S&P Global
Market Intelligence

CNA Financial Corporation NYSE:CNA

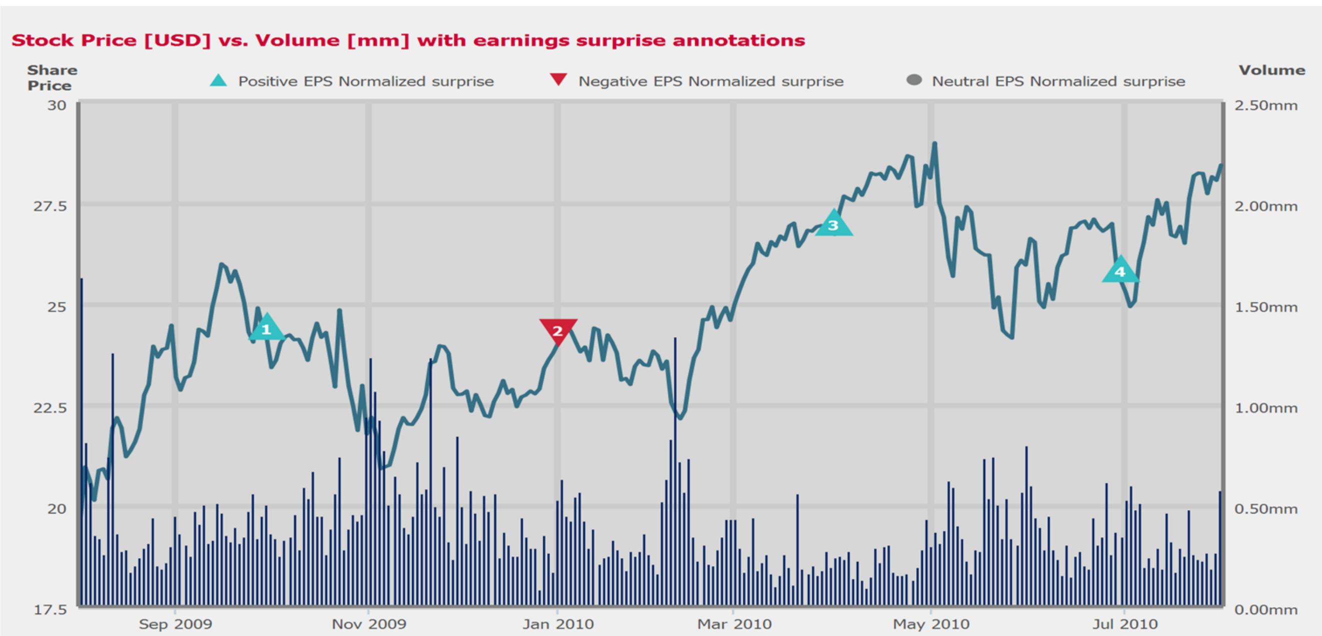
FQ3 2010 Earnings Call Transcripts

Monday, November 01, 2010 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2010-			-FQ4 2010-	-FY 2010-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	(0.40)	(0.66)	NM	0.58	1.85	2.70
Revenue (mm)	1824.52	1469.00	(19.49 %)	1821.67	7389.19	7396.08

Currency: USD
Consensus as of Nov-01-2010 11:45 AM GMT



- EPS NORMALIZED -			
	CONSENSUS	ACTUAL	SURPRISE
FQ3 2009	0.87	1.11	27.59 %
FQ4 2009	0.73	0.63	(13.70 %)
FQ1 2010	0.65	0.74	13.85 %
FQ2 2010	0.58	0.91	56.90 %

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Call Participants

EXECUTIVES

Craig Mense

Nancy Bufalino

Richard Scott

Tom Motamed

ANALYSTS

Amit Kumar
Macquarie

Bob Glasspiegel
Langen McAlenney

Jay Cohen
Bank of America-Merrill Lynch

Michael Bunyaner
TLF Capital

Presentation

Operator

Good day, and welcome to the CNA Financial Corporation's third quarter 2010 earnings conference call. Please note today's conference is being recorded. At this time, I'd like to turn the conference over to Ms. Nancy Bufalino. Please go ahead, ma'am.

