which we performed for the first time in the second quarter. Backing up these five items, you get adjusted core earnings of $0.92 per diluted share. This is a good indication of the fundamental earnings power of the franchise.

Going back to Slide 4, we are pleased with all-in book value growth of 6% to $41.29 per share. Book value growth was driven by the decline in unrealized losses in the investment portfolio. Diluted book value per share, excluding AOCI, grew 3% during the quarter to $40.95. The increase was a result of second quarter net income and a lower Hartford share price, which reduced dilution from our outstanding warrants.

Finally, the core earnings ROE for the 12 months ended June 2010 was 7.4%. Excluding the charge we recognized in connection with the CPP repayment in the first quarter, the core earnings ROE for the last four quarters was 9.7%.

Now, let's move to Slide 5 to discuss our second quarter results in Consumer Markets. We continue to position ourselves to generate growth and profitability in Personal Lines. The rate in underwriting actions we have taken to preserve margins continue to work their way through the book. For the second quarter, renewal price increases were 6% and 9% for auto and home, respectively. Written premium was off 1% from prior year. Policies in force were also down about 1%. This was expected as we transitioned to a more preferred book of business.

Profitability in Personal Lines was impacted by elevated cat activity in the second quarter. Excluding cat, the current accident year combined ratio was a solid 93.2%. This is about three points higher than prior year. As a result, we expect to continue to take rate increases in auto and home going forward.

Looking ahead, we are excited about the growth opportunities in Consumer Markets. Our premium retention is increasing as we take rate. And we are generating a higher concentration of preferred business. We expect written premium to improve in the second half of the year in response to increased marketing, and we are excited about the rollout of our universal auto product, which we plan to have in 36 states by the end of the year.

Now let's turn to Slide 6 for a discussion of our Commercial Markets results. In P&C, commercial lines performed well in the second quarter, with top line drivers trending favorably and the profitability of the underlying business remaining strong. P&C commercial insurance reported a 93.7% current accident year combined ratio, excluding cats, a good result at this point in the cycle. Our Small Commercial franchise continues to outperform the market, with an 85.9% combined ratio on the same basis. Plus, Small Commercial written premium improved 3% in the quarter, driven by positive renewal pricing and new business policy count growth of 9%.

We are seeing continued stabilization in pricing in the smaller end of the Commercial Markets. Renewal pricing in the second quarter was plus 3% in Small Commercial. However, industry pressure on pricing is more evident in our Middle Market and Specialty businesses. We are utilizing our sophisticated modeling capabilities to carefully balance profitability and growth on a granular level. We continue to maintain pricing discipline as demonstrated by flat renewal pricing in Middle Market for the last three quarters. We are taking rate as necessary and turning away business that does not meet our targeted returns.

On the top line, exposure reductions continue to impact our results. In Middle Market, auto premiums reduced written premiums by five points compared to the second quarter of 2009. That said, we are seeing signs that the decline in exposures is moderating. Endorsement activity is up and the rate of mid-term cancellations has declined. We expect these trends to continue.

Looking to the second half of 2010, we will continue to execute on initiatives to position ourselves for growth as the economy recovers by working to increase policy counts, driving to improve policy retention, and targeting areas of profitable new business growth, such as our industry verticals.

In our Group Benefits business, second quarter results were below our expectations, with core earnings of $34 million. The industry is experiencing higher disability claims frequency and we saw similar trends in the second quarter. We have closely reviewed our disability claims experience and the increased frequency is not correlated to any industry or plan size. This suggests that the overall frequencies maybe returning to historical levels. In response, we are taking rate in our disability lines to ensure that we continue to generate targeted margins going forward. On the top line, sales increased 13% over prior year, with persistency topping 90%. Fully insured ongoing premiums in Group Benefits declined 2%, pressured by lower payrolls and the sales challenges that were unique to The Hartford over the past year.

Looking ahead, Group Benefits is a great business and fits well with our strategy for Commercial Markets. Some top line and bottom line challenges exist. And Ron and his team are closely reviewing all elements of this business.

