S&P Global
Market Intelligence

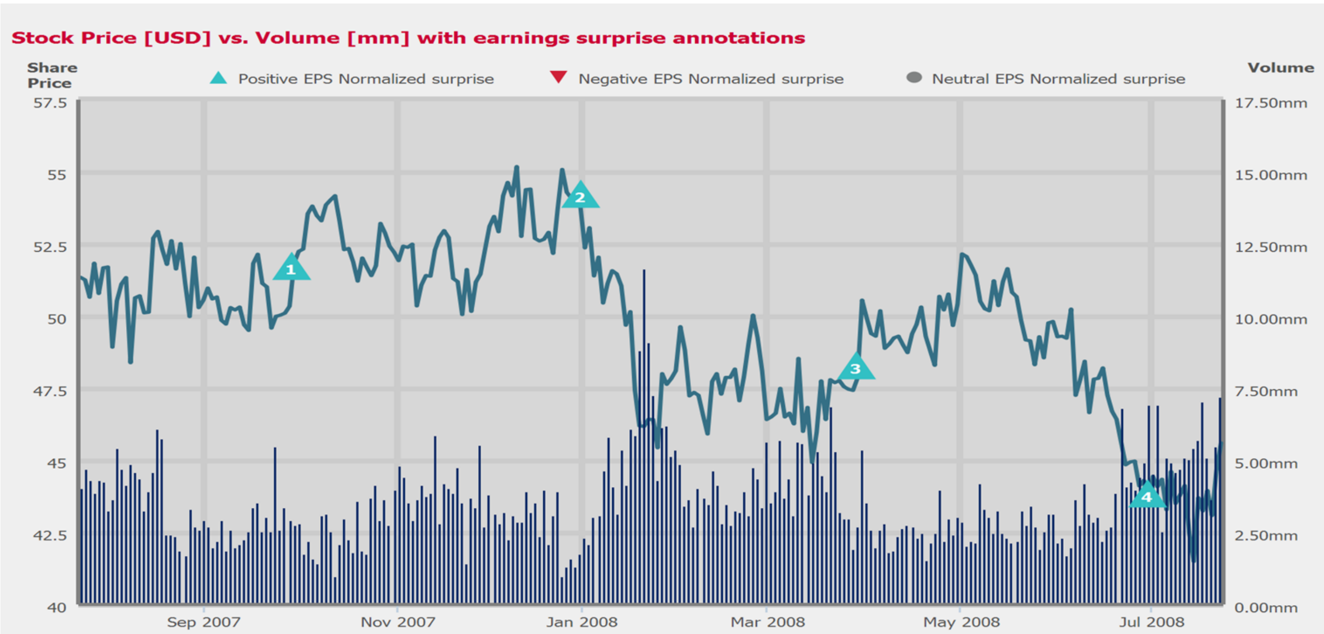
The Travelers Companies, Inc. NYSE:TRV
FQ3 2008 Earnings Call Transcripts

Wednesday, October 22, 2008 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2008-			-FQ4 2008-	-FY 2008-	-FY 2009-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.60	0.55	▲(8.33 %)	1.45	5.16	5.71
Revenue	-	-	▲1.06	-	-	-
Revenue (mm)	5390.83	5448.00	-	5378.75	21498.42	21354.08

Currency: USD
Consensus as of Oct-22-2008 1:51 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2007	1.49	1.81	▲1 21.48 %
FQ4 2007	1.60	1.63	▲2 1.88 %
FQ1 2008	1.54	1.61	▲3 4.55 %
FQ2 2008	1.45	1.50	▲4 3.45 %

Table of Contents

Call Participants

EXECUTIVES

Alan Schnitzer

Bill Heyman

Brian MacLean

Gabriella Nawi

Jay Benet

Jay Fishman

Joe Lacher

ANALYSTS

Alain Karaoglan Bank of America

Brian Meredith UBS

Ian Gutterman Adage Capital

Jay Cohen Merrill Lynch

Jay Gelb Barclays Capital

Josh Shanker Citi

Paul Newsome Sandler O'Neill & Partners

Terry Shu Pioneer Investments

Vinay Misquith Credit Suisse

Presentation

Operator

Welcome to the third quarter earnings review for Travelers. (Operator Instructions) At this time, I would like to turn the call over to Miss Gabriella Nawi, Senior Vice President of Investor Relations.

