S&P Global
Market Intelligence

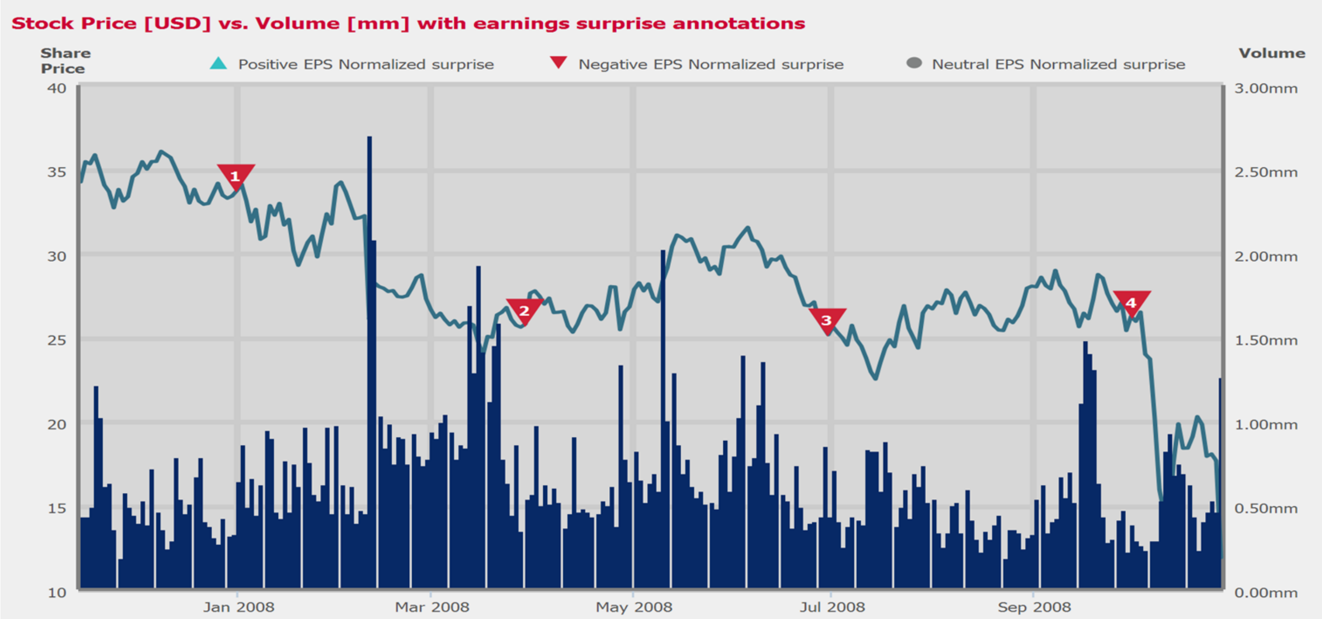
CNA Financial Corporation NYSE:CNA
FQ4 2008 Earnings Call Transcripts

Monday, February 09, 2009 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2008-			-FQ1 2009-	-FY 2008-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.45	(0.15)	NM	0.81	2.76	1.91
Revenue	-	-	-	-	-	-
Revenue (mm)	-	1564.00	-	-	6462.00	6555.00

Currency: USD
Consensus as of Jan-14-2009 6:48 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2007	1.02	0.82	1 (19.61 %)
FQ1 2008	1.01	0.82	2 (18.81 %)
FQ2 2008	0.96	0.93	3 (3.12 %)
FQ3 2008	0.69	0.31	4 (55.07 %)

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Call Participants

EXECUTIVES

D. Craig Mense

Larry A. Haefner

Nancy M. Bufalino

Thomas F. Motamed

ANALYSTS

Bob Glasspiegel
Langen McAlenney

Daniel Johnson
Citadel Investment Group

Jay Cohen
Bank of America Merrill Lynch

Ray Wicklander
Tradewinds Global Investors

Presentation

Operator

Welcome to the CNA Financial Corporation fourth quarter and full year 2008 earnings conference call. Today's call is being recorded. At this time I'd like to turn the conference over to Nancy Bufalino.

Nancy M. Bufalino

Welcome to CNA's fourth quarter and full year financial results call. Hopefully everyone has had an opportunity to review the press release and financial supplement which were released earlier this morning and can be found on the CNA website. This morning we're happy to have with us our new Chairman and CEO, Tom Motamed and Craig Mense our CFO. Tom and Craig will provide some prepared remarks before opening it up for questions from the investment community.