Nancy Bufalino

Thank you, Holly, good morning, and welcome to CNA's discussion of our third quarter 2010 financial results. Our press release was issued earlier this morning, and hopefully everyone has had an opportunity to review it along with the financial supplement, which can be found on CNA Web site at www.cna.com.

With us this morning are Tom Motamed, our Chairman and Chief Executive Officer; and Craig Mense, our Chief Financial Officer. After Tom and Craig provide their remarks about the quarter, we will open it up for questions.

Before we get started, I would like to advise everyone that during this call there may be forward-looking statements made in references to non-GAAP financial measures. Any forward-looking statements involve risks and uncertainty that may cause actual results to differ materially from the statement made during this call. Information concerning those risks is contained in the earnings release and in CNA's most recent 10-Q and 10-K on file with the SEC. In addition, the forward-looking statements speak only as of today, November 1, 2010. CNA expressly disclaims any obligation to update or revise any forward-looking statements made during this call

With respect to references to non-GAAP measures, reconciliations to the most comparable GAAP measures have also been provided in our most recent 10-K and 10-Q as well as the financial supplements. This call is being recorded and webcast. During the next week the call may be accessed again on CNA's Web site.

With that, I'll turn the call over to CNA's Chairman and CEO, Tom Motamed.

Tom Motamed

Thank you, Nancy. Good morning, everyone, and thank you for joining us today. Before I report on our third quarter results I would like to make a few comments about our announcement regarding CNA Surety.

We announced today a proposal to acquire the public minority of CNA Surety for $22 per share and our intention to seek negotiated transaction with a special committee of the company's Board of Directors. We believe a buy-in of the Surety minority is the natural next step for CNA and when it fits with the strategic objectives that we articulated when I joined the company.

CNA Surety is a business we know extremely well and this field represents an opportunity to make an additional investment in our specialty franchise while at the same time simplifying our ownership structure.

CNA Surety is a market leader in surety industry. The company has a solid capital position and we believe that it will be well positioned to deliver consistent underwriting profitability as a wholly-owned subsidiary of CNA.

Following completion of this proposed transaction, we expect that CNA Surety will continue to run its business in a manner that is generally consistent with its current operations. Craig will share some additional color on the transaction later in the call.

Now on to our third quarter results; our core Property & Casualty operations delivered a combined ratio of 97.9%. Net-written premiums declined 1% and the expense ratio improved slightly to 33%.

Our investment portfolio continued to perform very well. Our unrealized position improved by $1.2 billion from the end of the second quarter. Over the same period, CNA's book value increased 6% to $42.76.

We completed a major Loss Portfolio Transfer transaction. As announced last quarter, we ceded substantially all of our legacy asbestos and environmental pollution liabilities to National Indemnity Company, a subsidiary of Berkshire Hathaway. We also completed a $500 million debt offering and redeemed senior preferred stock with the proceeds.

Turning to the third quarter financial results, we reported a net operating loss of $158 million, or $0.66 per common share, and a net loss of $140 million or $0.59 per common share. These results include $365 million loss from the Loss Portfolio Transfer. We recognized $344 million of this loss in continuing operations and $21 million in discontinued operations.

Before the impact of the transaction, third quarter net operating income was $186 million or $0.62 per common share, as compared to $331 million or $1.11 per common share in the third quarter 2009. On the same basis, third quarter net income was $225 million or $0.77 per common share, compared with $263 million or $0.86 per common share in 2009.

In our core Property/Casualty operations, the third quarter combined ratio was 97.9% compared with 101% in the third quarter of 2009. The difference is primarily due to 6.5 points of favorable prior year loss development compared with 3.3 points in last year's third quarter. Consistent with previous quarters, accident years 2004 through 2007 continue to develop favorably.

Craig will provide more detail in his remarks.

In addition to the favorable development, the combined ratio included 0.8 points of catastrophe losses, compared with 1.5 points in the third quarter last year. Before development and catastrophes, the third quarter combined ratio was 103.6% compared with 102.8% in 2009. The accident year loss ratio before catastrophes was 70.3% in the third quarter, as compared to just 69.2% in the prior year period.

Net written premiums decreased 1%, as compared to an 8% decrease in the third quarter of 2009. Rates declined a 1%, a slight deterioration from the prior year period. Renewal retention improved one point to 83%. The third quarter Property/Casualty expense ratio improved slightly to 33%.