Gabriella Nawi

Welcome to the Travelers discussion of the third quarter 2008 results. Hopefully all of you have seen our press release, financial supplement, and webcast presentation earlier this morning. All of these materials can be found on our website at www.travelers.com under the Investor section.

With me today is Jay Fishman, Chairman and CEO; Jay Benet, Chief Financial Officer; Brian MacLean, President and Chief Operating Officer; Joe Lacher, head of our Personal and Select Businesses; as well as other members of senior management. They will discuss the financial results of our business and the current market environment. They will refer to the webcast presentation as they go through the prepared remarks and then we will open it for questions.

Before I turn it over to Jay, I would like to draw your attention to the following on page one of the webcast. Our presentation today includes certain forwardlooking information as defined in the Private Securities Litigation Reform Act of 1995. All statements other than statements of historical facts may be forwardlooking statements. Specifically, our earnings guidance are forwardlooking, and we may make other forwardlooking statements about company results of operations, financial condition and liquidity, the sufficiency of the company's reserves, and other topics.

The company cautions investors that any forwardlooking statement involves risks and uncertainties and is not a guarantee of future performance. Actual results may differ materially from our current expectations due a variety of factors. These factors are described in our earnings press release and in our most recent 10Q and 10K filed with the SEC. We do not undertake any obligation to update forwardlooking statements.

Also, in our remarks or responses to questions, we may mention Travelers operating income, which we use as a measure of profit and other measures that may be nonGAAP financial measures. Reconciliations are included our recent earnings press release, financial supplement, and other materials that are available in the investor section on our website, travelers.com. With that, I will turn it over to Jay.

Jay Fishman

Before we get into the specific results, let me start this morning with something of a view from 40,000 feet. The last several months have been unprecedented in financial market dislocation and its impact on the financial services community broadly. We have seen upheaval at Fannie Mae, Freddie Mac, Lehman Brothers, Bear Stearns, and AIG. We have seen governments all around the world step up and commit trillions of dollars to financial institutions that previously appeared to be pillars of strength.

Given all of this turmoil, the speed with which it has happened, and the number of pitfalls challenging the financial services industry over these months, we couldn't be more pleased with the way Travelers has managed through this dislocation. The success that we have had has little to do with anything that we have done these last several months, but rather result from the philosophy and culture that has existed here for a long time.

We are first and foremost an insurance underwriting organization, and the skills to do that successfully are at the highest level here. Our investment function as best articulated by Bill Heyman, our Chief Investment Officer himself, is in business to support our insurance underwriting operations and to do so with an extraordinarily balanced view of risk and return.

That philosophy has kept our investment decisions straightforward and simple and viewed towards providing consistent and appropriate risk-adjusted returns over time rather than responding to the investment idea of the day. Simply put, we focused on providing quality products and service to our agents and customers and building a longterm value of our franchise. We couldn't be more proud of what we have accomplished and the fact that we have come through this as a strong, resilient, wellcapitalized company.

The results for this year speak for themselves. For the 9month period, we posted net income of $2.1 billion and a return on equity of 10.9%. All of our financial strength indicators are at or better than target levels, including our holding company liquidity, now just in excess of $2 billion, which is approximately twice our target level.

For the quarter, we posted operating income of $330 million after tax, or $0.55 per share. As we previously reported, the third quarter was meaningfully impacted by $682 million after tax of storm losses from Hurricanes Ike, Gustav, and Dolly. However, the losses from these storms were consistent overall with our risk models and pricing assumptions. Given our size, storm losses such as these will occur from time to time.

While difficult financial market conditions impacted our net investment income to some extent for the quarter, and Jay will speak about that in a bit, our insurance underwriting operations continue to be pretty much consistent with what we saw in the second quarter; and it's very much steady as it goes.

Retentions remain high across virtually all of our businesses, and the loss cost and rate changes generally continued in pattern with the second quarter.

The story, however, is less about the results of the third quarter than the positioning of this organization. Our underwriting discipline, both with respect to investing and insurance was clearly evident this quarter. Our net realized investment losses of $133 million after tax were quite modest when compared with our overall investment portfolio, and the change in our unrealized losses was driven largely by general changes in spreads rather than issue or issuerspecific deterioration. As evidence of our underwriting strength, excluding the impacts of catastrophes and net favorable prior year reserve development, our combined ratio was 91.8%.