Before we get started I'd like to advise everyone that during this call there may be forward-looking statements made and references to non-GAAP financial measures. Please see the section of the earnings release headed financial measures and forward-looking statements for further detail. In addition, the forward-looking statements speak only as of today, February 9, 2009.

CNA expressly disclaims any obligation to update or revise any forward-looking statements made during this call. This call is being recorded and webcast. During the next week the call may be accessed again on CNA's website at www.CNA.com. With that, I'll turn the call over to CNA's Chairman and CEO Tom Motamed.

Thomas F. Motamed

Many of you know me from my previous life and I look forward to renewing our acquaintance in my new position at CNA. My first analyst call at CNA coincides with prolonged and severe disruptions in the debt and equity markets. These conditions resulted in significant losses in our investment portfolio as well as declines in our net investment income during 2008.

The impact is clear to see in our fourth quarter and full year results. As you read in our press release, CNA had a $21 million operating loss for the fourth quarter or $0.15 per share and a net loss of $336 million or $1.31 per share. Both were driven by investment results whether it was the $309 million of limited partnership losses that adversely affected operating income or the $419 million of investment impairments that contributed to a $314 million realized loss.

For the year, net operating income was $533 million or $1.91 per share. Catastrophe losses reduced earnings by $0.89 per share. The net loss of $299 million reflects the investment and catastrophe losses.

I am pleased to say that operating performance of our core property casualty business was a much better story and that will be my focus this morning before turning it over to Craig who will discuss our reserve position, investments, capital management and other topics. Property and casualty operations which consists of specialty and standard lines delivered a fourth quarter combined ratio of 89.1%, the best quarterly result in seven years.

Favorable development reduced the quarter's combined ratio by 11.8 points, catastrophe losses added .6 points, before development and tax the combined ratio was 103%. For the full year, the combined ratio was 98% which included 4.4 points of favorable development and 5.7 points of catastrophe losses. Before development and tax, the combined ratio was 96.7%.

In the quarter, the favorable development is primarily attributed to first party coverages and standard lines, mainly property and marine and the CNA Global businesses and specialty which include our international operations and First Insurance Company of Hawaii. This quarter's favorable development continues the recent trend that now shows eight straight quarters of favorable development for property casualty operations.

We believe this reflects our prudent reserving philosophy and we are confident in the adequacy and accuracy of our reserves. For the full year, favorable development in standard lines was driven by the first party coverages. In specialty lines the drivers were CNA Global and HealthPro for accident years 2003 through 2006. As for premium volume, net written premiums decreased about 4% in the fourth quarter and the year. We continue to focus on underwriting discipline in all our business segments.

Now, let us take a closer look at specialty lines and standard lines starting with specialty. Specialty lines which represent 60% of total premiums delivered a fourth quarter combined ratio of 87.5 in 2008 compared with 91.1 in 2007. Favorable development in the quarter had a 14 point impact in 2008 versus 2.6 points in 2007. Before development and catastrophe losses, the fourth quarter combined ratio was 101% in 2008 as compared to 93.4% in 2007.

During the quarter the current accident year was unfavorably impacted by seven points to reflect our exposure to claims arising from the credit crisis. For the year, the combined ratio was 90.1 which included favorable prior year development of 5.4 points. Before development and catastrophe, the 2008 combined ratio was 95.

Specialty lines net written premiums declined 4% for the quarter, 2% for the year. The fourth quarter decline was primarily driven by the impact of currency fluctuations on our Canadian and European businesses. The ratio of new to loss business was 1.2 to 1. We retained 84.6% of renewal business consistent with the past few quarters and three points better than the fourth quarter of ’07. Renewal rate decreases averaged 2.5%, a slight improvement over the past few quarters and two points better than the fourth quarter of ’07.

I would now like to give you some color on the specialty marketplace. Competition remains strong and pervasive in the fourth quarter as underwriters press for new business while showing a willingness to reduce rates in order to retain renewals. Although pricing seems to be a part of every equation, we saw little evidence of pressure to modify terms and conditions.

Regarding the market dislocations that occurred in 2008, we are seeing significant price reductions by incumbents to retain accounts. Surprisingly enough, we do not see brokers and agents replacing these positions but rather taking the price reduction and in some cases reducing the line participation. On a more positive note, we continue to see price strengthening in the financial institution segment and a stabilization of commercial D&O pricing.