CNA Specialty continues to perform well, delivering a combined ratio of 88.5% compared with 88.8% in the third quarter of 2009. These ratios benefited from favorable prior year loss development of 9.8 points and 5.5 points respectively.

Catastrophe losses had a modest impact on the third quarter combined ratio this year and last year. Before catastrophes and development, Specialty's combined ratio was 98.2% compared with 94% in the third quarter of 2009.

We had seen an increase in the frequency of employment practices liability claims, which we believe is related to the weak economy. We also have seen an increase in severity in our medical technology business.

Specialty's accident year ex-cat loss ratio was 67.5% in the third quarter, as compared to 65% in the prior period for the reasons I just stated. Specialty's net written premiums increased 2% in the quarter as compared to 1% increase in the third quarter of 2009.

Decreased exposures continue to pressure our professional and management liability book, particularly architects and engineers and realtors which continue to be challenged by the weak economy.

We are pleased with our growth in private company D&O, professional liability program business and community banks. In addition, our renewal retention increased 1.86%. As per renewal rates our rates decreased approximately 2% as compared to 1% decrease in the prior year period.

Virtually all segments in the specialty market are extremely competitive, particularly healthcare and public company D&O. Specialty continues to generate a healthy flow of business, the ratio of new to loss business was 1.3-to-1.

Quarter-over-quarter submissions increased 30%, driven primarily by growth in our private company management liability and professional liability businesses.

New business across the segment increased 5%. Turning to CNA Commercial, the third quarter combined ratio was 105.7 compared with 110.6 in the prior year period. These ratios benefited from favorable prior year loss development of 3.9 points and 1.5 points respectively.

Catastrophe losses had a relatively light impact on our third quarter combined ratio, 1.4 points this year compared to 2.4 points last year. Before catastrophes and development, the combined ratio was 108.2 compared with 109.7 in the third quarter of 2009. The difference was largely driven by expenses for industry assessments we recognized in last year's third quarter.

Commercial's accident year ex-cat loss ratio was 72.7% in the third quarter as compared to 72.5% in the prior year period. Commercial's net written premiums decreased 3% in the quarter as compared to a 14% decrease in the third quarter of last year. Excluding the Argentina operation which we sold in June of this year, third quarter net written premiums were essentially flat.

Across the commercial segment, renewal rates were generally flat. However, we continue to get rate in our small and middle market business. We're seeing improved retention and increased new business in small.

We're also seeing a shift in our middle market new business to those segments we view as more desirable including manufacturing and technology.

Renewal retention is improving as well, up 1.81%. On the other hand, we continue to feel the impact of decreased exposures and return premiums which reduced our third quarter net written by 4% in 2010 and 5% in 2009.

Third quarter submissions in commercial were up 9% which we believe is a reflection of our broadened underwriting appetite. We continue to exercise underwriting discipline as evidenced by 2 point reduction to 24% in our written-to-quoted ratio.

With that I will turn it over to Craig. Craig?

Craig Mense

Thanks, Tom. Good morning, everyone. The third quarter highlights include a net operating loss of $158 million and a net loss of $140 million. Both were driven by the impact of the Loss Portfolio Transfer transaction with National Indemnity Company.

Excluding the Loss Portfolio Transfer transaction impact, net operating income was $186 million and operating return on equity of just under 7%. On a year-to-date basis, our operating return on equity is approximately 8%, again excluding the impact of the NICO transaction.

Our Property & Casualty business contribution to operating earnings remained at a steady, respectable level given the weak economy, competitive insurance market and low interest rate investment environment.

Net operating income from our P&C operations was $252 million this quarter and $769 million year-to-date. Net income was $225 million in the third quarter, reflecting another quarter of modest realized investment gains and a relatively low level of impairment losses.

Our balance sheet and financial flexibility continue to improve. Book value per common share increased 6% from the end of the second quarter to $42.76, driven by further improvement in the market value of our investment portfolio.

Our investment portfolio's pre-tax net unrealized gain was approximately $2.3 billion at September 30, 2010, reflecting a market value improvement of $1.2 billion during the third quarter. This portfolio valuation improvement was driven by lower risk-free rates and continued credit spread tightening.