As a result of specific initiatives, we continue to see a significant flow of new business opportunities. We're fortunate to have ample liquidity, capital, and the ability to respond to the market. We are, of course, in the property casualty business with all the risks and opportunities that entails. But all things considered, even with 20/20 hindsight, there isn't much we would have done differently. As a consequence, we're as well positioned as we could be. We remain committed to producing shareholder value by seeking to achieve mid-teens return on equity over time. Since January 1, 2005, our cumulative operating return on equity now stands at approximately 15%. We are going to keep our comments very brief today, especially since there really hasn't been much change in the insurance environment broadly. We'll leave ample time to answer any questions you have. With that, let me turn it over to Jay.

Jay Benet

Thanks, Jack. Let me begin by reiterating that our investment portfolio and our balance sheet continue to be in terrific shape, despite the turmoil that's been taking place in the financial market. Page 4 of the webcast shows that we ended the quarter with almost $25.5 billion of common equity excluding FAS 115 and book value per share excluding FAS 115 of $43.34, up 5% yeartodate even after $2 billion of share repurchases and $535 million of stock dividends.

Our operating company capital remains at or above all of our target levels, and we continue to generate significant amount of excess capital and liquidity. Our debttototal capital ratio is 19.9% at the end of the quarter, compared to our 20% target, which is the midpoint of a 15% to 25% range that the derived from our doubleA ratings target.

Holding company liquidity was $2.1 billion or almost twice our target of one year’s worth of interest and dividends. We expect to be able to use internal funds to retire all debts scheduled to mature during the next three years. We're not relying on the commercial paper market and participate at a very modest level, generally $100 million or below only when rates are attractive.

Page 5 of the webcast shows that composition of our investment portfolio at different points in time, along with certain of its characteristics. Composition of the portfolio has been very stable in the periods shown. Total fixed income comprising 94% and nonfixed income 6% of the total portfolio. Its quality has been maintained at doubleA plus. Its duration has been very steady, and the below investment grade portion of the fixed income portfolio is actually decreased to only 2.4%. It remains a very well diversified portfolio across industries, investment types, and individual issuers.

Having said this, our portfolio is not immune from recent market changes. In this quarter, we did experience net realized losses of $116 million after tax, mostly related to impairments of Lehman and a small number of other fixed income holdings. The unrealized loss on that portion of our investment portfolio, for which estimated market value is less than 80% of amortized costs, now stands at $270 million, up from $52 million at the end of the second quarter and mostly in this position for 30 days or less. Still a small fraction of both total investments and shareholders' equity.

We've always maintained the very rigorous process for identifying investments for which writedowns should be considered and take such actions when appropriate.

At the end of the current quarter, we had pretax unrealized investment losses of $1.3 billion compared to a net unrealized gain of $86 million at the end of the second quarter. This change in unrealized, which will not reflect in net income, is reflected in shareholders' equity pursuant to FAS 115. This is primarily the result of credit spreads widening broadly during the quarter and, to a lesser extent, other unrealized losses widely distributed among issuers and not generally reflective of significant issuance or specific credit problem. I would also like to point out that no single corporate issuer accounted for more than $40 million of the net unrealized loss at the end of the quarter.

We've updated page 6 of the webcast to include additional areas of concern that have emerged this quarter in the financial market and their impact or lack thereof to Travelers. We dramatically curtailed our securities lending program during the quarter, based on current market conditions to where we only have $15 million outstanding. We experienced no losses in this program during the quarter and we do not expect any. Also, we are not a party to any credit default swaps.

As the slide indicates, we also remain unaffected by the other areas of market disruption discussed in prior quarters.

As the data of page 7 indicates, both CATs and net favorable prior year reserve developments played a meaningful role in our results this quarter. CAT losses of $682 million net of reinsurance and after tax which mostly related to Hurricanes Ike, Gustav, and Dolly, added 19.1 points to our GAAP combined ratios this quarter. A net favorable prior year reserve development of $210 million after tax resulting from betterthanexpected loss experience in each of our business segments reduced our GAAP combined ratio by 6.2 points.

