S&P Capital IQ

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The Hartford Financial Services Group, Inc. NYSE:HIG

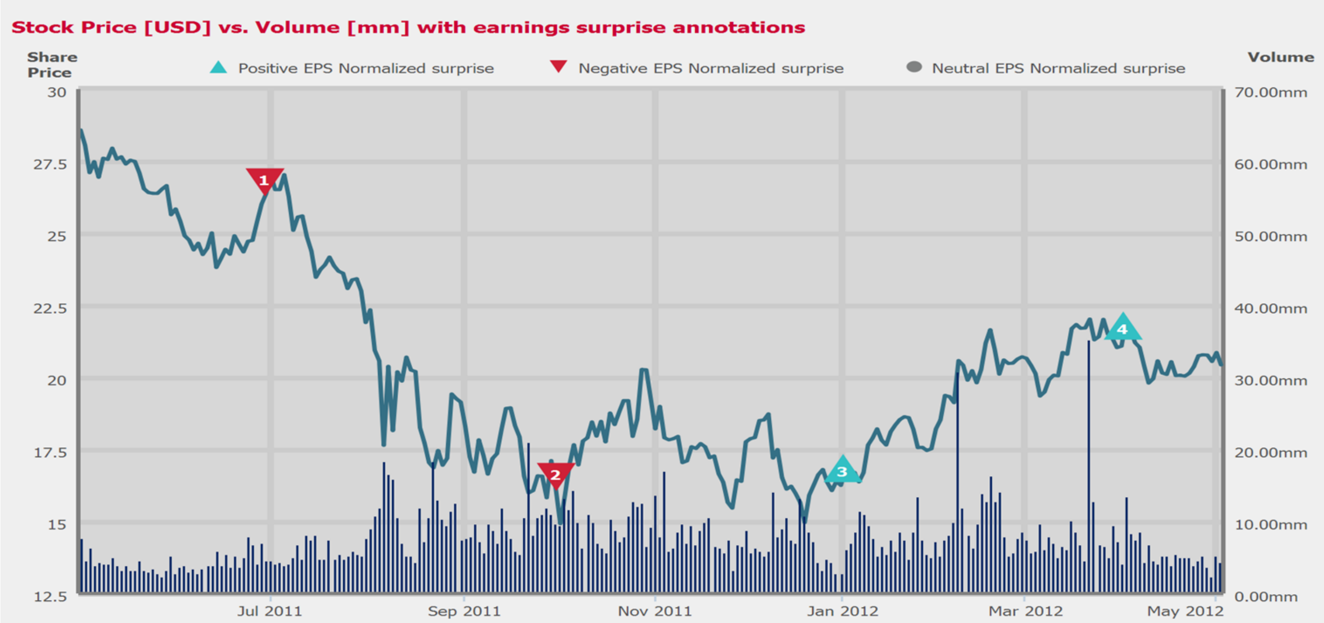
FQ2 2012 Earnings Call Transcripts

Thursday, August 02, 2012 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2012-			-FQ3 2012-	-FY 2012-	-FY 2013-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.47	0.23	(51.06 %)	0.80	3.28	3.59
Revenue (mm)	6245.50	4574.00	(26.76 %)	5944.27	23970.33	22426.83

Currency: USD
Consensus as of Aug-02-2012 12:17 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2011	0.01	0.00	1 (100.00 %)
FQ3 2011	0.25	0.05	2 (80.00 %)
FQ4 2011	0.62	0.69	3 11.29 %

FQ1 2012	1.06	1.25	▲17.92 %

Call Participants

EXECUTIVES

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

Christopher John Swift
Chairman & CEO

Douglas G. Elliot
President

Liam E. McGee
Former Chairman

Sabra R. Purtill
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Presentation

Operator

Good morning. My name is Darlene, and I will be your conference operator today. At this time, I would like to welcome everyone to The Hartford Second Quarter 2012 Earnings Call. [Operator Instructions] Ms. Sabra Purtill, you may begin your conference.

Sabra R. Purtill
Senior Vice President of Investor Relations

Thank you, Darlene. Good morning, and welcome to The Hartford Second Quarter 2012 Conference Call. Our speakers today are Liam McGee, The Hartford's Chairman, President and CEO; and Chris Swift, our CFO. Other members of our senior management team here today include Doug Elliot, Brion Johnson, Alan Kreczko, Andy Napoli, and Bob Rupp.

As detailed on Page 2 of the presentation, statements concerning The Hartford's future results or actions should be considered forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These forward-looking statements are not guarantees of future performance. Actual results may be materially different. We do not assume any obligation to update the forward-looking statements. You should consider the important risks and uncertainties that may cause The Hartford's actual results to differ, including those discussed in our press release, our second quarter 10-Q, 2011 10-K and other filings we make with the SEC.

Please note that our presentation includes financial measures that are not derived from Generally Accepted Accounting Principles or GAAP. Definitions and reconciliations of these measures to the most directly comparable GAAP measure are provided in our financial supplement, press release, 10-Q and on our website.

I'll now turn the call over to Liam.

Liam E. McGee
Former Chairman

Thank you, Sabra. Good morning, everyone, and thank you for joining us today. Before I get started, I want to welcome Brion Johnson, our recently appointed Chief Investment Officer. Prior to his appointment in May, Brion was Head of Strategy and Finance for our Investment Management subsidiary.

This was a productive quarter at The Hartford. We generated good underlying financial results, marked by improved performance in our go-forward businesses. We successfully refinanced the Allianz debt and completed the $500 million equity repurchase program. We also made progress in executing our new strategy, particularly in the sales processes for the Life businesses, which are proceeding as expected.