Now let's turn to Wealth Management results on Slide 7. Once you exclude the effects of the DAC unlock in the second quarter, margins in Wealth Management businesses continued to recover from last year's level. The margin improvements are being driven by year-over-year equity market appreciation and positive net flows in the non-annuity businesses. For the U.S. annuities business, core earnings, ex the DAC unlock were $98 million in the second quarter. This is a 61% increase over prior year and was driven by higher average account values. In international annuities, core earnings, ex the DAC unlock, were $59 million, an 84% increase over prior year. This increase is the result of higher account values, as well as the significant expense reductions in our Japanese and UK operations. In mutual funds, deposits totaled $4.3 billion. This is an 11% increase over the second quarter of 2009 on a comparable basis, demonstrating the strength of our distribution platform. Core earnings were $22 million, up sharply from the year-ago quarter.

In retirement plans, second quarter deposits were $2 billion, up 12% over prior year. Core earnings in the second quarter, excluding the DAC unlock were $13 million, more than double from prior year. Our transition to one administration platform is on track for completion in the second quarter of 2011. This scalable platform will be key to expanding margins in this business.

In our individual Life business, second quarter results were very strong. Core earnings, ex-DAC unlock, jumped to a record $55 million. We benefited from favorable mortality, as claims in large face in our policies were lower than the rolling four-quarter average. On the top line, life insurance sales were up 8% over prior year. We are expanding in the independent agent space. We've signed up more than 400 of the nation's largest independent life insurance producers, with an initiative that began earlier this year.

Now let's turn to Slide 8 for a review of our investment results. Once again, there was significant improvement in the investment portfolio in the quarter. As the slide shows, net unrealized losses continued to decline and as of June 30, were at their lowest levels since 2007. The main driver of the improvement was lower interest rates, which were partially offset by modest spread widening in a number of fixed maturity asset classes.

Impairments also improved during the quarter. Total impairments, including OTTI and mortgage loan valuation allowances were $148 million. The primary source of these impairments was weaker collateral performance in certain commercial real estate securities. Net investment income, excluding trading securities, was $1.2 billion, 13% higher than prior year. Strong performance from partnerships and alternative investments drove the improvement, and generated a 20% annualized return this past quarter.

This is a great result and we have been pleased by the recovery here. However, given the volatility of returns over the last couple of years in this asset class, we think it is prudent to stick with our guidance assumption of zero return at least for the balance of 2010. Longer term, we expect this asset class to yield 6% to 8% annually.

Finally, we continued to reposition the general account assets. Over the course of the second quarter, we reduced net commercial real estate exposures by almost $800 million. As we said in April, we are balancing yield, capital and fair value in determining whether to hold or sell individual securities. Our purchase activity favored higher quality corporate debt, as well as agency-backed MBS. In total, we purchased about $2.1 billion of corporate debt and slightly less than $1 billion of agency-backed MBS.

We like the progress we're making in the investment portfolio. The actions we have taken have improved the risk profile of the general account. And while liquidity remains higher than our long-term target, for now, we like the flexibility it affords us in this investment environment.

Now let's turn to Slide 9 for our updated guidance. As we announced last evening, our core 2010 earnings guidance is $2.10 to $2.30 per share. At the midpoint, the guidance range implies core earnings of about $0.90 per share for each of the next two quarters, taking into account a slightly higher share count. The updated range reflects actual core earnings results for the first half of the year, equity market levels at the end of July and a modestly lower Group Benefits margin. Otherwise, there are no changes to the second half outlook.

As we said in April, our third quarter financial results will reflect the new organizational structure. We will provide the analyst investor community with recast historical financial information to update your models well in advance of the earnings call.

Our second quarter results can be summarized as follows: In [ph] (0:49:12.6) a period of market volatility, with several items impacting earnings, the core franchise performed well and our capital position remained very strong, with statutory surplus essentially unchanged from year-end levels; investments continued to recover, with net unrealized losses declining 50% to $1.5 billion; we are balancing growth and profitability in a low interest rate environment today, while continuing to invest in our businesses for the future; and finally, we operationalized the new strategy focusing on customers, brand, growth and efficiency, with early signs of traction.

With that, I'll turn the call over to Rick as we move into the Q&A session.

Richard Costello
Thank you, Chris. Before we begin the Q&A session, I would ask the callers to limit themselves to two questions. This will allow us to get to as many callers as possible. Ginger, you may now open the call to questions.