As for standard lines, the fourth quarter combined ratio was 90.9 in 2008 compared with 105.4 in 2007. Favorable development in the quarter had a 9.2 point impact in 2008 versus 2.9 points in 2007. Before development and catastrophe losses the fourth quarter combined ratio was 99.4 in 2008 as compared to 105.8 in 2007. For the year, the combined ratio was 107 which included favorable prior year development of 3.2 points. Before development and catastrophe the 2008 combined ratio was 98.8.

Net written premiums decreased 4% in the fourth quarter, 7% for the year. The ratio of new to loss business was 1.2 to 1. We retained 85.1% of the business available to renew, there points better than in the third quarter and fourth points better than the second quarter. Rate decreases on renewals averaged 3.2%. This too represents an improvement over the previous two quarters, in fact the fourth quarter rate decline was the lowest in eight quarters.

With respect to the standard lines marketplace, we see the same trends as on the specialty side. While rate decreases moderated somewhat in the fourth quarter, it is still a very competitive market. Carriers are fighting to hold their renewals and new business pricing on the best accounts is still very aggressive.

This has been complicated by new entrance in the ocean cargo, monoline umbrella property and energy segments. Although we are quite pleased with the deceleration of rate declines and hopefully a bottoming out of rates, we’re closely watching our exposure factors such as payrolls, sales and insured valuations. Since price is a composite of rate and exposure, the current condition of our economy is and will continue to impact overall price and ultimately premium growth.

Turning briefly to expenses, CNA continues to run a competitive and stable expense levels. The property casualty operations fourth quarter expense ratio was 30%. For the year, we ran at 29.6%, our third consecutive year below 30. With that, I will turn it over to Craig.

D. Craig Mense

As Tom outlined, CNA's property casualty store insurance operations turned in another strong performance during the fourth quarter as measured by their 89.1% combined ratio. As importantly, the operating fundamentals for those businesses is improving, especially with regard to rate and retention. We have a well established brand and an excellent competitive position.

In addition to solid business operating performance, the company has a solid reserve position. A track record of eight straight quarters of positive loss development in P&C operations, much diminished reinsurance recoverable credit risk and substantial enterprise liquidity. We believe we have the flexibility and financial resources to successfully manage this company through the market stresses that we are all currently experiencing.

Let me now turn to investment results and the investment portfolio. Fourth quarter pre-tax investment income was $170 million compared with $574 million in the prior year period. These results include $45 million of losses from our trading portfolio in the current period compared with $31 million of trading losses in the previous period. Excluding the impact of trading gains and losses, the primary driver of decreased results was our portfolio of limited partnership investments.

Limited partnership losses during the quarter were $309 million compared with LP income of $41 million in the fourth quarter of '07. The carrying value of our limited partnership investments at year end was approximately $1.7 billion. We have 82 active LP investments across a broad range of strategies. The majority of them invest in marketable securities while engaging in various risk management techniques. We have minimal exposures to private equity, approximately 7% and real estate less than 1%.

Our fourth quarter 2008 LP numbers reflect results through December for roughly 40% of the reported value whereas 45% are on a one month lag and the remainder are on a more than one month lag which is typically 90 days. That means that the majority of the bad news in last year's fourth quarter has already been reflected in our results.

Overall, our portfolio of limited partnerships continues to be an attractive investment. Despite their performance in recent quarters these holdings bring diversification to the overall portfolio with less volatility and higher absolute returns in equities. We continue to believe that they will perform well over the long term just as they have over the last decade. As an aside, these LPs have produced an annualized return of approximately 10% over the last 10 years which compares to returns from the S&P 500 of a -1.4%.

After tax net realized investment losses were $314 million this quarter compared with a loss of $61 million in the prior year period. Those realized losses included after tax impairments of $419 million the majority of which were driven by credit issues. The impairments were primarily recorded in the corporate and other taxable bonds and asset backed bonds sectors.

Book value per share at yearend 2008 was $20.92 per share which reflects after tax accumulated other comprehensive income adjustments of $3.9 billion. Excluding accumulated other comprehensive income book value per share was $35.50 at yearend 2008. The extreme market valuation of the third quarter continued in to the fourth quarter before stabilizing somewhat in mid December. These valuations affected virtually all asset classes. Our net unrealized loss position stood at $5.4 billion pre-tax as of yearend 2008.

Our investment portfolio is highly liquid, well diversified and of high quality. There has been no change to the average credit rating of our fixed income portfolio which is AA-. The effective duration of the total portfolio is 5.8 years, up from 5.6 years at September 30th. The increase is attributable to duration extension in the structured security sector.

