S&P Global Market Intelligence

CNA Financial Corporation

NYSE:CNA

Earnings Call

Monday, July 31, 2023 2:00 PM GMT

Call Participants

EXECUTIVES

Dino Ennio Robusto
Chairman & CEO

Ralitza Todorova
Assistant Vice President of Corporate Development

Scott Robert Lindquist
Executive VP & CFO

ANALYSTS

Kyle Robert Labarre
Dowling & Partners Securities, LLC

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Presentation

Operator

Ladies and gentlemen, good day, and welcome to the CNA Second Quarter 2023 Earnings Conference Call. [Operator Instructions] As a reminder, today's conference is being recorded.

I would now like to turn the call over to Ralitza Todorova, EVP, Investor Relations, for opening remarks and introductions of today's speakers. Please go ahead.

Ralitza Todorova
Assistant Vice President of Corporate Development

Thank you, Rocco. Good morning, and welcome to CNA's discussion of our second quarter 2023 financial results. Our second quarter earnings press release, presentation and financial supplement were released this morning and are available on the Investor Relations section of our website, www.cna.com.

Speaking today will be Dino Robusto, Chairman and Chief Executive Officer; and Scott Lindquist, Chief Financial Officer. Following their prepared remarks, we will open the line for questions.

Today's call may include forward-looking statements and references to non-GAAP financial measures. Any forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from the statements made during the call. Information concerning those risks is contained in the earnings press release and in CNA's most recent SEC filings. In addition, the forward-looking statements speak only as of today, Monday, July 31, 2023. CNA expressly disclaims any obligation to update or revise any forward-looking statements made during this call.

Regarding non-GAAP measures, reconciliations to the most comparable GAAP measures and other information have been provided in our earnings press release, financial supplement and other filings with the SEC.

This call is being recorded and webcast. A replay of the call may be accessed on our website. If you are reading a transcript of this call, please note that the transcript may not be reviewed for accuracy, thus it may contain transcription errors that could materially alter the intent or meaning of the statements.

With that, I will turn the call over to our Chairman and CEO, Dino Robusto.

Dino Ennio Robusto
Chairman & CEO

Thank you, Ralitza, and good morning all. In the second quarter, CNA once again produced very strong results with excellent profitability and double-digit top line growth from continued strong renewal change, retention and new business success.

Core income increased by 34% in the second quarter compared to last year with net investment income up 33%, with strong income growth in our alternatives portfolio and a continued tailwind in our fixed income portfolio. Scott will provide more detail on investments.

The P&C all-in combined ratio was strong at 93.8% with pretax catastrophe losses of $68 million or 3.1 points of the combined ratio and 0.4 points of favorable prior period development. The underlying combined ratio was 91.1%, generating a record $200 million of pretax P&C underlying underwriting gain. The underlying loss ratio was 59.9%, slightly less than the same period last year. And the expense ratio was 30.9%, up 0.4 point compared to last year, primarily due to higher pension expense.

In the quarter, we achieved very strong production performance with 12% growth in gross written premium ex captives and 9% growth in net written premium. Excluding currency fluctuation, gross growth was 12% and net growth was 10% led by our Commercial and International segments this quarter.

Renewal premium change was stable at 7% but accelerated 2 points in Commercial to 11%. Importantly, rate change and the portion of exposure change that acts like rate continues to cover our long-run loss cost trends, which were unchanged this quarter at roughly 6.5%. New business was up 11% in the quarter, in line with the growth in the first quarter and with the most significant opportunities continuing to be across our Commercial business units.

We continue to closely track the strength of our pricing on new and renewal business. And that has remained consistent as have the stronger terms and conditions achieved during the hard market years. We continue to lock in the hard market improvements in pricing and terms and conditions with consistently high retention levels which, in the second quarter for P&C overall, was 86%. And it has been at that level for 5 straight quarters.