Question and Answer

Operator

[Operator Instructions] And your first question is from Jimmy Bhullar from JP Morgan.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

I had a question first on your -- like just to get an idea on how far along you are in your portfolio restructuring. And then related to that, on the CMBS assets that you sold, the $800 million, what sort of pricing you got on those? And then secondly, on the variable annuities, your deposits and flows have obviously been weak. And the new products have been only out for a little bit. But it doesn't seem like it's been as well received as I would have thought at least initially. So just wanted to get an idea if you've discussed or would you consider rolling out products with more rich equity market type guarantees that some of the competitors are selling, to improve your results?

Liam E. McGee
Former Chairman

Hi Jimmy, this is Liam. Why don't I take the second question first and I'll turn the first question over to Greg on the portfolio. I think in context, as you allude, the new product is just now fully available in the distribution partners, as well as the larger states. We've told you in the last quarter or two, that, that process took longer than we would like. You're right. The volumes have not yet hit the levels that we would like in total for annuity. But we still receive quite encouraging feedback. I was with one of the larger broker dealers myself just a few weeks ago and the feedback has been quite positive. So as I said in my remarks, now that we're in the distribution and in the states we need to be in, we'll evaluate it very factually over the next few quarters. Lastly, just to reiterate, we are committed to the Annuity business. We're going to continue to invest in product, marketing and distribution toward our ultimate goal of that approximately $5 billion in 2012. Greg, why don't you comment on Jimmy's questions around an investment portfolio?

Gregory G. McGreevey
Former Chief Investment Officer, Executive Vice President and Member of Office of the Chairman

Yes, Jimmy, there's two parts to your question. On the first part on portfolio repositioning. I think overall, we feel very comfortable and largely through a lot of our portfolio positioning from a de-risking standpoint, we're encouraged by a lot of the transactions that we've done in the first half of this year. Balancing the things that Chris had mentioned, which are fair value, capital and future net investment income. We'll continue to re-underwrite our portfolio, come up with fair values, look at market values relative to those fair values and then, again balance capital and income and continuing to look at trade opportunities. But in general, we feel from a de-risking standpoint, we feel largely through most of that portfolio positioning. In terms of CMBS, which was the second part of your question. In the second quarter, we sold about $600 million of CMBS holdings. Most of those were to take advantage of an improvement that we've seen in CMBS pricing overall. We sold those at a net slight unrealized gain for the quarter. And again, it's really taking into consideration those things that I had mentioned before, in balancing, those fair values, capital and future net investment income. And we'll continue to look at our CMBS portfolio and other parts of our portfolio to take those things into consideration.

Operator

And your next question from Darin Arita from Deutsche Bank.

Darin C. Arita
Deutsche Bank AG, Research Division

On the investment portfolio, and going back to the capital scenario laid out in April. And you talked about a $2.8 billion investment really that impacted the use of capital. I'm wondering how reasonable is that number, given the unrealized loss position is now down to $1.5 billion.

Liam E. McGee
Former Chairman

Hi, Darin. This is Liam. First, just to put in context. Recall, the $2.8 billion was under a severe stress scenario, as you recall. There were many factors but the two primarily stress factors were prolonged S&P decline starting at $700 million and then an additional 20% reduction in values were residential and commercial real estate. Even under that scenario today, we think the $2.8 billion number would be reduced. And obviously, assuming that scenario, which we all hope doesn't materialize, our losses over the cycle should be well inside that number. Greg, is there anything else you want to say?

Gregory G. McGreevey
Former Chief Investment Officer, Executive Vice President and Member of Office of the Chairman

The only thing I'd say, Darin, is clearly, that's not our expected view of economic formation. We're beginning to see stabilization in real estate values of both residential and commercial. And I think as Liam pointed out in his comments, we think impairments as we move forward, are going to moderate compared to certainly what we've seen. And we'd expect that trend to continue as we proceed over the next number of quarters.

Darin C. Arita
Deutsche Bank AG, Research Division

Thank you. And just one other looking at the Life business and the statutory capital. The declines during the quarter, can you talk about the cause of the decline and whether we should expect a similar size decline if the market fell by 12% again in the third quarter?