Let me start with an overview of our quarterly financial results. Core earnings were $119 million or $0.23 per diluted share, including high catastrophe losses, although less than last year's; restructuring expenses; and an unfavorable DAC unlock. Adjusting for these items, core earnings were $0.85 per diluted share, ahead of our May outlook.

Importantly, earnings were marked by favorable momentum in our go-forward businesses. Core earnings in P&C Commercial increased 67% from the prior year, reflecting lower catastrophe losses and the favorable impact of the pricing and underwriting actions launched last year, particularly in workers' compensation.

We saw adverse loss trends in the comp line early and immediately began taking action. Workers' compensation trends are generally performing as we expected, with only a slight adjustment this quarter.

Our actions are now yielding results, and we're optimistic that we've turned the corner. We're getting price increases in all lines with a 7% renewal price increase in standard commercial. In Middle Market, our renewal pricing was up 16% in workers' compensation, and we expect to continue to improve margins and product mix.

Retention remains strong for the accounts we want to keep, although down a bit in total as we shed more of our unprofitable accounts.

In Group Benefits, core earnings were up from first quarter. We had favorable Life and AD&D results, as well as a seasonal improvement in long-term disability trends. The Hartford was among the first to recognize adverse trends in incidence and terminations, which we addressed by taking pricing actions beginning in early 2011 and continuing through today. It will take more time and work to get this business back to historical profitability, but I'm encouraged with our progress.

In Consumer Markets, the quarter's financial results were adversely affected by heavy cat activity. We remain focused on profitable growth and improving both margins and ROEs. Retention continues to improve in both homeowners and auto, even as we continue to take rate in each. New business trends are also good, up 17% over the prior year.

We remain excited about the prospects for our Mutual Funds business and our expanded relationship with Wellington. During the quarter, we completed the transition of fixed income funds to Wellington, and our marketing initiatives will expand in the second half. We're confident that our Mutual Fund assets will grow, given Wellington's leading capabilities in managing both equities and fixed income. This is particularly important, given the continued flows out of equity and into fixed income funds industry-wide.

We're on track for our targeted expense reductions, and as Chris will present in more detail, have increased our 2013 goals. In addition, in order to remain efficient in our go-forward businesses, we will eliminate all expenses for the Life businesses that are being sold.

Now let me review this quarter's progress and our strategy announced in March, to focus on P&C, Group Benefits and Mutual Funds. As you recall, these businesses satisfied all 3 of our requirements: first, that they have competitive market positions on which we could invest for future profitable growth; next, that they generate, not consume capital; and finally, that they will lead to lower market sensitivity for the company.

We also announced that we shut down our U.S. VA business and put it into runoff, and that we would sell the Individual Life, Retirement Plans and Woodbury Financial Services, our retail broker-dealer. Since that announcement, we've made solid progress in achieving our sharper focus strategy.

First, the sales processes are proceeding as planned. On Tuesday, we announced the signing of a definitive agreement to sell Woodbury Financial Services for proceeds totaling $115 million, subject to closing adjustments. The sales processes for the remaining Life businesses continue, and we look forward to updating you when definitive sales agreements have been reached.

Second, we have effectively shut down our U.S. variable annuities business. We signed a definitive agreement to sell the new VA business infrastructure, which we expect to close by year-end. The sale provides a smooth transition to more than 100 of our teammates in the U.S. Individual Annuity organization. We expect to reduce expenses by $100 million before tax in 2013 as a result.

Third, on the legacy annuity block, we announced the appointment of Beth Bombara as President of the Life runoff business. Beth has a deep knowledge of The Hartford and the annuity business and has a track record of significant accomplishments. She and her team will accelerate the good work already underway to reduce the size and risk of our legacy annuity liabilities, as well as initiatives that could isolate or separate them from the ongoing businesses and, over time, free up capital.

Given current economic conditions, this process will take time, but we will be prepared to take advantage of opportunities to reduce or sell blocks of business. We will balance economics and any possible consumption of statutory surplus against the potentially positive impact on shareholder value of reducing the block.

We are confident that we will achieve our goals. In the meantime, the VA hedging programs provide protection to policyholders and shareholders from adverse economic environments.

I know that there's a lot of interest in our plans for the use of the proceeds from the sales of the Life businesses. As we discussed in March, we will maintain capital sufficient for adverse economic environments and supportive of our go-forward businesses and their current ratings. We will work with all of our constituencies, including regulators and rating agencies, to develop a final plan that supports both our business and capital management goals.

Now, while our plans are not final, we expect to repay a minimum of $320 million of debt maturing in July 2013, in order to maintain leverage and interest coverage ratios at levels that support current ratings and also to pursue accretive actions for shareholders, which currently would be common stock repurchases or future potential transactions that would reduce the size and risk of the annuity book. We will update you in early 2013 as our plans and the business sales are finalized.

So to conclude, the second quarter was successful at The Hartford on many fronts. We had good core earnings and continued momentum in our go-forward businesses. We completed the $500 million stock buyback, repurchased the Allianz debt and made more progress on our expense initiatives. We announced an agreement to sell Woodbury Financial Services on Tuesday, and the sales processes of the Individual Life and Retirement Plans businesses are proceeding as planned. We are diligently exploring opportunities to reduce the size and risk of our annuity exposures, isolate or separate them from the ongoing businesses and, over time, free up associated capital.

We know we have a lot more work to do, but we are confident that we're on the right path. And I look forward to sharing our progress with you next quarter and beyond.

I'll now turn the microphone over to Chris, who will cover our financial results in more detail. Chris?