We all recognize that this interest rate environment will inevitably change, and that we are unlikely to harvest a meaningful amount of these unrealized gains given current reinvestment prospects.

Just as we did not get overly excited about the portfolio's unrealized loss position during 2008 and 2009, neither are we overly excited about today's unrealized gain position. I would point you to our book value per share, excluding AOCI, which is largely made up of our net unrealized gains.

Our common shareholders' equity excluding other comprehensive income at quarter end was $10.3 billion or $38.38 per share. This number represents an increase of 6% year-over-year, and this is the number that we anchor on in all our capital planning discussions. Of course, we're also very attentive to our regulatory capital. Our statutory surplus at quarter end was $9.6 billion, an increase of 7% year-over-year.

We were pleased to close the Loss Portfolio Transfer transaction with National Indemnity during the third quarter, which we discussed with you in our second quarter call.

As we said during that call, we believe that this transaction marked a significant milestone for CNA and our ongoing efforts to enhance our earnings consistency and financial stability and that it also truly differentiated CNA from most of our competitors.

We successfully completed a $500 million debt offering in August at attractive terms and used the proceeds to redeem $500 million of outstanding 2008 senior preferred stock held by Loews. These transactions enhance our annualized earnings available to common shareholders by approximately $30 million.

Last week, we filed for approval with the State of Illinois for Continental Casualty Company, our primary operating company, to pay down $500 million of the $1 billion surplus note purchased by CNA Financial from Continental Casualty in 2008.

We intend to use the proceeds of the surplus note repayment to redeem the remaining $500 million of preferred stock still held by Loews. We would hope to complete this transaction by the end of 2010.

After this anticipated final repayment of the senior preferred stock, which files a series of refinancings and repayments over the last year, we will have added $90 million of annualized earnings to CNA's income available to common shareholders.

In addition, during the third quarter we repaid a final $100 million that have been drawn down under our bank credit facility. This $250 million credit facility is now fully replenished and is available to us for any potential future need.

As you heard from Tom, our net operating income this quarter was helped by $95 million of pretax favorable prior year reserve development in our core Property & Casualty operations, which lowered our calendar year loss ratio by over 6 points. This was our 15 consecutive quarter of favorable prior year reserve development.

We recognized favorable development in our European book driven by first party property lines in accident year 2009.

We also recognized continued favorable development in our professional liability and surety line, both from accident years 2007 and prior. The reserve releases were driven by better than expected frequency as well as settlements on large claims.

These releases were partially offset by unfavorable development in our medical technology liability and employment practices liability coverage's in accident years 2008 and 2009. All of these reserving decisions were based on the analysis completed in the third quarter.

Net operating incomes in the third quarter included pretax and net investment income of $581 million, a decrease 12% from the prior year period. The unfavorable year-over-year comparison was driven by the exceptional returns from limited partnership investments during the third quarter of 2009. Investment income other than from limited partnerships was flat at $513 million pretax.

Our LP investments produced third quarter pretax income of $68 million as compared to $145 million of income during the third quarter of 2009. Our LP investments are performing well and continue to produce higher cumulative returns with less volatility and equities.

Third quarter and year-to-date rates of returns for our LPs were 3.2% and 7.1% respectively. These returns compared to 11.3% and 3.9% for the S&P 500 Total Return Index for the same periods.

Third quarter results included after-tax realized gains of $40 million. Those results include $29 million of after-tax impairment losses. Almost all of the impairment losses reflect intent to sell decisions that are part of our ongoing portfolio management.

We made very few changes to our investment portfolio of asset allocation during the quarter. We continued to be a buyer of investment grade corporate and taxable municipal securities. During the quarter, we purchased approximately $1.1 billion in these asset classes.

Our cash and short-term positions stood at $2.2 billion at quarter end as compared to $3.1 billion at the end of the second quarter of 2010. This change reflects the approximate $2 billion premium paid to NICO in a Loss Portfolio Transfer transaction and our continued healthy operating and investment cash flow.

Overall, our investment decisions continue to reflect our sustained emphasis on diversification, quality and liquidity as well as the importance of ensuring that our portfolio is aligned with our business objectives. The average credit quality of the fixed maturity portfolio remain A, unchanged from the prior quarter.