Christopher John Swift
Chairman & CEO

Darin, it's Chris. Thank you for the question. I think as I pointed out, from the end of the year, statutory surplus is level. We increased in the first quarter, decreased here, primarily driven out of equity market decline and the yen/dollar, yen/euro movement. As we sit here today, as you know, the markets were recovered slightly in July. And I would estimate that we recovered approximately 50% of that $700 million decline that you referenced.

Darin C. Arita
Deutsche Bank AG, Research Division

Okay. Just so I understand though. Is it rather linear as we go up and down? Or is it a little more complex than that?

Christopher John Swift
Chairman & CEO

It's a lot more complex. We could talk to you more about it if you'd like but it's more complex.

Operator

And your next question from Ed Spehar from Bank of America.

Edward A. Spehar
BofA Merrill Lynch, Research Division

First, I was wondering if you could give us some sense for statutory earnings, either six months or how you're thinking about statutory earnings for the full year in the Life business. And then the second question is I was wondering if you had thought or looked at any closer the idea of hedging more of the risk in Japan. And if you have any update as to how much it might cost today if you were to go out and try to hedge the entire exposure.

Liam E. McGee
Former Chairman

Ed, it's Liam. On the second part, obviously, in any element of our business, we're constantly evaluating risk and risk protection. Japan would be among those. I couldn't give any more specifics about what the cost parameters would be for a variety of options. But as in any part of our business, we're evaluating risk protection. Chris, did you want to comment on the first part?

Christopher John Swift
Chairman & CEO

On the statutory, Life earnings, I have numbers in front of me, Ed. Maybe we could talk more in detail offline. But through the first half of the year, we actually lost about $500 million on a statutory basis and then projected to make up all that and then some in the second half of the year, ultimately earning $700 million of statutory net income. And I would just add on Japan. We've looked at a lot of different activities over the last couple months here. There's nothing out there that we feel is appropriate at this time.

Edward A. Spehar
BofA Merrill Lynch, Research Division

Okay. And just to follow up. The statutory numbers that you're giving me, that's net income or operating?

Christopher John Swift
Chairman & CEO

Operating income.

Edward A. Spehar
BofA Merrill Lynch, Research Division

And is the loss in the first half because of the reserve increases for the equity market decline? Or is something else going on?

Christopher John Swift
Chairman & CEO

Exactly, the [indiscernible] (59:13) impact coming through the second half of the year. Our outlook as you know, assumes that the equity markets still rise 7.2% in the second half of the year. So that's where we see the recovery.

Edward A. Spehar
BofA Merrill Lynch, Research Division

Okay. Can I just ask, when you gave your -- you had your investor day and you talked about sort of the stress analysis and you gave a two-year cumulative number for statutory operating income under sort of a bad case scenario. If I recall, I think there was like $1.6 billion or something of earnings. Is that correct over two years?

Christopher John Swift
Chairman & CEO

Over two years for both the Life and Property and Casualty.

Edward A. Spehar
BofA Merrill Lynch, Research Division

Okay. But I guess the question is if you lose money when the market's down in the Life business, what was it that led you to assume that you made money over two years in a down market scenario?

Christopher John Swift
Chairman & CEO

Well, if you recall, we shocked the down market scenario, we shocked at 1/1/2010. So you had the immediate decline and then sort of the gradual recovery in market rates, plus the other spread-based businesses that would produce statutory income. So it's a day one impact and then sort of slow and steady going forward.

Operator

And your next question is from Tom Gallagher from Crédit Suisse.

Thomas George Gallagher
Crédit Suisse AG, Research Division

Chris, just a follow-up. The $700 million reduction in the statutory capital in the Life business. Can you just split that out between equity market impacts, interest rates and other, just so we have the components? And then the second question is, can you talk also about how lapse rates are trending for your U.S. variable annuity business? In particular, when I think about the DAC review that you'll be doing for 3Q for your full-year update, are they trending better or worse than expected as it relates to utilization of the GMWB benefit and just overall for withdrawals?

Christopher John Swift
Chairman & CEO

Sure, Tom. On your first question, I think you were looking really for the attribution of the $700 million. Simply stated, through a number of pluses and minuses on the liability side to hedge asset offset, I would attribute 60% of the $700 million decline to equity and 40% to FX, with interest rates really being offset by our hedge position on the hedge side. On lapses, as you know, we're in the middle of our review right now. I don't think we have a definitive view, if we're seeing a trend one way or the other at this point in time. So as we continue to close out the third quarter, we'll keep you posted as far as what we're seeing. But right now, we don't have any indications one way or the other.