Turning to our three business units. The all-in combined ratio was 90.9% for Specialty this quarter, which includes 0.3 points of favorable prior period development. The underlying combined ratio was 91.2% with an underlying loss ratio of 58.6%, which is stable compared to last year, while the expense ratio in Specialty was up by 2 points to 32.4%. The increase in the expense ratio is partially due to the lower net earned premium growth. And as usual, Scott will provide more detail on expenses.

Gross written premium ex captives growth and net written premium growth for Specialty were each down minus 1% this quarter. New business was down 9%. While most of the decrease was driven by the protracted decline in M&A opportunities affecting our transaction liability book, we are also being prudent in management liability lines, given the competitive landscape.

Within Specialty, written rate change was minus 1% in the quarter driven by continued competitive pressure on management liability lines where the rate decrease was 9% compared to flat pricing at the end of last year. Cumulative rate movement across these lines since mid-2018 through the hard market years and inclusive of the declines in the first half of 2023 is plus 61%, which continues to favorably impact the overall strong profitability of the portfolio.

In the other Specialty segments, rate increases persist. Our Affinity Programs have much less pricing volatility over time and continue to produce stable rate increases in the low to mid-single digits. Our health care business has undergone tremendous re-underwriting in addition to significant improvement in pricing as well as terms and conditions that we've pushed through the portfolio over the last 5 years.

We highlighted these changes quite regularly on prior calls and pointed out that our health care portfolio is now smaller but profitable. Of course, we remain vigilant in pursuing additional rate increases. And in the second quarter, rates were up mid-single-digit for health care. Retention in Specialty remains strong, improving by 1 point to 89% in the aggregate and is up in each of the 3 business areas.

Turning to Commercial. The all-in combined ratio was 96.3%, which includes 5.2 points of cat loss in the second quarter. The underlying combined ratio was 91.6%, 0.4 points lower than last year and the lowest on record. The underlying loss ratio of 61.5% was stable year-over-year. The expense ratio improved 0.4 point to 29.6% in the quarter, representing the lowest quarterly expense ratio in 15 years.

Gross written premium ex captives grew by 21% this quarter and net written premium grew by 17% this quarter. Renewal premium change was 11% in the quarter, up 2 points from the first quarter and is close to the hard market high of 12% we achieved in early 2021. Excluding work comp, the renewal premium change was plus 13% in the second quarter, actually similar to the high-water mark we achieved early 2021. The Commercial written rate change in the second quarter of plus 8% continues to accelerate and reflects double the level it was in the third quarter of last year.

Commercial rate increases, excluding work comp, were up plus 10% in the second quarter. Importantly, the increase in the rate change was broad-based across business units and line of business. In middle market, rate was plus 6% and renewal premium change was plus 8%, each up 2 points from last quarter. Construction rate was plus 6%, up 1 point from last quarter and renewal premium change was plus 10%. In national accounts, rate was plus 20% and compared to plus 17% last quarter.

Looking by line, Commercial auto rates were low double-digit in the quarter, 2 points higher than the last quarter. Rates for excess casualty have also accelerated over the past year and are now high single digits. Primary liability rates are up in the mid-single digits, also representing an increase from last quarter.

We believe it is rational that rates in casualty lines inflected and continue to increase since bottoming out in the third quarter of 2022 because, as we have said, social inflation had only been obfuscated during the pandemic. And although loss cost trends remained essentially stable in the second quarter, it is an annual compounding cost and it's appropriate that rates increase for longer.

Work comp rates continue to be flat to slightly negative. But renewal price change remains quite strong, about mid-single-digit, as we are benefiting from exposure increases as payrolls rise. And medical trends continue to be below our long-run loss cost trend assumptions, which we have not lowered despite the favorable trends over the last several years.

Property continued to achieve significant rate increases this quarter. In our national accounts area, property rates are up in the 25% to 30% range. In addition, we continue to achieve increases in valuation averaging mid-single-digit and non-rate terms and conditions also remain strong. In our middle market space, property rates are now low double digits, up 4 points from last quarter. And we continue to see insurance value increases here as well.