As I have described in earlier calls and presentations, we segregate assets in our investment portfolio to facilitate asset liability duration management. The larger portfolio, approximately 76% or $25.2 billion of our interest rate sensitive securities supports the P&C and corporate segment. That portfolio had 4.5 year duration as of the end of the fourth quarter.

The second smaller portfolio, approximately $8.2 billion or 24% of our interest rate sensitive securities are segmented and aligned to support certain long term interest sensitive liabilities, primarily in the life group non-core segment. We refer to this portfolio as our matched portfolio. That portfolio had a 9.9 year duration as of the end of the fourth quarter.

It is important to recognize that roughly 80% of unrealized losses as of December 31, 2008 were in investment grade securities. In addition, over 50% of those losses are in securities with maturities that are over 10 years. These longer maturity assets are generally aligned with liabilities in the matched portfolio that have a duration need of 10 years or longer.

Many of the liabilities held in the matched portfolio are subject to cash flow testing that essentially requires us to own the long duration bonds that have been significantly affected by turmoil in capital markets during the past year. Among the liabilities that the matched portfolio supports are long term care and structured settlements which do not have potential policyholder liquidity demands that many other life products contain.

The nature of the liability cash flows both in the matched portfolio and the property and casualty portfolio, greatly mitigating the risk of unexpected liquidity stress. In addition of course, we maintained substantial liquidity in our insurance subsidiaries and generate significant positive operating cash flow. The company generated over $3 billion in operating and principal cash flows in 2008. In addition, we held $3.6 billion in cash and short term investments at yearend 2008.

At the Lowe’s investor conference in November, we outlined our ability to generate positive cash flow under extreme and prolonged market stress scenarios. Even in these highly improbable scenarios we would not be forced to sell investments to meet liquidity needs. In short, we have the ability to hold currently underwater securities until maturity if necessary.

We have a $7.8 billion structured portfolio that is well diversified and of high quality. 90% in government or AA rated or better securities. This portfolio is paying down monthly, generating over $150 million in principal cash flows per month in 2008. While it is likely that these cash flows will decrease somewhat in 2009, they will still be a healthy contributor to our overall cash flow.

Exposure to subprime and ALTA is decreasing. Additionally CNA has approximately $660 million of exposure to commercial mortgage backed securities. For the month of January, we saw our unrealized loss position improve modestly, roughly 1%, on an overall basis. While this may not mean the end to the negative news, it does reflect improvement in some sectors of the market such as municipal securities.

Before opening up the call for questions, I would like to report briefly on our non-core businesses as well as our capital management activity during the quarter. The life group segment produced a fourth quarter net operating loss of $39 million in 2008 versus a loss of $17 million in 2007. The difference was primarily the result of adverse investment performance on a portion of our pension deposit business.

The corporate segment had a fourth quarter net operating loss of $105 million in 2008 versus the $29 million loss in 2007. The decline was primarily the result of reduced investment income. During the quarter we completed our annual ground up reserve analysis for both our asbestos and pollution liabilities. As a result of the analysis we made no change to our carried asbestos reserve and increased our pollution reserves by $80 million pre-tax.

Turning to capital management, we completed the $1.25 billion preferred stock issues to Lowes as announced in our last call. We contributed $1 billion of the proceeds to our major insurance subsidiary Continental Casualty in the form of a surplus note. Subsequently, we further bolstered the surplus of Continental Casualty with another $500 million cash contribution. In addition, we drew on our $250 million credit facility to retire $200 million of CNA public debt that matured in the fourth quarter.

Despite the pressure that valuations have put on capital, we have maintained a consistent and healthy, as measured by RBC level of regulatory capital. We also still maintain holding company cash of over $500 million which amount represents more than three times our annual level of net corporate obligations. The lack of debt maturities until 2011 and bank revolver maturity in 2012 should provide further comfort.

Let me finish where I started, our company has built a solid foundation capable of withstanding prolonged market stress. CNA is well positioned to capitalize on opportunities likely to emerge in the insurance marketplace in 2009 and beyond. With that, let me turn it back to Tom.

Thomas F. Motamed

Before we open it up for questions, I would like to close with two summary observations. First, our insurance businesses performed well in the fourth quarter as they did for all of 2008. I'm also pleased to say that it was not a unique quarter from the standpoint of core business performance.