Christopher John Swift
Chairman & CEO

Thank you, Liam. Good morning, everyone. My comments this morning will cover 3 areas: a review of second quarter results; an update of our expense targets; and our third quarter current outlook.

Second quarter core earnings were $119 million or $0.23 per diluted share, representing a significant improvement over prior year. These results include 4 items I want to highlight. First, catastrophe losses were $189 million after tax, which is $105 million higher than our original outlook. Second, we had unfavorable prior year loss reserve development of $32 million. Both of these items are in line with our July 16 announcement. Third, our results included unfavorable DAC unlock of $127 million, largely related to our quarterly adjustment for market performance on our runoff annuity block. Finally, we also incurred $31 million of restructuring charges, primarily for severance and retention associated with the sales of Individual Life, Retirement Plans and Woodbury Financial services, as well as the shutdown of U.S. VA new business.

Core earnings this quarter, excluding these 4 items, were $414 million or $0.85 per diluted share based on a 485 million share count. This is higher than May's outlook of $0.70 to $0.75 per share, primarily driven by better-than-anticipated group benefit results. In this low interest rate environment, we remain focused on pricing actions, as well as strategies to maintain investment yields. The investment portfolio yield was stable this quarter at 4.3%, excluding limited partnerships and other alternative investments, which had a 10% annualized return in the quarter.

Consistent with last quarter, we modestly extended the duration of the portfolio and slightly increased our holdings in higher-yielding asset classes. Impairments and changes to the mortgage loan loss reserve rose this quarter to $60 million after tax and DAC, largely due to losses on some recently downgraded financial institution preferred equity securities. Overall, fundamental credit performance remained strong, with no material changes in default experience or expectations.

Turning to Slide 6. Second quarter book -- 2012 book value per diluted share was $45.59, an increase of 14% over last year. Book value benefited from declining interest rates, which increased the unrealized gains in our fixed investments. Excluding AOCI, book value per diluted share rose by 2% to $40.91. Book value growth over the last year was muted by higher catastrophes, as well as this quarter's $587 million charge for repaying the Allianz debt. This was a major step in restructuring the balance sheet and enhancing our financial flexibility. We also repurchased $106 million of common stock this quarter to complete our $500 million share repurchase plan. This is also reflected in our book value.

Turning to segment results. Slide 7 shows the summary results for P&C Commercial. Core earnings were $160 million, a 67% increase from the prior year due to better catastrophe results. Results also include a $12 million after tax of net unfavorable prior year loss reserve development across multiple lines. This included about $28 million after tax of adverse development on our workers' compensation book, largely for accident year 2011. The combined ratio, x cat, x prior year, was 94.5%, up slightly over prior year's 93.1%, which did not include the change in our 2011 accident year loss picks we made in the third and fourth quarter last year. We continue to expect the P&C Commercial combined ratio, x cats, x prior year, to improve based on achieved pricing and outlook for future rate increases.

As Liam mentioned, we continue to see strong price increases in P&C Commercial. We achieved renewal rate price increases of 7% in standard commercial equal to the first quarter. Workers' compensation is a key driver, with a 16% rate increase in Middle Market. Consistent with first quarter, all other commercial lines had rate increases as well, with 6% in Small Commercial, 8% in Middle Market property, 6% in Middle Market general liability.

Our pricing actions have impacted retention slightly. Middle Market retention was lower at 73% in the quarter, which is a top line trade-off we are making to improve margins. Small Commercial retention remained strong at 82%, slightly down from last year and last quarter. We will continue to be disciplined in our pricing initiatives, which are focused on achieving better margins on underperforming accounts, while maintaining margins and retention on our best performing accounts.

Shifting to Group Benefits. Core earnings of $34 million were a significant improvement, well above first quarter levels and up $4 million from last year's quarter. The loss ratio was 78.6%, an improvement over the first quarter, which tends to be seasonally high but still up from the 78% in prior year. As a result of our rate actions and the very competitive marketplace, premiums declined 6%. This reflects the impact of pricing action on both new business and renewal trends occurring over the last 18 months.

We had favorable Life and AD&D experience, so I wouldn't annualize this quarter for the second half of the year. We still expect Group Benefit results this year to be flat, with the $86 million earned in 2011. Nevertheless, we are encouraged by our results in this line, and we are confident that our initiatives over the past 18 months will get us to where we need to be.

Turning to Slide 9. Consumer Markets had core losses of $48 million due to catastrophe losses above budget, although below last year's level. Andy Napoli and his team are managing the book for profitable growth by balancing pricing, retention, new business levels, and like the entire organization, expense efficiency. Retention has improved over the past several quarters and was up 2 points in both lines compared to a year ago.

Net written premiums declined 2%, partially due to lower than historic retention, which was partially offset by strong new business production. Auto new business was up 13% for the quarter and 21% year-to-date. AARP Agency is a strong growth source. First half 2012 written premiums in AARP Agency almost doubled to $59 million from the prior year period. The second quarter combined ratio, x cat, and prior year development was 91.3%, essentially flat with last year's 91.2%.

Homeowners, in particular, remains negatively impacted by elevated weather events. We remain focused on improving profitability with renewal, written price increases in the quarter of 6% in homeowners and 4% in auto. Auto physical damage loss severity remains a challenge, and we are watching frequency carefully. Auto liability frequency ticked up a little bit in the first quarter, but that trend did not continue in the second quarter. We are monitoring auto loss cost trends closely, and we'll adjust our pricing as necessary. But in general, we are comfortable with our current balance of pricing, retention and new business. Homeowners, on the other hand, needs more rate industry-wide, principally because of cats and non-cat weather.