Thomas George Gallagher
Crédit Suisse AG, Research Division

And just a follow-up, Chris. Can you talk about what kind of utilization rates you're seeing on your GMWB policies, as a percent of in-force?

Christopher John Swift
Chairman & CEO

What I've seen is it's fairly consistent. I can't quote you the exact numbers, but the trends and the data I see, it's fairly consistent from period to period.

Operator

And your next question is from John Nadel from Sterne Agee.

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

As it relates to the guidance, you're assuming the S&P of 7.2% annualized from June 30 and that clearly looks reasonable after we see the move in July. However, in the next sort of bullets in the release, you talk about that the guidance doesn't include an estimate on DAC unlocks, positive or negative. But clearly, if the S&P were to close the quarter around this level, you've got a positive DAC unlock. I mean I guess ignoring the potential for some hits or some adjustments with your annual review. I was just hoping you could sort of quantify what the positives essentially DAC unlock, reversing the second quarter numbers would be if markets closed here?

Christopher John Swift

Chairman & CEO

Thank you. The way we estimate it is basically for each 10-point movement in the S&P, we would expect to see a $10 million to $20 million earnings impact. So if it's up 100, hopefully through today, you could see a general range of what we would expect the DAC unlock to be positive in the third quarter. Does that help?

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

I'm sorry, that was 10% is $10 million to $20 million or 1% is $10 million to $20 million?

Christopher John Swift
Chairman & CEO

A 10-point move.

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

A 10-point move, thank you. My second question's just on Group Benefits. In your supplement, you show the reserves for the underlying product lines there and I noticed that the group disability reserves increased nearly $100 million quarter-over-quarter, about 2% and premiums in group disability fell 2% quarter-over-quarter. So I was just wondering if you could give us some detail on the driver of that reserve increase. Was that incidents related? Was that lower discount rate on new claims reserves? Something else?

Juan Carlos Andrade
Former President and Chief Operating Officer of Property & Casualty Operations

Yes, John. This is Juan Andrade. Really, the driver of all of this is really increased incidents from long-term disability. And also to a lesser extent, lower claim terminations.

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

Okay. And is that increase reflecting just what you saw in 2Q? Or does that bake in an expectation that those incidence rates and lower claim terminations continue?

Juan Carlos Andrade
Former President and Chief Operating Officer of Property & Casualty Operations

Yes, so this is basically baking in the trend that we started to pick up, I would say at the end of the first quarter, really into the second quarter of '09, of '10 rather.

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

Okay. So in other words, if incidence and claim terminations remained at around the same level, we shouldn't see increased reserves as a result, you already have that baked in?

Juan Carlos Andrade
Former President and Chief Operating Officer of Property & Casualty Operations

We're already starting to bake that in. The other thing that we're putting in there is additional pricing in our long-term disability lines to make sure that we maintain our pricing for our target returns.

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

Okay. And how long should it take to re-price the book then?

Juan Carlos Andrade

Former President and Chief Operating Officer of Property & Casualty Operations

So I would say, as you know we have three-year guarantees on this book of business and so roughly 40%, 50% of the book would be impacted on an annual basis.

Operator

And your next question is from Randy Binner from FBR Capital Markets.

Randolph Binner
FBR Capital Markets & Co., Research Division

I think Ed was asking about Life's stat earnings. Did we discuss P&C's stat earnings in the quarter or first half?

Christopher John Swift
Chairman & CEO

No, we did not, and again, they're trending as expected as had a little bit of obviously a bump with cat. We've been taking dividends out. So their statutory surplus is pretty much unchanged also from year end. On the statutory, I'll call it actual earnings side, just looking at my notes here, we'd expect the second half of the year to make statutory net income of around $600 million.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay. And then that's operating, right?

Christopher John Swift
Chairman & CEO

Correct.

Randolph Binner
FBR Capital Markets & Co., Research Division

And then, I'm sorry, what was the first half number?

Christopher John Swift
Chairman & CEO

View it as pretty much breakeven to maybe just slightly positive.