We continue to segment our portfolio to facilitate our asset liability management discipline. The assets to support our long duration life-like liabilities had an effective duration of 11.2 years at quarter end, very similar to the second quarter, and in line with portfolio targets.

The effective duration of the assets, which support our traditional P&C liabilities was extended to 4.6 years at quarter's end, up from 4.2 years at the end of 2010 second quarter. This lengthening was driven by the NICO transaction premium payment, and resulting reduction in our short-term position.

While this is above our portfolio target and estimated liability durations, we have chosen not to immediately rebalance this segment of the portfolio given the operating earnings impact. You should expect to see us shorten this portfolio duration gradually over the next year to year and a half towards its longer-term target.

As I said earlier, our capital position and balance sheet remained very strong. We continue to maintain a very conservative capital structure and to exhibit a strong liquidity profile.

The negative operating cash flow in the third quarter reflects the use of cash for the premium paid for the Loss Portfolio Transfer. On a normalized basis, net cash generated by our business operations was approximately $300 million this quarter. This number also excludes the effects of trading portfolio activity and a large tax refund.

Additionally, during the quarter, we received nearly $900 million of principal cash repayments through pay downs, bond calls, and maturities.

All of our capital adequacy metrics remained well above our target levels, even after taking into account the Loss Portfolio Transfer and the anticipated pay-down of the surplus note and preferred stock redemption. We have more than $900 million of dividend capacity in our primary insurance subsidiary.

Our financial flexibility is further enhanced by approximately $224 million of cash and short-term investments, held at the holding company level, which remains at two times our net corporate obligation. As previously mentioned, the full $250 million of our credit facility is also available to us.

Our Life & Group Non-Core segment produced a third quarter net operating loss of $55 million, compared with net operating income of $51 million in 2009. The period-over-period comparison was affected by a $61 million after-tax gain in 2009 arising from a litigation settlement. The 2010 results include a $39 million increase to payout annuity benefit reserves.

The Corporate segment produced a third quarter net operating loss of $355 million in 2010, as compared to net operating income of $9 million in 2009. The change was driven by the after-tax net loss from the Lost Portfolio Transfer.

Before turning it back to Tom, I would like to provide some additional information about our proposal to acquire the public minority of CNA Surety. We view this deal as the natural next step for CNA and one that offers compelling benefits for the shareholders of both companies.

Our proposal of $22 per share provides CNA Surety's minority shareholders the opportunity to monetize their investment at a substantial premium to the current and historical stock price. Our proposal represents a 14% premium to CNA Surety's last closing price and a 13% premium to its recent 52-week high.

Our proposal also represents a 24% premium over Surety's closing stock price one month ago and a 31% premium over its closing stock price three months ago. $22 per share is 1.17 times multiple to CNA Surety September 30th, tangible book value per share excluding net unrealized gains.

Moving forward with the proposed transaction at this time recognizing that CNA Surety hit a new 52 week high last week, because we believe this is the right strategic move for both CNA and CNA Surety.

CNA has the balance sheet strength and financial flexibility to do this deal and repay the final $500 million of loads preferred stock all with internally available funds. The proposed allows us to invest in a business that we know well and at our $22 proposed price is expected to be modestly accretive to earnings that have only a slight impact on our capital position.

We believe that CNA Surety will be better positioned to deliver a consistent underwriting profitability and compete with a large diversified commercial alliance companies it faces in the surety market, over the long term as a wholly owned subsidiary of CNA.

Assuming this transaction is completed we expect that CNA Surety will continue to run its business in a manner that is generally consistent with its current operations. Continuity is very important to us, and we all work hard to make sure this proposal does not interrupt the business operations of CNA Surety.

We intend to pursue the proposed transaction and seek to negotiate an agreement with the special committee of CNA Surety's Board of Directors. We have just initiated this transaction and we will not be able to share any information beyond what Tom and I have already outlined on this call.

Overall, we have had an active quarter and year. We are confident that the actions we've taken will help to make CNA a better company over the long term and remain excited about our future prospects.

With that I will turn it back to Tom.