We renewed all of our property reinsurance treaties June 1. We were successful in maintaining all coverages and covered payrolls in all our treaties and layers. There were very minimal increases in attachment points. On our corporate cat treaty, the attachment increased a little less than $50 million but remains still lower than the $250 million it had been historically.

While costs increased overall as anticipated, the increases were in line with our good performance and prudent management of our cat exposure over the last several years. And with a very favorable price and valuation increases we expect to continue to achieve across our property portfolio, we don't anticipate margins to be impacted.

Commercial retention remained strong at 85% and was strong in all business units. New business was up 23% with excellent opportunities spread across all our Commercial business units. We have been effectively leveraging the favorable property market conditions and growing our property portfolio without significantly increasing our P&L.

While we are writing cat and non-cat property new business, we are also optimizing our renewal book by changing layers and exposures, leading to a better risk-adjusted returns than we had at expiry on certain renewals. And we're also letting accounts go where we can't achieve the improved pricing and terms and conditions available today. We also saw some great opportunities in the E&S channel for national accounts. Now it's still a relatively small portfolio but providing excellent opportunities.

For International, the all-in combined ratio was 92.2% and the underlying combined ratio was 89.1%, a record low. International had strong top line growth this quarter with gross written premiums up 10%, or 12%, excluding currency fluctuation. Net written premiums grew 9%, or 10%, excluding currency fluctuation. Renewal premium change was 7% with written rate change of 4%, consistent with last quarter.

We see many analogous trends to the U.S. in our Continental European and London portfolios with continuing hardening of property rates and rate decreases on management liability classes. Retention was strong in International at 83% for the quarter and has been stable at this higher level for more than a year. New business was up by 5% in the quarter. Our International operation continues to contribute positive top and bottom line results to CNA.

And with that, I'll turn it over to Scott.

Scott Robert Lindquist
Executive VP & CFO

Thank you, Dino, and good morning, everyone. I will provide some additional information on our results as Dino indicated.

Core income of $308 million is up 34% compared to the second quarter of last year, leading to a core return on equity of 10.2%, while our P&C segment had record pretax underlying underwriting income of $200 million and core income of $374 million.

Our second quarter P&C expense ratio was 30.9%, which is a slight increase when compared to last year's second quarter expense ratio of 30.5% due to higher legacy U.S. pension plan expense reflecting financial market conditions at the time of valuation in late 2022.

At the segment level, both Commercial and International saw improvements in their expense ratios compared to prior, primarily driven by strong growth in net earned premium. For Specialty, as Dino just noted, the expense ratio increased due to lower net earned premium growth, higher employee-related costs, including higher pension expense, as well as higher acquisition expense, partially due to mix of business in the quarter.

As I have noted in prior calls, there will be a certain amount of variability quarter-to-quarter. However, we continue to believe an expense ratio of 31% is a reasonable run rate for 2023.

The P&C net prior period development impact on the combined ratio was favorable by 0.4 points. In the Specialty segment, favorable development was driven by surety. And in the Commercial segment, favorable development in workers' compensation was partially offset by unfavorable development in general liability and auto.

The P&C paid-to-incurred ratio was 0.83 in the second quarter, which is about flat with the first quarter of this year and is broadly consistent with the second quarter of 2022. The ratio, which fluctuates quarter-to-quarter, has been consistently lower over the past 3 years.

Our Corporate segment produced a core loss of $46 million in the second quarter compared to a $78 million loss in the prior year quarter. We conduct a comprehensive review of mass tort reserves in the second quarter of each year. And we also react to facts and circumstances in the interim quarters. As a result of this quarter's review, the segment includes a $28 million after-tax charge related to unfavorable prior period development largely associated with legacy mass tort claims. As a reminder, our asbestos and environmental reserves are reviewed every fourth quarter.