We are encouraged by our results in Consumer Markets as we continue to focus on opportunities for profitable growth and improving margins and ROEs.

Mutual fund results are summarized on Slide 10. All fixed income funds have now transitioned to Wellington, and expanded marketing initiatives are planned for the second half of the year. However, near-term earnings have been impacted by continued negative flows from equity funds, an industry-wide trend.

Mutual fund core earnings this quarter were $18 million, down $9 million from prior year due to a 14% decline in assets under management compared to a year ago. Core earnings also included expenses for moving the business to Pennsylvania and expanding distribution teams.

The results of our combined Life and P&C runoff division are on Slide 11. Core earnings, x DAC unlock, were $148 million. This includes $162 million from Life and a loss of $14 million in P&C, which includes the asbestos environmental charge. Excluding the A&E charge and DAC unlock, core earnings were in line with our expectations.

I know there is interest in our annuity surrender experience since our March 21 announcement. Surrender activity for the U.S. block averaged an annualized rate of 17.5% for the quarter. The surrender rate increased to 20% in April immediately following the announcement but has since trended down to last year's level of 14% in July. Some of the decline is probably due to the decline in market levels, as we normally see lower surrenders in down markets. These surrender rates include both full and partial surrenders, which are now disclosed separately in the IFS.

Full surrenders for the second quarter were 13% annualized, up from 10% in the first quarter. Partial withdrawals were flat at 4.8%. While either type of activity helps reduce the size of the annuity liabilities, full surrenders completely eliminate the risk of those contracts. It's worth noting that this 2Q in-the-moneyness surrenders have been running about 35% of the total, roughly consistent with the overall in-the-moneyness of the U.S. VA GMWB block.

Slide 12 provides a summary of VA hedging results for the quarter. Our VA hedging programs primarily focus on economics. As you know, there are differences between GAAP, stat and economic results. During the quarter, the net statutory impact of our VA liabilities and hedges was a negative $228 million before tax, which excludes fees and other impacts to surplus. We ended the quarter with nearly $4 billion of VA statutory reserves in our U.S. and Japan subsidiaries.

Slide 13 is our surplus roll-forward. Total U.S. statutory surplus increased approximately $200 million in the second quarter. This is after $200 million of dividends from the P&C operations to the holding company. P&C had statutory operating earnings of about $100 million. VA statutory impacts were $100 million positive. Other items, primarily deferred taxes, were almost $200 million favorable.

In total, U.S. statutory Life surplus increased to $7.7 billion from $7.5 billion, while P&C surplus was essentially flat at $7.7 billion.

As you can see on Slide 14, capital resources remained strong at $18 million after -- excuse me, $18 billion after completing the share repurchase program and the Allianz refinancing. Holding company cash and short-term investments totaled $1.3 billion, down slightly from March, due principally to the settlement of the warrant repurchase and the $106 million of share repurchases in the quarter.

Slide 15 set forth our updated expense target reductions. In December of last year, we laid out a $450 million expense reduction target for year-end 2013. We have increased that by a net $30 million to $480 million. This includes a $70 million reduction reflecting the portion of the original target that was attributable to the Life businesses being sold. It also reflects $100 million of expense reductions arising from the shutdown of U.S. VA business.

Additionally, in the quarter, we incurred about $31 million of after tax restructuring and other expenses associated with the sales process, including retention expenses and advisory fees. We expect to incur approximately $40 million after tax in additional restructuring charges related to these activities in the second half of 2012.

Before taking questions, I want to briefly provide you with our outlook for the third quarter. We expect third quarter core earnings to be in the range of $0.75 to $0.80 per diluted share, including catastrophe losses of approximately $75 million after tax. Our third quarter estimate does not include the following items: first, it does not include prior year P&C loss reserve development; second, the outlook does not reflect any DAC unlocks, including those related to our annual third quarter assumption study; finally, it does not include any expenses or charges relating to the sales processes for the Life businesses, and it excludes $25 million of restructuring and other expenses we expect to occur in the quarter.

To conclude, I am pleased with our business results this quarter and for the year-to-date. With the exception of catastrophes, our businesses this quarter performed largely in line with our expectations, with a slight positive from Group Benefits. Our investment results remained strong despite the challenging low interest rate environment.

Looking forward, we will continue to maintain our pricing discipline in the P&C businesses, and we expect our initiatives in Group Benefits and Mutual Funds to help improve profitability in 2013 and beyond.

At this point, I'd like to turn the call back over to Sabra to begin the Q&A session.

Sabra R. Purtill
Senior Vice President of Investor Relations

Thank you, Chris. We have time for about 30 minutes of Q&A. [Operator Instructions]
Darlene, could you please start the Q&A process?

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Jay Gelb with Barclays.

Jay H. Gelb
Barclays PLC, Research Division

On the proceeds from the sale of the businesses currently in runoff, Liam, you talked initially about using buybacks or reducing the size of the annuity book, giving us an update there in early 2013. Does that mean the sale process might be taking a little longer than you thought? And can you frame it out just a bit more in terms of how you're thinking about deploying those proceeds?

Liam E. McGee
Former Chairman

Jay, first of all, the sales process is proceeding as we expected. As you recall, Jay, when we announced our decision to sell the 3 businesses in March, we also indicated we were prepared. We have done all of our actuarial studies, and so the offering memorandum were in the marketplace approximately a month after our announcement. I would say that, as I said earlier, the process is proceeding as we expected. These are attractive businesses, and it's been a competitive process. In terms of the capital plan, we want to get the agreement signed. As I mentioned in my remarks, work with our constituencies. And I think the convergence of those things says that we'll give you a final capital plan in early 2013. So I would describe everything proceeding as we had expected when we announced things in March.