Good things have been happening here for some time: consistently solid net operating income from property casualty operations; combined ration consistently below 100; expense ratio consistently below 30; solid accident year results, prudent reserving practices; eight consecutive quarters of favorable development; and positive trends in rate and retention. Second, we don't underestimate the challenges of the insurance and the financial markets.
Against this backdrop you should expect us to stay focused on the fundamentals and to achieve continuous improvement in our business performance over time. With the earnings potential of our core business and the highly liquid financial position, we are excited by the opportunities that present themselves in 2009. With that, we will take your questions.

Question and Answer

Operator

(Operator Instructions) Your first question comes from Jay Cohen - Bank of America Merrill Lynch.

Jay Cohen
Bank of America Merrill Lynch

Two questions, the first one maybe more numbers oriented, the second question bigger picture. The first one, the accident year combined ration excluding catastrophe losses seemed to jump in the fourth quarter versus the first three. It had been running about 96 and now all of a sudden it's at 100, this is for property casualty operations. I'm wondering what's behind that increase. Then secondly, Tom if you could talk about your main focus at the company. You've been there now for a bit of time, you've had a chance to look at things, as you look in to 2009/2010 what are your main focuses that you'll be working on?

Larry A. Haefner

On the first question, the comparison of the accident year loss ratio from fourth quarter was that to the first quarter? What was your point of comparison?

Jay Cohen
Bank of America Merrill Lynch

It was the accident year combined ration ex cats in the fourth quarter versus the first three quarters which my numbers suggest is running closer to 96, this quarter was just over 100 for kind of the standard in the specialty business combined.

Larry A. Haefner

Yes but the major change in the fourth quarter for the current accident year involved the specialty lines business and that was primarily taking action on the credit crisis including [made] off exposures.

Thomas F. Motamed

I guess number one, I'm pretty excited to be here, I think there's a lot of upside at CNA or I wouldn't have come here. Today is my 26th day so I still have a lot to review and understand about CNA and how they operate and their position in the marketplace but I guess I would start off by saying I want to be thorough and thoughtful about the strategy going forward. It would be great to make a lot of promises today but I really want to do the right research and be able to tell you something at the end of the first quarter that has staying power.

All of that being said, a couple of real positives that I found when I got here, number one, a lot of support from the producer plant. They are very interested in CNA as a market, not only what we do today but what we could do for them in the future. As we mentioned on the call, we think that the underwriting results have improved a lot and that's pretty good considering what's been going on with rates for the last few years.

Definitely some clear underwriting strengths and capabilities and segments like HealthPro, construction and programs. They really are well thought out by our producer plant and our customers. Strong service platforms, I think we've had a first rate claims operation, risk control as well as the back office. Probably the last point I'd make is some very, very capable people here at CNA and ultimately people make the difference.

With that, I think what you could expect to hear from me at the first quarter conference call is a lot more how we expect to grow the top line and the bottom line, more on the underwriting appetite, customer segmentation and expertise from an underwriting and service standpoint. More about how we're going to develop our producer network to really produce great results not only for us but for them and ultimately what our underwriting strategy will be going forward for those segments that we choose to play in. I think you're going to have to wait until the end of the first quarter, but I'll give you plenty then Jay.

Operator

Your next question comes from Daniel Johnson - Citadel Investment Group.

Daniel Johnson
Citadel Investment Group

Two questions Craig, first on the muni portfolio, in the P&C business it is being carried at about $0.90 and on the life side about $0.80. Can you give us a little bit of color as to sort of what sort of munies were invested in? I don't know how you want to characterize it but it would be helpful to understand that. Then finally, can you touch on what sort of rating triggers the company has say within a notch or two from where you stand today?

D. Craig Mense

Let me take the muni question first and I'd just refer you to that part of my remarks where I mentioned the matched portfolio and the duration of those liabilities. Those are the longer duration which have been hit the hardest by the market valuations this year so that's what's really driving those differences in the marks P&C munies and then life group matched portfolio munies. I'm not sure exactly what your question is about rating notch.

Daniel Johnson
Citadel Investment Group

Ratings triggers that you have whether it's sort of anywhere on the business, whether it's counterparties financing, just within a notch or two where you sit today, what should we be mindful of?

D. Craig Mense

I'd refer you back Dan to the Lowe's investor conference presentation where we laid out a bunch of stress scenarios on liquidity and we said if we had more than a two notch downgrade there was less than $70 million of potential collateral that would be accelerated so it was diminuous and most of that was some former client settlements. So, there are no potential stresses or watch outs out there on that regard.

Operator

Your next question comes from [Ray Wicklander] - Tradewinds Global Investors.

Ray Wicklander
Tradewinds Global Investors

Can you just give us an idea of the distribution of the limited partnership portfolio and the top five accounts for what percent of that portfolio?