Tom Motamed

Thanks Craig. All-in-all, the third quarter was marked by respectable operating results and further improvement in our capital position. The highlights were

Before the Loss Portfolio Transfer transaction, net operating income was $186 million or $0.62 per share and net income was $225 million or $0.77 per share, a combined ratio of 97.9% in our core Property & Casualty operations, positive growth in Specialty and improving growth in Commercial.

Solid investment results with $581 million of pretax net investment income and approximately $1.2 billion improvement in our unrealized position. Improvement in our capital position reflecting a 19% increase in book value per common share to $42.76 from year end 2009.

Completion of the Loss Portfolio Transfer transaction that substantially eliminated our exposure to legacy asbestos and pollution risk. A $500 million debt issuance and redemption of senior preferred stock that enhances our annualized earnings by approximately $30 million.

We intend to redeem the balance of the preferred stock in the fourth quarter. In addition to these third quarter highlights, we announce today a proposal to acquire the public minority of CNA Surety.

Before we take your questions, I'd like to say a few words about the market and our strategy going forward. We continue to believe that the competitive environment will persist into 2011. At the same time, we believe that growth rate and exposure and retention will stabilize and that calendar year loss ratios for the industry will deteriorate due to less favorable releases from older accident years. For us, at CNA, we will continue to focus on improving our commercial results, protecting our margins in Specialty, and focusing on opportunistic growth.

With that, we will take your questions.

Question and Answer

Operator

Thank you. (Operator instructions) We'll take our first question from Jay Cohen with Bank of America-Merrill Lynch.

Jay Cohen
Bank of America-Merrill Lynch

Thank you. A couple of questions. First is I noticed that the statutory surplus was down in the quarter. I assume there was some sort of dividend to the holding company. Can you clarify that?

Craig Mense

That was the impact of the loss portfolio transaction, Jay, and the loss from those transactions.

Jay Cohen
Bank of America-Merrill Lynch

Okay I see. That comes at a surplus. Okay. Second thing, looking specifically at the P&C portfolio came down and as you alluded to, that also was due to the LPT deal, would you still characterize your cash and short-term position as sizeable, above average or is it more normal now?

Craig Mense

That's about 5% of the portfolio. I don't know would I say normal, but that's still pretty sizeable.

Richard Scott

Hi, guys. This is Richard Scott I would note that given our desire to bring our P&C portfolio duration in the line with our longer term goals, I personally believe that a barbell approach to hitting that duration target makes a lot of sense given the steepness in the curve today.

Jay Cohen
Bank of America-Merrill Lynch

So, that cash position is unlikely to change too much in the near term?

Craig Mense

That's correct, Jay

Jay Cohen
Bank of America-Merrill Lynch

Last question. Could you talk about the DAC related charge in the run of, this is exactly what gave rise to that?

Craig Mense

Well, it's really more driven by poor mortality, and this really was a book of business that was written out of our Bermuda subsidiary, relatively small, but just looking at mortality, and looking at what we thought is a more reasonable expectation mortality for the book, we unlocked those reserves and increased them, also driven by interest rate environment going forward.

Jay Cohen
Bank of America-Merrill Lynch

Okay. That's helpful. Thank you.

Operator

Our next question comes from Bob Glasspiegel with Langen McAlenney.

Bob Glasspiegel
Langen McAlenney

Good morning, everyone. Expense ratio showed an improvement over several quarter trends. Is anything driving there or were there some one time is in there?

Craig Mense

The only thing really driving it over the quarter, when you're looking at last year was, as Tom said in the call, we had a…

Bob Glasspiegel
Langen McAlenney

That's again sequentially. I'm sorry.

Craig Mense

Well, sequentially, our spending is pretty flat, sequentially, if you look at it, and we have had some stabilizing of the earned premium, and we have also had some though we had really help on those top line and controlling on the expenses on the bottom, and you're starting to see the impact some of the other actions we've taken to reduce and realign expenses from staff areas.

Bob Glasspiegel
Langen McAlenney

Help me a little bit with interest, you gave sort of savings year-over-year with the preferred coming down under 10%, I can figure out what's going away. Give me a little help on interest expense in 2011 pro-forma versus 2010?

Craig Mense

Well, I think you know what we've done relative to refinancings, right, in the third quarter that coupon was 5875, I think you can see in the other expenses in the corporate sector about what our interest expense is on a quarterly basis which is a little over $40 million a quarter.