Jay H. Gelb
Barclays PLC, Research Division

Okay. And then for the third quarter DAC study, can you -- is there any sort of boundaries you can give us on that in terms of what we should be thinking about in terms of potential charges going into that study?

Liam E. McGee
Former Chairman

Chris?

Christopher John Swift
Chairman & CEO

Jay, it's Chris. I wouldn't say there's anything other than normal, I'll call it expense, mortality, interest rate-type assumptions, policyholder behaviors. So I wouldn't say there's any boundaries. It's just our normal annual update that we'll go through.

Jay H. Gelb
Barclays PLC, Research Division

Year-to-date, how are things tracking along with current assumptions?

Christopher John Swift
Chairman & CEO

I'd say they're tracking very well.

Operator

Your next question comes from the line of John Nadel with Sterne Agee.

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

So just as a quick follow-up on the early 2013, Chris or Liam, it sounds like that's really just around giving us some clarity on the deployment of proceeds. So nothing really changing in terms of your expectation for timing of actual sale announcements. Is that correct?

Liam E. McGee
Former Chairman

That's an accurate statement, John, so let me reiterate. I want to be crystal clear on this point. The sales processes are proceeding as we expected. These -- we're pleased to have announced the Woodbury transaction on Tuesday. The Life and Retirement Plan process is proceeding. It -- these are attractive businesses, and it's been a competitive process. The -- we want to present to you and investors an updated, more final capital plan, which will include prospective capital management actions. So I think we're right on schedule.

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

Okay, that's helpful. So then a question -- maybe 2 quick ones for Chris. A question on interest rate risk. Just on the conference call before this one with the folks at Met, they sort of gave us an update of looking at instead of a 2% 10-year, looking at a 1.4%- or 1.5%-type 10-year environment. Can you give us a sense, too, for what that incremental 50 or 60 basis points lower-type rate environment would do to that earnings sensitivity you had provided some -- a few quarters ago?

Christopher John Swift
Chairman & CEO

Yes, happy to, John. And low interest rates, as you know, just are a headwind for everyone in financial services. But our specific, either way I think about it from a momentum side, the assets that we have on the books, so the maturing cash flows and the new cash flows, if we look at the impacts in '13 and '14, I'd call it, roughly the $25 million to $30 million in '13. And you can roughly double it from there in '14 if rates stay low at today's level.

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

So that's it? That's the incremental above the original guidance?

Christopher John Swift
Chairman & CEO

Yes, it is the incremental impact to sort of the momentum that we will give up in the run rate earnings.

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

Yes. Okay, that's helpful. And then just a last real quick one. On Slide 12 in your conference call presentation, just can you give some granularity on the VA? I guess the hedge assets didn't quite keep up with the liability in the quarter. Can you give us just a little bit of granularity on what drove that? Was that equity markets, rates, currency? What...

Christopher John Swift
Chairman & CEO

Again, John, I think the attribution, we could work with you off-line, if that's really important to you. But I think the big thing is just, generally, keep in mind, we're not 100% hedged on the economics. So there's always going to be a basis difference. You're always going to have, I'll call it a Japanese impact because most of our Japanese hedges are in the U.S. legal entity. So I would describe it mostly basis difference from my perspective.

Operator

Your next question comes from the line of Randy Binner with FBR.

Randolph Binner
FBR Capital Markets & Co., Research Division

So I kind of wanted to try and, I guess, follow up on Jay's question and talk a little bit about your comments on kind of reducing the size of the VA book, isolating and separating it. I appreciate that this is not what's in focus now. Right now, you're focused on selling the 3 other properties. But, I mean, would it be possible to kind of at least frame out at a high level what that might look like? Meaning, could we expect to lose the DAC that's associated with the VA business? I mean, that's an assumption we're making with the potential Life divestiture. And kind of feel confident that there's some material on a capital that could get out of the VA book if you are able to isolate or separate some of that risk from Hartford.

Liam E. McGee
Former Chairman

Well, Randy, I'm going to ask Chris to give a little more detail on that, but let me just be very clear in the comments that I made. Our -- under Beth's leadership, our goal is to reduce both the liabilities and the risk of the annuity book. And if opportunities present themselves, to potentially isolate or separate it. In terms of the -- and we do think, over time, there will be a capital that will be freed up as a result of that. In terms of your question on DAC and everything, I'm going to turn to Chris.

Christopher John Swift
Chairman & CEO

Randy, a couple of points. One, I agree with Liam. And I think what we've been trying to communicate clearly is that as the block runs off, capital will be freed up, not necessarily literally, probably, generally, just take more time. And of the $7.6 billion of, I'll call it, statutory surplus, we have in all the legal entities. I mean, that's our -- our objective is to maximize that value and trading off maybe potential transactions or other types of things. So we're focused in on statutory. Your point on DAC, obviously, DAC is a GAAP concept, so that doesn't affect statutory results. And a lot of our DAC assumptions, as I said, are updated quarterly, and we still make money on these blocks of business. I mean, they're still earning fees, so we are still following our historic, I'll call it, U.S. GAAP accounting conventions is how we amortize DAC in.

Randolph Binner
FBR Capital Markets & Co., Research Division

Well, yes, I mean, I guess just a follow-up on DAC. I appreciate that they're currently there, but if there was a transaction to separate -- I mean, the stock is trading like $14 below book value. So I think it's -- it would be helpful to just kind of understand that if there was a separation, what would happen to that intangible that's in the GAAP book value?