D. Craig Mense

Hold on one second and we'll see if we can get that answer for you but I would tell you that it's very well distributed across different strategies and the results have been pretty evenly distributed across strategies too. So, really the two top sectors would be relative value and multi strategies and then long short equity plays. Those there would account for over 50%.

Ray Wicklander
Tradewinds Global Investors

The disclosure in the 10K is still fairly accurate, there's about 60 partnerships in there?

D. Craig Mense

There about 82.

Ray Wicklander
Tradewinds Global Investors

There's good disclosure on the structured side but on the other taxable, presumably all corporate, what is the average rating of that portfolio, how has that migrated and what is the component that is BB and minus?

D. Craig Mense

The high yield portfolio, meaning the below investment grade portfolio is market value a little less than $2.6 billion. But, over 40% of that is in bank debt and I'd day that's been particularly beaten down by the market because of quantitative easing impacts on short term rates and just what people think extension, but we feel very comfortable that position in the corporate structure and the security there. The overall fixed income portfolio is AA-.

Ray Wicklander
Tradewinds Global Investors

Right but just for the sleeve other taxable because most of the structured is AAA, right? Can I just assume the other taxable is AA as well?

D. Craig Mense

Well, about a little over 10% is government and agencies, about 35% is AAs, another close to 30% is A and AA, about 17% BBB and then you've got the non-investment grade that I talked about.

Ray Wicklander
Tradewinds Global Investors

Finally, what tax rate do you use for the deferred tax asset against these unrealized losses?

D. Craig Mense

It would be actually calculated by the individual security by individual security depending on where we are with the tax basis and where we are with the certain impairment basis. It's roughly in the low 30s range.

Operator

Your next question comes from Bob Glasspiegel - Langen McAlenney.

Bob Glasspiegel
Langen McAlenney

I got bumped off so I apologize if you answered this Tom, but could you talk about the due diligence process you went through before leaving what was a pretty good job to take this with respect to the investment portfolio and operations? Secondly, what sort of changes do you think you're going to be able to bring to the party strategically that you think should be done differently or is it just a question of keeping the operating agents on track?

Thomas F. Motamed

I guess number one on due diligence certainly, all of the public information was available to me and I read that pretty thoroughly. Having been in the business for a few years I certainly understood the marketplace and how the market worked whether it was by underwriting or I'll say the sales distribution perspective. In my old life we would run in to CNA and I had some impressions about how CNA operated in the marketplace and how they performed as an underwriter.

You know, I did a lot of homework, I did talk to a lot of producers to get a feel for what CNA was about after I had left my prior employer. Quite honestly, I had a feeling that there was a lot of upside here as I said earlier on the call. I think the market is what the market is today. I think the market will hopefully change, maybe not right away but timing is everything in this business and I think we're in a pretty good position.

I did comment earlier about what I'm going to do but just to be brief, I'm going to be pretty thorough and thoughtful about what CNA needs to do to be a great company and I expect that at the first quarter conference call I can tell you a lot more about what's happening. So, from that perspective, we will come out and tell you what we expect to do to grow the top line, the bottom line, underwriting appetite, customer segmentation, talk about the distribution capabilities that we have today and maybe what we'll do in the future and underwriting strategy.

Bob Glasspiegel
Langen McAlenney

Nothing from investment or run off business management orientation, you didn't mention those as priorities?

Thomas F. Motamed

Well, we're certainly interested in the performance of our investment portfolio I think like any other insurer would be. We continue to watch that very closely, I can tell you that we have very good data and information here to track these things. I've been very impressed with the level of detail when I ask a question so just as I said I'll be thorough and thoughtful we will continue to be thorough and thoughtful on all fronts. But, you know this isn't Washington DC that has a plan in 16 days and they don't know how they're going to pull it off. We're going to have a plan and we're going to know how to pull it off.

Operator

Your next question comes from Jay Cohen - Bank of America Merrill Lynch.

Jay Cohen
Bank of America Merrill Lynch

Just a quick one for Craig, what's the debt to capital now at the end of the year?

D. Craig Mense

23%.

Operator

It appears there are no further questions.

Nancy M. Bufalino

Thank you all for joining us today and once again I'd just call your attention to the disclosures concerning forward-looking statements and non-GAAP measures. A taped replay of today's call will be available for one week immediately following this call until February 16th. You can see the replay detail in our earnings release. Again, we appreciate your participation and thank you again.

Operator
This concludes today's conference. We appreciate your participation.