Bob Glasspiegel
Langen McAlenney

How much of 5875, what was the size of that one?

Craig Mense

500.

Bob Glasspiegel
Langen McAlenney

In the surplus transaction, is there any interest computed into that or how is that worth?

Craig Mense

Obviously, there is an opportunity cost of that $500 million is on investment, so what we'd use is about 2.5% after-tax.

Bob Glasspiegel
Langen McAlenney

Okay. Unfortunately, I've got enough experience to remember your recent unsuccessful bid on CNA Surety before March 2010. Can you remind me what the relationship to book that rejected offer was?

Craig Mense

I don't recall exactly what that was, Bob. As I said, given we've just initiated transaction, we're really not in a place to take questions about it.

Bob Glasspiegel
Langen McAlenney

Okay. I thought that was a historical number but I can understand your…

Craig Mense

I'm sure we can find it for you later and help you if you call back but…

Bob Glasspiegel
Langen McAlenney

Okay, appreciate it. Thank you very much.

Craig Mense

You're welcome.

Operator

(Operator instructions) Next we'll hear from Amit Kumar with Macquarie.

Amit Kumar
Macquarie

Thanks and good morning. I guess just going back to the charge in the Life and the Non-Core book just so that I understand this clearly I thought this was an increase in the reserves it was not a DAC unlocking I mean this was a charge on the liability side. Can you just sort of walk us through those numbers one more time and if it's just an increase in the future policy benefits?

Craig Mense

Yes.

Amit Kumar
Macquarie

So there was no adjustment on DAC right?

Craig Mense

No, its reserves, loss reveres.

Amit Kumar
Macquarie

Yes. That's what I thought. Maybe just staying on that topic, can you just tell us you sort of broadly touch that it was a change in interest rate and change in mortality rates maybe just expand on that a bit more i.e. what is sort the sensitivity analysis you have done. I thought what a scenario like if rates change 100 basis points than what happens going forward?

Craig Mense

We're going to have to maybe do a little bit of work on that as we sit here and think about it but we looked at lower yield rates going forward. This is a relatively small book of business. This is a $200 million of reserves, so it's not going to be all that sensitive to changes.

Amit Kumar
Macquarie

Maybe I can follow up offline on this just moving on in terms of the CNA Surety deal, have you had any discussions with the ratings agencies on the deal as well as the pay down of the remainder of the preferreds?

Craig Mense

No, we've not had discussions with the rating agencies about the deal. I don't think they would be surprised about our decisions around the preferred.

Amit Kumar
Macquarie

In your opening comments you talked about the returned premiums, rates are still flat. Previously I think in Q2 rates were up 2%, they were up 1% in Q1 2010. And in the Commercial segment, I'm listening to your commentary and then I'm sort of comparing it with another specialty player. They recently said that in fact for them the trends had reversed, and in fact audit premiums had become positive. I'm sort of trying to reconcile the differences here, what exactly are you seeing what they might not be seeing?

Tom Motamed

Well, first of all for us, when we speak of the returned premiums, audit premiums, we are speaking about commercial lines; we're not talking about our specialty business, all right. So, I don't know who you are referring to, but when we talk about it, we're talking about it for our commercial lines business. If we look at exposure in the quarter, it was off about seven-tenths of a point, and the returned premiums were in the area of two points, maybe a little bit slightly higher, so that's the composition of that number. But we are seeing exposure getting a little bit better, and we continue to see RPs.

We believe, we will continue to see RPs, because the way this works is you have to look at the particular policy year, the policy year has to end, you then go out and do the audit, you reconcile the numbers and then you return the premium. So, depending on the particular policy year, we would believe we have two or three more quarters of potential RPs out there.

Amit Kumar
Macquarie

In terms of your comments on growth in the community banks, I am just curious, what's the thought process behind that growth? All of us have recently seen news reports about FDIC going after these smaller banks to recover $1 billion. Maybe just give some more color as to what the thought process behind that growth in community banks is?