As to Life & Group second quarter results, we had a core loss of $20 million as compared to a $9 million core loss for last year's second quarter. Investment income was up $28 million pretax compared to the prior year, mostly driven by limited partnership performance, while the underwriting loss reflects a $13 million pretax loss related to the impact of $67 million of cash policy buyouts during the quarter.

For year-to-date, Life & Group core loss was $23 million compared to a core loss of $4 million in the prior year-to-date period. Year-to-date, Life & Group results reflect $30 million in higher pretax investment income as well as a $26 million pretax loss related to $121 million of cash policy buyouts. Excluding policy buyouts, Life & Group year-to-date underwriting results are broadly in line with reserve expectations.

As I noted last quarter, as an integral component of our risk mitigation strategy, we expect to continue offering policy buyouts as part of approved rate increases for the rest of 2023 and future years. GAAP losses are expected on the buyout program, given the cash offers are linked to higher statutory reserve levels.

In the near term, we expect policy buyouts could generate quarterly GAAP losses up to $10 million pretax, depending on the respective policy year cohort and the actual acceptance rates of such offers. Looking to future years, we expect such buyouts will continue to impact underwriting results with a certain amount of variability quarter-to-quarter.

Also, as I noted last quarter, our LTC business is now accounted for under LDTI, which we adopted as of January 1, 2023. And prior period results were adjusted to reflect LDTI. A reminder that LDTI has no effect on the underlying economics of CNA's business.

However, we expect a modestly higher underwriting loss under LDTI over the next several years as compared to legacy GAAP, putting aside any assumption changes arising from our annual third quarter assumption review. You can find a reconciliation of our 2022 quarterly results adjusted for LDTI as reconciled to legacy GAAP in our first quarter financial supplement as well as our first quarter Form 10-Q.

Turning to investments. Total pretax net investment income increased 33% to $575 million in the second quarter. The increase was driven by our limited partnership and common stock portfolios, which returned a $68 million gain in the second quarter compared to a $15 million loss in the prior year quarter.

The second quarter gain reflects positive contributions across strategies and a favorable equity market environment while the prior year quarter includes losses from our hedge fund and common stock portfolios. And we're in line with unfavorable equity market performance at that time. Additionally, our fixed income and other investment portfolios were $60 million favorable to the prior year quarter.

Our fixed income portfolio continues to produce consistent income, which has been steadily increasing over the last year as a result of favorable reinvestment rates in our P&C portfolios as well as a growing investment base funded by strong cash flow from operations.

Within our P&C and Corporate segment portfolios, the average effective income yield was 4.2% in the second quarter compared to 4.0% in the first quarter of this year and 3.7% in the prior year quarter. As of the end of the second quarter, reinvestment rates were well above our P&C effective income yield. Our Life & Group portfolio effective income yield was 5.5% in the second quarter compared to 5.4% in the prior year quarter, a more modest increase as this portfolio is longer duration and has embedded yields more comparable to today's interest rate environment.

Additionally, within the other category of net investment income, which includes interest income on short-term investments and cash, we are benefiting from significantly higher short-term rates as compared to a year ago. We believe our investment portfolio to be both high quality and well diversified. Our fixed income portfolio, which makes up 88% of our total investments, has a weighted average credit rating of A and is made up of 96% investment-grade securities.

While we maintain an allocation of risk assets, including limited partnerships, common stocks and below investment-grade securities, we believe it is positioned conservatively and well within our risk appetite. Additionally, we maintain ample liquidity to meet obligations and withstand significant business variability at both the holding and operating company levels.

At quarter end, our balance sheet continues to be very solid with stockholders' equity, excluding AOCI, of $12.2 billion or $44.86 per share, an increase of 5% from year-end 2022, adjusting for dividends. Stockholders' equity, including AOCI, was $8.7 billion or $32.22 per share.