Randolph Binner
FBR Capital Markets & Co., Research Division

Understood, with the surplus comment, that's great. And then just on the 11% ROE goal for 2012, that was kind of the key takeaway from the April Investor Day. Expense improvements, P&C margins, among other items, were kind of the key drivers there. There's been a moderate decrease here in guidance, but just would appreciate any color on how that longer-term goal is still trending.

Christopher John Swift
Chairman & CEO

Randy, I would just point out that I don't believe we decreased guidance. So if your premise is that we decreased guidance, I would say that's generally not true, except for Group Benefits. Everything else in our guidance remains unchanged. If you look at total Property and Casualty, loss ratios are still within the range that we published initially. We still see that during the outlook years through 2012. So we believe completely that the 11% is an achievable number based on the results that we're producing right now.

Operator

And your next question is from Eric Berg from Barclays Capital.

Eric Noel Berg
Barclays PLC, Research Division

I mean I know sort of why you wrote down the goodwill. I mean it's not an inconsequential number. Could you offer some insight into what happened there? I realize that this was part of a larger plan here, but I'm not sure if it sort of justified overpaying to the extent that you did. And my second question is in your financial supplement, you disclosed the results of proprietary versus non-proprietary mutual funds. When you were talking about the -- when one is talking about the funds that are marketed under The Hartford brand by independent financial advisers and managed by Wellington, would those be the proprietary funds?

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

So on the non-proprietary side, those are the funds that are subsidized by Wellington. And on the proprietary side, those are the funds that are managed internally by HMCO [ph] (1:09:50).

Liam E. McGee
Former Chairman

And then, Eric, on the first question. It's Liam. As you're well aware, the thrift was purchased primarily as a vehicle to receive CPP funds from the government. As Chris also said, GAAP requires a goodwill evaluation at year end, which we just completed. And the difference, as he said, is between what the purchase price was and what our current valuation of its value is. And all of the charge that was taken and the timing, again I'd reiterate, is really driven by GAAP.

Operator

And your next question is from Mark Finkelstein from Macquarie.

A. Mark Finkelstein
Macquarie Research

I want to go back to Group Benefits and maybe reframe Nadel's question just a little bit. Thinking about it from a guidance perspective. Year-to-date, the loss ratio is about 77%. The full year guidance, if I'm reading this correctly, is 73% to 76%, implying a 75% or lower benefit ratio for the back half of the year. I mean knowing the environment we're in and just kind of the rising level of incidents that you're showing, I guess what gives you the confidence that the benefit ratio is going to subside as much as that in the back half of the year?

Juan Carlos Andrade
Former President and Chief Operating Officer of Property & Casualty Operations

Great thanks, Mark. This is again Juan Andrade. I would say the revised guidance that we put out there on loss ratio for the Group Benefits business is between 73% and 76%. Part of the reason that we have confidence that the second half of the year will be better is historically, we do see lower claims incidents in the second part of the year, typically about one point on after-tax profit margin. So that does give us the confidence that we'll be able to be within that guidance range.

A. Mark Finkelstein
Macquarie Research

Okay. So typical 4Q seasonality is a pretty sizable benefit assumption.

Juan Carlos Andrade
Former President and Chief Operating Officer of Property & Casualty Operations

That is correct.

A. Mark Finkelstein
Macquarie Research

Okay. And then Chris, at your Investor Day on April 1, you discussed the 200-basis-point cut in the expense ratio. I think you'd been there a month at that stage. I guess what I'm asking is do we now have a formal plan on the expense side? How crystallized is it and how should we think about the timeframe for these expenses starting to get pushed through the businesses?

Liam E. McGee
Former Chairman

Hi, this is Liam. Let me take that one. As you accurately recall, we did talk about 200-basis-point reduction in the efficiency ratio, which as you know is both revenue and expenses, number one, and that's by 2012. Secondly, as I alluded in my comments, we do have very specific work already underway. First tangible evidence of that was to take the various parts of the operations in the company, which were distributed among the businesses and now running it as an enterprise operations function, which will help us from a customer service perspective, as we do have inconsistencies. We have redundant, and oftentimes non-compatible technology platforms between those businesses and we'll drive efficiencies. And so there will be other bodies of work across the company, very analogous to that. So that work is underway. It has very specific project management and accountabilities for the results.