Tom Motamed

Number one, we like this segment. We think it's a good segment over time. We appear to be doing pretty well in it. I would tell you relative to your question on the claim front, we do not currently appear to have any material exposure associated with the defective documentation of these real estate transactions. We haven't received any notifications. So for us at this point it's benign at best. So we continue to underwrite these exposures closely, but we like community banks and we think it's a good place to be over time.

Amit Kumar
Macquarie

This is a final question. In terms of your limited partnerships, can you remind very quickly what those buckets were, I think half of that was in one month lag and there was a meaningful hedge fund component. Can you just quickly remind us what those buckets in the limited partnerships are?

Tom Motamed

Ask that one more time?

Amit Kumar
Macquarie

The segments, hedge funds, you have public fixed income, equity markets into limited partnerships. I'm just trying to recall how much of it is reported on a lag basis and what is current?

Craig Mense

87% is on one month for current basis, so 13% is lagged. And about 8% is of the total private equity and there is very little real estate in there.

Amit Kumar
Macquarie

Okay. That's very helpful. Those were all my questions. Thanks.

Craig Mense

You're welcome.

Operator

And next we'll hear from Michael Bunyaner [ph] with TLF Capital [ph].

Michael Bunyaner
TLF Capital

Yes, good morning.

Tom Motamed

Good morning.

Michael Bunyaner
TLF Capital

One question to you Tom, last quarter, you shared your thoughts about the cycle and fact that we are in our seventh year in that we should the terms and conditions were changing and therefore we should see at some point a change especially as the losses were to develop. Can you share a little bit more with us as you think about over the next two, three years as to what needs to happen for the pricing to begin to improve?

Tom Motamed

Yes. I think that couple of things. First of all, I'm not going to give you an exact date and time when the market will turn, but clearly I think what we believe is that if you look at current accident year results for us and our competitors were all over 100 for the current accident year.

If you look at the calendar year results everybody is still releasing from older accident years and the ultimate effect is calendar year numbers are pretty good. I think what we're seeing is exposure declines are improving which suggest to me that from an economic perspective, the economy is bottoming out. So as we look at 2011 and I can't really say much beyond that I think 2011 is kind of flat.

The real issue becomes how much companies had from the reserve redundancy perspective that they can release and as the calendar year numbers inch up and accident year numbers are over a 100, you're going to get some firming of the market.

A lot of people refer to the fact that it's a low investment environment, but I don't think until you get the economy to improve that people are going to be willing to pay you more price for the product, there is still a lot of competition out there, whether it'd be in specialty or commercial, and I think what you have to do is see companies really start to show declines in underwriting income, and when that happens then you might see some hardening, but I don't think it'll take off like a rocket ship.

Michael Bunyaner
TLF Capital

In terms of the excess capital, it sounded like at the insurance company level, you had about $900 million and that the holding company had over $200 million. As you think about the cycle improvement, how much of that do you actually need to retain or think of as needed versus excess capital for the total business?

Craig Mense

First, let's say we didn't characterize it as excess. That was just $900 million of dividend capacity available to us to upstream the holding company from the operating company if we chose to. There was another $224 million of cash at holding company. So, we didn't give you and we haven't discussed before what we calculated our excess capital position.

All we've said and which we say again is that, all the capital metrics that we look at whether it's that surplus, GAAP capital, our own economic capital, the rating agency metrics are all well above the current rating at the levels anticipating all these transactions we've taken.

Michael Bunyaner
TLF Capital

I guess what I'm trying to ask is, especially in light of the transaction with Berkshire Hathaway, you are clearly in a terrific position. And what are you thinking of in terms of what's required in terms of your mind to write the new business when the cycle improves versus what you may or may not need in terms of the capital, as we go over the next three years or five years I guess?

Craig Mense

I think what we said the last second quarter call was the Berkshire transaction freed up $500 million. And you can see we have acted on repaying that $500 million, and we haven't commented or disclosed any amount beyond that that we intend to reduce the capital. So I understand what you're asking, but we haven't disclosed that and I am not prepared to comment on it.

Michael Bunyaner
TLF Capital

Thank you very much. Best of luck.

Craig Mense

Thank you.

Operator

At this time we have no further questions in the queue. We will turn the conference back over to our speakers for any additional or closing remarks.

Tom Motamed

Thank you very much and have a good day.

Operator
Thank you and this does conclude our conference. We thank you all for your participation.