We continue to maintain a conservative capital structure with a low leverage ratio and a well-balanced debt maturity schedule. During the second quarter, we successfully issued $400 million of senior notes to help position us ahead of upcoming debt maturities in November 2023 and May 2024.

Cash flow from operations was $501 million for the second quarter, which is down $608 million from last year's second quarter. The decrease in the second quarter is primarily attributable to the aforementioned long-term care policy buyouts. Otherwise, cash flow from P&C underwriting activities and fixed income investments remains very strong, reflecting continued excellent underwriting and fixed income results, respectively.

Turning to taxes. The effective tax rate on core income was 21.6% and reflects several adjustments related to state tax audits and our foreign operations as well as lower tax-exempt investment income as compared to prior periods. Looking forward, we continue -- looking forward, we expect our full year 2023 effective tax rate to be about 21% and with a certain amount of variability quarter-to-quarter.

Finally, we are pleased to announce our regular quarterly dividend of $0.42 per share to be paid on August 31, 2023, to shareholders of record on August 14, 2023. And with that, I will turn it back to Dino.

Dino Ennio Robusto

Chairman & CEO

Thanks, Scott. To recap, we had an excellent quarter with strong top and bottom line performance and significant improvement in net investment income. The pricing cycle continues to be varied by line, reflecting the unique dynamics impacting loss cost trends. The rate decreases in management liability is consistent with prior underwriting cycles post very large spikes during the hard market years. And the firming in all Commercial lines ex work comp is a reflection of the market need for further rate increases for longer due to the elevated cats and the compounding impacts of economic and social inflation.

This improved Commercial pricing continues to flow through to our new business writings. And with our major reinsurance treaty renewals complete with no substantial changes in protection, we feel confident about our ability to continue to leverage those segments and lines of business with the most favorable overall terms and conditions in the second half of the year and to do so while covering our long-run loss cost trends.

And with that, we will be happy to take your questions.

Question and Answer

Operator

[Operator Instructions] Today's first question comes from Meyer Shields with KBW.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

I was hoping to spend a little time on a couple of lines of business within Specialty. First, I guess, I was a little surprised that as rate decreases accelerated in financial institutions and management liability, I'm sure that's D&O, but we saw a sequential uptick in retention, which went sort of the opposite direction. I'm hoping you could talk us through that.

Dino Ennio Robusto
Chairman & CEO

Yes, Meyer. Thanks. It's Dino. Again, this is a very profitable portfolio. And as I indicated, even if you account for the increase in loss cost trends, the rates today are still above a pretty hard market. And so we feel good about the portfolio, and we obviously want to lock in good, strong terms and conditions on our renewal book. As I said, I don't think it's very inconsistent, some of the rate decreases, given some of the large increases you've seen over the hard market. So I think, in general, all of the underwriters are doing a good job about balancing rate and retention in the management liability lines. And we still feel very comfortable with the portfolio.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Okay, fair enough. Second question on medical malpractice. I guess, I'm surprised that, that line's rate increases are decelerating just based on how some competitors are doing. Can you give us any insight into the CNA-specific book?

Dino Ennio Robusto
Chairman & CEO

Yes, I think you hit the nail on the head. CNA's book today, Meyer, is unique because of, as I alluded to in my prepared remarks, it's been a 5-year process of remediating this portfolio. It's been a tremendous amount of re-underwriting. The book is considerably smaller. We've gotten substantial cumulative rate increases. We started considerably before the broader market.

And if you recall, Meyer, during those years, our retention had plummeted in the low 60s, a reflection of the fact that we were clearly swimming upstream in pursuit of the rate increases. But today, we find ourselves with a smaller portfolio. It's profitable. It's the segments of middle -- of medical mal that are typically more profitable. I think some of the rates reflect that. But make no mistake about it, we're going to continue to push for rates and continue to work on all of the underwriting strategies that we've had over the last 5 years. And I think it's fair to consider the CNA portfolio today somewhat unique.