Christopher John Swift
Chairman & CEO

Yes, I hate to speculate on types of separations, what would be involved and things like that. But any, I'll call it, separation transferred to a third party of any liabilities, we'd have to account for that in proceeds and have a gain or loss that's reflective of total proceeds. So in a transaction setting, correct.

Randolph Binner
FBR Capital Markets & Co., Research Division

One more related follow-up, and this is kind of a simple, maybe it's a dumb question. But, I mean -- so the surrenders have been elevated on balance since the runoff decision being made. Is that positive for freeing up capital? Meaning, the faster the VA block runs off, that would lead us to freeing up capital sooner?

Christopher John Swift
Chairman & CEO

Yes. What we're trying to say is that all surrenders, all reductions of account value, are beneficial over the long-term, and that's our goal. And just to give you the perspective, surrenders in '11 ran about 14%, '10, they were about 11%. So they're going to settle in somewhere between 14% and 16% in my judgment going forward. And the block will run off, and we'll look for opportunistic transactions to help accelerate that runoff if they are in a marketplace that we find accretive to shareholders. That's the real strategy, simply, Randy.

Liam E. McGee
Former Chairman

Randy, we are laser-focused on all possible ways to accelerate reducing the liabilities and the risk.

Operator

Your next question comes from the line of Brian Meredith with UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

A couple of questions here for you. Just first one, on the commercial Middle Market's retention, I'm curious, why the sudden drop-off this quarter? You've been pushing the rate in that business for a while now. Was something different that happened this quarter? Where you pushing a little bit harder on terms and conditions or something?

Douglas G. Elliot
President

Brian, this is Doug. I don't think the marketplace was really any different in the second quarter. We are continuing our march to improve our margins. As you know, workers' comp is a priority for us. And so as I reflect on our chief pricing increases and the trade-off on retention, I'm very satisfied with what happened in the second quarter and expect to see more of that moving ahead.

Brian Robert Meredith
UBS Investment Bank, Research Division

Does it say you expect the retention to stay pretty low for Middle Markets here for a couple more quarters?

Douglas G. Elliot
President

I at least think third quarter. We're very pleased with the pricing increases, and as you can tell, our margins are improving. So we feel good about that progress. And at the moment, the trade-off between rate and retention, I think, is a good one for us, and we're going to stay right there.

Brian Robert Meredith
UBS Investment Bank, Research Division

Great. And then just a quick one over on the personal lines on consumer side. AARP written premium still declining here. Are we getting close to a point where you're comfortable from a profitability standpoint that we're going to start to see that start to pick up here going forward?

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

Brian, Andy Napoli here. Yes, good question. I would say, over the past year, we've had a really nice, strong rebound in new business production, in AARP Direct and Agency, you can see that in the numbers. That's probably at a level that relative to total premium, where we're comfortable with a new business production at this point at about 12% to 13%. So then you shift the conversation to retention. We've had 2 points improvement in retention on a year-over-year basis. We've got a little bit more ground to make up there. I see growth to the division being flat in 2013. And as I think about the factors that could influence that, we're experiencing a rate need relative to -- or because of the increase in physical damage severity that I think is pervasive across the industry, and we'll have to sort of dynamically manage how we price that into our business going forward. And that's something we're going to pay very close attention to.

Operator

Your next question comes from the line of Vincent DeAugustino with Stifel, Nicolaus.

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

The press release mentioned 7% renewal price increases for Middle Market, and I think it also mentioned overall increases of 10% for the same segment. And I'm -- if I'm thinking about that correctly, I should be able to attribute the GAAP to even stronger new business pricing. Am I thinking about that right?

Liam E. McGee
Former Chairman

No. Let me adjust your thinking just a bit. First point I'd make is, although it looks relatively flat quarter-over-quarter, 7% versus 7%, actually, there was an increase in the second quarter. We rounded up the first quarter. It was 6.6%, and the second quarter came in roughly at 7.4%. So there is positive movement in the second quarter that we feel good about, and actually, that positive movement really runs across our lines, including comp, which we spoke to. The new business environment really sits outside of the pricing disclosures that we've shared with you. So I would separate those 2. And we can talk about them separately, but they're really 2 different topics.

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

So -- sorry, I'm just a little confused in the difference between the 7% and the 10%.

Liam E. McGee
Former Chairman

I think the 10% was a Middle Market pricing, and the 7% was the combination of our Small and our Middle together.

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

Okay, I see. I'm sorry about that. And then also, you mentioned earlier in your comments that mutual fund marketing initiative is going to ramp up in the second half. Would you be able to say what the incremental expense would be there or would this be de minimis?

Christopher John Swift
Chairman & CEO

I generally think it's rounding. I mean, it's people more than anything. So it will be -- the compensation will be tied to sales and things like that, but it's pretty de minimis, Vince.

Operator

Your next question comes from the line of Mark Finkelstein with Evercore Partners.

A. Mark Finkelstein
Evercore ISI, Research Division

I guess sort of a follow-up on the prior question. I guess how would you characterize the rate environment? I think you just said that 6.6% in the first quarter, 7.4%. Do you see this stabilizing? Do you see further momentum as you look at kind of the June and July results or any slippage?

Liam E. McGee
Former Chairman

We see a relatively stable environment. I would look at the last 60 days and think about May and June and be encouraged by the improving signals. But overall, we see a relatively stable environment that we expect will move into the third quarter.

A. Mark Finkelstein
Evercore ISI, Research Division

Okay. And then when you think about, I guess, Small Commercial in particular, how would you characterize the rate increases relative to your assumptions around lost cost trend?

Liam E. McGee
Former Chairman

At or slightly exceeding would be my answer in the Small Commercial space. It's a very strong line for us. You can see our returns, as noted in the supplement. And our mid single-digit pricing increases are essentially right on our trends.