Operator

And your final question is from Andrew Kligerman from UBS.

Andrew Kligerman
UBS Investment Bank, Research Division

I wanted to ask about the $700 million drop in surplus and the fact that your macro hedge delivered $193 million. Is that robust enough in your view? And you mentioned you weren't changing the international hedging program, but maybe some additional plans on that. Then real quickly, LTD. You mentioned you're taking rates. How much? To what degree? And on asbestos, could you give us a ratio that would indicate the adequacy of your new reserves? I remember about seven years ago, I think asbestos reserves were taken up by about $3 billion. So I'm wondering if there's some ratio or benchmark that would give us comfort that your new study really nailed it and that we shouldn't expect more reserve hits.

Liam E. McGee
Former Chairman

Andrew, on the first question, I'll let Juan answer the second one. On the first question, as you know, we have a combination of hedging and capital. And we'll constantly, as I said in my earlier response to the specific Japanese question, we do and we'll constantly reevaluate that balance. And if we think we should rely more on hedging than we have, we'll do so or less if we think that's appropriate. So I think that's a dynamic process. But let me reiterate, as I said in my comments and I think Chris has said in his comments as well. On the capital side, I'm really pleased with the capital strength we are able to demonstrate with all the volatility in this quarter. Juan? How would you answer Andrew's question?

Juan Carlos Andrade
Former President and Chief Operating Officer of Property & Casualty Operations

Great, Andrew. Thanks. This is Juan Andrade. First, on the LTD piece of it. As I mentioned, we are seeing increased incidence in LTD. And in order to ensure that we continue to price to our long-term partner returns, we are taking price. I would say in the low single digits at this point in time. But this is something that we monitor very carefully and we will react as we need to. I think with regard to asbestos, I think as you know, every second quarter, we do our ground-up review. We took asbestos up by about $169 million, and what we found this time was really an increase in severity and expense, driven by litigation in certain jurisdictions, cancer cases, et cetera. Very much in concert with what some of our competitors have also reported in recent asbestos studies. As to the number that we took up in this study, we do feel very comfortable with it. Obviously, we don't forecast what we think development is going to be. It's one of the reasons why we do such a thorough ground-up review of this. And we have consistently been really in the 61-percentile range, as we said, our asbestos reserves and we continue to be there. So we actually feel very good about the number that we've just put up.

Andrew Kligerman
UBS Investment Bank, Research Division

61 percentile, Juan, meaning 61% of what?

Juan Carlos Andrade
Former President and Chief Operating Officer of Property & Casualty Operations

So this is typically the range of reserves for asbestos and this number happens to be again, between the 50th and the 70th percentile of confidence. So it's typically where we have been historically with our asbestos reserves. So again, it goes back to the confidence that we feel about the consistency of our reserving methodology.

Andrew Kligerman
UBS Investment Bank, Research Division

And I mean there's no number on like reserve to trailing, payments or something like that, that kind of sticks out, that would give us additional comfort?

Juan Carlos Andrade
Former President and Chief Operating Officer of Property & Casualty Operations

No, I think really, there isn't per se anything at least that is comparative. We look at these ground-up studies on a very detailed basis every time that we do them. And the number that we put up is really the number that we feel is the exact number that we need at that point in time.

Christopher John Swift
Chairman & CEO

It's Chris Swift. If it disappears, I'll throw this out there. I just wanted to clarify your question, now that I could picture the chart that we put up there on April 1. On the right-hand side of the page was the VA impact of the down-market. So we isolated the impact of the down-market of $1.7 billion on the right-hand side of the page. The left-hand side of the page was again, stressed operating income for the two periods for Property-Casualty and Life, shown on a gross basis. So we didn't net the two numbers together. We showed them gross, and my comments still stand. I mean they will have normal operations that'll produce operating income outside of the VA decline effective 1/1/2010. Hope that helps.

Richard Costello

Ginger, I think we have no more questions at this time.

Operator

No, sir.

Richard Costello

This is Rick Costello, with no more questions. Thank you all for joining us. We look forward to seeing you on the third quarter conference call.

Operator
Thank you, ladies and gentlemen for participating in today's conference call. You may now disconnect.