Operator

[Operator Instructions] And it appears our next question is a follow-up from Meyer Shields.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

One other thing I was hoping to ask about, and I apologize if I missed this, but we saw the P&C and Life & Group durations contract in the quarter. And again, that was a little bit surprising. And I was hoping that we could talk to that.

Scott Robert Lindquist
Executive VP & CFO

Sure, Meyer. It's Scott here. Thanks for the question. So I would say nothing dramatic at all changed within the portfolio -- either of the portfolios. There's going to be a certain amount of variability based on just where interest rates are at quarter end. But I have -- we were probably carrying a little bit more cash in P&C right now than we were at last quarter end. That's probably the only thing I would flag for you on that. Other than that, no real significant or material change at all in the portfolio composition.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Okay, perfect. And I know the starting point was different from a lot of P&C carriers.

Operator

And our next question today comes from Kyle Labarre with Dowling & Partners.

Kyle Robert Labarre
Dowling & Partners Securities, LLC

I just wanted to talk a little bit about the property growth. I know, Dino, you gave some good commentary in the opening remarks from a rate perspective. But I was wondering if we could maybe dive a little bit deeper into what are the sort of the makeup of that portfolio where you're seeing the best opportunity across national accounts and middle market.

Dino Ennio Robusto
Chairman & CEO

Yes. So I think we're seeing it both in national accounts and middle market. But obviously, in the national account space, you're seeing a lot more rate increases, larger schedules. We're also seeing larger valuation increases or also some opportunities in the E&S space, which we started about a year ago. And so we're seeing some good opportunities there. It's all within our target market. Nothing has really changed in what we go after. But obviously, both in the shared and layered and ground up, there's plenty of opportunity and capacity needs. And so as I indicated, we're growing the portfolio. But also, we continue to optimize it as we get better terms and conditions even at renewal today than we did a year ago before the market really hardened at Jan 1.

Kyle Robert Labarre
Dowling & Partners Securities, LLC

Great. And then just another question on loss cost trends, I imagine they were relatively stable. You've mentioned overall loss trend relatively stable at 6.5%. But we've heard some varying trends within the medical side so far during the reporting season. Curious what you're seeing there in terms of medical cost inflation.

Dino Ennio Robusto
Chairman & CEO

When you look at our work comp, Kyle, medical costs are up. And you've got to be specific. You've got to really look at the components of medical costs when you look at CPI that really impacts work comp like, for example, physician services, so -- but even with them being up somewhat, they are still well below our baked-in assumptions, which we have never lowered, notwithstanding the benign trends for many years. So still very good, and we feel very good about the portfolio. And it's very profitable.

Kyle Robert Labarre
Dowling & Partners Securities, LLC

Perfect. And just one more for me. And we started to see some more headlines on whether it's the forever chemicals or the lead wiring, just sort of the increase in latent liability concerns. Now I know you've got the reserve cover in place for A&E. But maybe just sort of from a high level, curious how you're thinking about those sorts of exposures. What are the things that we should be focused on as we think through what the impact for the industry could be?

Dino Ennio Robusto
Chairman & CEO

Kyle, as Scott mentioned, right, we do a ground-up mass tort review in the second quarter. And then as he also indicated, I mean, if there's anything specific that might transpire during the year, like abuse cases, then we'll act during the quarter. And we look at all of those things and we try to capture in our reserves in mass tort the information that we have. It's obviously evolving. It's going to take time to evolve. And we'll continue to incorporate the information as it develops. There's not much else we can say at this particular juncture.

Operator

This concludes our question-and-answer session. I'd like to turn the conference back over to Dino Robusto for any closing remarks.

Dino Ennio Robusto
Chairman & CEO

Well, thank you, everyone. And we'll chat again with you next quarter. Thank you.

Operator
Thank you, sir. This concludes today's conference call. We thank you all for attending today's presentation. You may now disconnect your lines, and have a wonderful day.