A. Mark Finkelstein
Evercore ISI, Research Division

Okay. I guess can you just talk a little bit about -- the overall development was, in ongoing businesses was largely flattish, I mean, some favorable coming out of the cats. But the one notable was I think the $43 million of adverse development in workers' comp. Can you just talk about that and whether there's any changes in how you're looking at, I guess, the reserve levels based on the trend that you saw this quarter?

Liam E. McGee
Former Chairman

Sure. Our view of the comp book really hasn't changed in the last 90 days. We did some tuning in the second quarter. I'd characterize out of the $43 million, roughly, $25 million of that was in accident year 2011. We're watching carefully those trends. We had some medical losses that moved to med and indemnity, but nothing that I would say would be significant or out of pattern. As you know, we call our reserves straight up as we see them in the quarter. So we did do some adjusting in the quarter, but I feel like we're all over the issues, we're watching them carefully. As we've mentioned in the past, we feel positive about the improving claim incidence trends inside our book of business. So we're very bullish about an improving go-forward comp book and the fact that we've got our arms around our prior books.

A. Mark Finkelstein
Evercore ISI, Research Division

Okay. And then I guess just one question on Group Benefits. I mean, the results were more favorable, I think, than most have expected, including myself, but it sounds like it was largely group Life and AD&D. And I'm trying to understand how much of that is just good luck versus some core margin expansion, particularly on the disability side that we should be thinking about as trendable.

Douglas G. Elliot
President

This is Doug again. As Chris mentioned, our run rate for the year still looks like it's going to be flat with 2011, which is in that 80, 85 range. As I think about the quarter, clearly, it was $5 million to $6 million of favorable Life and AD&D experience, and there's some good things on the expense side that were kind of one-timers. So when I look at the quarter and think about Chris' comment about overall 2012 performance, I think we're right on pretty solid run rate.

Operator

Your next question comes from the line of Chris Giovanni with Goldman Sachs.

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

I guess one additional question just on the VA runoff book. We're starting, I guess, to see some competitors that are trying to accelerate the runoff, offer lump-sum payments. Can you comment if this is something you're exploring the regulatory and capital considerations for doing so? And then lastly, just any comments on appetite from external participants in the VA market.

Liam E. McGee
Former Chairman

I'll take the first one, and I'll leave the second one for Chris. We're well aware of what a couple of players are doing to your point in product. I would say, Chris, we are exploring, under Beth's leadership, every possible area for accelerating the runoff, including that concept. As you know very well, guarantees differ from insurance company to insurance company, and there is no evidence yet that, actually, consumers will make that trade. But notwithstanding all that, we are aggressively looking at that. But that is one of many work streams that we're considering with great urgency and diligence because we're determined to reduce the book as quickly as we can. Chris, any comments you'd make on Chris' second question?

Christopher John Swift
Chairman & CEO

Yes, I think your question really was an appetite in VA transactions. I would say, right now, it's very early, Chris. I don't think there is much appetite at all in the marketplace right now, so we would continue to explore, continue to have discussions and thinking. But as far as real appetite, it's just not there yet.

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

Okay. So should we take that sort of a sense the decision was reached in March, sort of the opportunities as you saw them at the time are really pretty consistent today with where you saw things back in March?

Christopher John Swift
Chairman & CEO

Yes, I would say so. I mean, I think what we're trying to say, hopefully, as clearly as possible, that the opportunities are probably more short-term based on the fixed block businesses, and that will take longer time on the VA. So I think there is good interest. We've seen transactions, you've seen transactions in fixed annuity space, our fixed annuities' structured settlements, terminal funding. Those are all blocks of business that we're exploring, what is the most economic to do for the long-term.

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

Okay. And then just one quick one...

Liam E. McGee
Former Chairman

Chris, if I might add, I totally concur with what Chris Swift just said. And as the environment evolves, and we expect that it will, we fully understand the potentially positive effect on shareholder value, if there are transactions that make sense to get some of these block-off off of our book. And we have a mindset consistent with that sentiment.

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

Okay. Understood. And then just a quick one for Doug. I guess specifically on the rate you're getting in the Mid Market comp book, the 16% that you guys alluded to. Can you comment about how much of that rate is needed purely just based on the decline in interest rates?

Douglas G. Elliot
President

So let me take that in 2 pieces. Clearly, we feel like we're out in front of trends and improving our margins across our comp lines, for sure. When we look at the change in the yield, I would say, across our Middle comp lines, the pressure for more rate is roughly in the 4 to 5 range over time that we need to get to make up what I'll call 200 -- 150- to 200-basis-point change over the last 6 quarters.

Operator

Your next question comes from the line of Tom Gallagher with Crédit Suisse.

Thomas George Gallagher
Crédit Suisse AG, Research Division

I just, first, wanted to follow up on the VA restructuring opportunities a little bit. So if I've heard you correctly, especially with the comments Chris just made, if we used the hypothetical, fast forward it to year-end, assuming your -- the 2 other property sales transactions are consummated, so you have those proceeds or at least the anticipation of those proceeds, there's nothing in the environment today, again, I'm kind of pro forming this, that would suggest there would be a third-party transaction market solution for restructuring the VA book, based on what you're seeing today. Thus, is it fair to conclude, if I'm right on that, that buybacks would be the preferred use of proceeds, assuming nothing changes in the environment today? Is that a fair way to think about it?

Liam E. McGee
Former Chairman

Tom, going back to the remarks I made, the formal remarks, we do intend to pay down some debt, as you would understand, to manage our leverage and debt service coverage ratios, to protect our ratings and take shareholder accretive actions. I think either one of those, whether that would be share buybacks or transactions that would economically and appropriately get the -- some part of the annuity book, a block off of our books would both be shareholder-accretive. If there's not -- I can't speculate on what's going to be happening at a particular given time, but it is clear to say that among the most accretive things we could do today at the share price self-evident, where it is would be to buy back shares. But we're going to be -- our measure is what is the most accretive thing for shareholders.

Thomas George Gallagher
Crédit Suisse AG, Research Division

Okay. And just in terms of -- can you also just discuss a little bit about what is the main impediment or challenge as you think about restructuring opportunities? I'm not even asking for something so specific, but as you think about what potentially can be done here, is there -- is the most likely course here, having a third party involved that assumes the liability? Would it be actually legally separating the liability through some kind of spin-off of the business where there isn't a third party involved per se? And then also if you could just mention whether the whole captive reinsurance encumbers your opportunity set here.

Christopher John Swift
Chairman & CEO

Tom, it's Chris. The challenge, I'll call it succinctly, is, I mean, if you look at the balance sheet, we have about $165 billion of liabilities that are in runoff in the Life group. So one, it's obvious, just the sheer size and scale. There's not going to be, I'll call it, 1 solution, 1 silver bullet. So the way we're thinking about it right now, I mean, this will be a series of moves over a longer period of time to eventually transfer runoffs, isolate, separate these liabilities. So there isn't going to just be 1 thing. I think I've always said, Tom, and particularly, I know you know, I mean, if you really look at the fundamentals of the U.S. and Japan, they're different. The U.S. block from a relative risk perspective or relative size and its components are fixed and variable, actually, it's a balanced portfolio liabilities. Japan, on the other hand, I think from a shareholder value perspective, is the greatest opportunity we have to manage that in the most accretive way long term. So whether that be a short-term transaction or that would be long-term, just managing the cash flows as effectively as possible, those are the things that we're thinking about and modeling and working very diligently on.

Thomas George Gallagher
Crédit Suisse AG, Research Division

And Chris, any issues with captive re and whether or not -- I think there's some level of speculation out there that because the way the captive reinsurance is capitalized, the captive reinsure is capitalized, that it would take years and years before you could release capital out of these businesses. Is there any truth to that? Or maybe you can comment on that.

Christopher John Swift
Chairman & CEO

No. I don't think the reinsurance structure has anything to do with capital movements and release. And as you know, we have 2 captives: one that manages our XXX program that will be dealt with in the sales process; and then White River, which is our Vermont-based captive. So is there -- I mean, it is -- just view it as a way to manage RBC and risk-based capital between the 2 organizations. So they go hand-in-hand, but there are no structural limitations, just to be clear, on how and when we would release capital because of that structure.

Operator

Your next question comes from the line of Bob Glasspiegel with Langen McAlenney.

Robert Ray Glasspiegel
Langen McAlenney

Chris, I wanted to just push you a little bit on -- you said the stat capital is really the most important consideration over the near term, which I agree. Could you amplify your answer to John's question of the stress test of $1.50 [ph] 10-year for 5 years, whether there would be any statutory implications to that?

Christopher John Swift
Chairman & CEO

Bob, I know you know the answer. I mean, low interest rates over a longer period of time won't be good, and I think we've discussed in prior quarters managing cash flow testing, C3 Phase 1 implication. So all that would come into the mix, Bob. And you never want to be, I'll call it, totally predictive and judgmental, but those would be issues everyone in the industry would have to face, including The Hartford, in the amount of additional reserves and capital we would have to put up for interest rates if we're 5 years out.

Robert Ray Glasspiegel
Langen McAlenney

Okay. Just a rough sense of like number of years of $1.50 [ph] 10-year that you can withstand before it becomes a stress.

Christopher John Swift
Chairman & CEO

Well, again, I'm not going to try to predict the precise number, so it's hard. All I could say though from a current point of view, I mean, we do have cash flow testing reserves up for blocks that see compression of spreads out 5, 6 years right now. So we're dealing with it right now. I think you're ultimately asking about the pace of that, and I'm not going to be in a position to predict that right now.

Robert Ray Glasspiegel
Langen McAlenney

Okay. And just -- as I read your comments on sort of pausing on capital until 2013, you want to keep some flexibility to deal with runoff more seriously. Is there a maximum statutory hit that you'd be willing to take on the runoff business? Is there sort of a borderline -- how much flexibility do you have?

Christopher John Swift
Chairman & CEO

I think from a pure financial side, we have a lot of flexibility. I think the calculus that Liam referred to is -- will it create shareholder value, and that's the math and calculus we'll go through, when and if we're presented with transactions.

Robert Ray Glasspiegel
Langen McAlenney

Okay. So there's no sort of upper bound on how much of a hit you'd be willing to take, even though it would make sense to get rid of it from an economic point of view.

Christopher John Swift
Chairman & CEO

Yes, I think what you have to think about, Bob, is on 1 individual transaction, what does it mean for the rest of the block, the rest of the liability? So I mean, it is, I'll call it, a complex equation because, again, it's not just 1 transaction. So if for say you wanted to take a hit, what does that do for the other liabilities? What does that do to your stress scenario? So those are all the things that we would consider.

Sabra R. Purtill
Senior Vice President of Investor Relations

Thank you. And Darlene, I know we're bumping up against somebody else's conference call. So for those of you who are in the queue, thank you very much. I'll be happy to follow up with you after the calls today. We appreciate your interest in The Hartford, and the IR team is here today and available for any follow-up questions you may have after the call. Thank you.

Operator
This concludes today's conference call. You may now disconnect.