On a yeartodate basis, our GAAP combined ratio, even including the large CAT losses we have experienced during the year, was a very healthy 94%. Ex CATs, net favorable prior year reserve developments and last year's timing impact of the change to the fixed valuebased agent compensation program, our GAAP combined ratio was 92.5%, an increase of 2.4 points from the prior year period. We remain very pleased with the underlying profitability of our business.

Page 8 of the webcast shows components of operating return on equity. Fixed income, net investment income, less interest expense remained the major driver of yeartodate operating ROA. This passage of time component produced an 8.7% return in the current period, down slightly from the prior two years due to lower shortterm interest rates. A much smaller contributor to operating ROE, both historically and yeartodate, is nonfixed income investment income, which produced a very small positive return yeartodate, down from prior periods as expected and due to current market conditions.

Underwriting income provided a return of 3% yeartodate, down from recent periods, due to the very high weatherrelated losses which offset underlying underwriting margins that were very healthy and high levels of net favorable prior year reserve development. Cumulatively from January 2005, we have produced a 15% annual operating ROE, consistent with our stated longerterm goal of mid-teens ROA.

Net investment income for the third quarter, as shown on page 9, was $587 million after tax or $137 million lower than the prior year quarter. Longterm fixed income related NII of $592 million was unchanged while the shortterm component of fixed income NII was down $27 million due to the lower shortterm interest rates. The major variance between the two periods was the low level of nonfixed income related NII due to lower real estate hedge funds and private equity partnership returns in the current economic environment.

Finally, our after tax yield was 3.2% for the quarter. With that, let me turn the mike over to Brian and Joe for discussion of the underlying fundamentals of our businesses.

Brian MacLean

Before Joe and I get into the business results, let me take a few minutes to give some broad background. The highlight is that our results, especially as they relate to the top line, remain stable. I know that sounds out of pattern with the mood around broader economic trends, but our fundamentals are the same ones we have been describing for the last several years. That is, we are retaining our customers at historically high levels and at close to expiring price and are seeing a healthy flow of new business. This stability is partially a function of the market in which we compete, but also we believe a function of who we are. That is, a company with solid financial performance whose people are not distracted by franchise changing events, but instead are focused on consistently executing on our strategy in their market place. Given this dynamic, Joe and I will spend a little less time than usual on the actual numbers and leave more time for Q and A.

Looking at the details on slide 10, you can see that the retentions remain high across all our commercial business. The only exception is our international operations, where retention was down from last year due to competitive market conditions impacting our Lloyd’s business and the intentional nonrenewal of certain property business in Canada.

The renewal price change data reflects both rate and exposure changes. Underlying rate changes were consistent with and, in some cases, modestly improved from last quarter. In the aggregate exposure change, which fundamentally measures our account insurable interests, was also consistent.

We are seeing in a few of our businesses signs of a contracting of economic environment. For example, in owneroperated commercial trucking, we've seen an increase in business failures. In our construction book, although account retentions and new business opportunities have been strong, payrolls are declining. So, overall, a very stable renewal book of business.

Slide 11 shows that our new business dollars are essentially flat last quarter. As we have talked about in previous quarters, the overall flow of new business opportunities has been up in nearly all our businesses and that trend continues this quarter. For example, flow to our small commercial platforms increased 78% over 2006, while several of our middle market businesses have seen a 50% increase in submissions over the last two years.

Some of the middle market increase in this quarter is attributable to volatility among certain carriers, but most is consistent with the positive trends that we've been seeing over the last several years. Our new product offerings, platform enhancements, and strong positioning with agents and customers are driving these opportunities. This level of deal flow is a clear competitive advantage for the company.

As we have previously discussed, pricing on new business continues to gradually deteriorate. As a result, our hit ratio, or the percentage of these quotes that we're writing, has declined. This demonstrates that in light of the pricing deterioration, we have maintained our underwriting discipline focusing on insuring new business that meets our criteria. These dynamics, that is, significantly increased deal flow with a lower hit ratio, resulted in a slight increase in net written premiums and business insurance segment and you can see the details on slide 12.

Slide 13 shows operating income and combined ratios for business insurance. The adjusted combined ratio was 92.7 for the quarter, 2.3 points worse than the third quarter last year, but still at a very healthy level. The margin compression is due to the modest decline in pricing and modest increase in loss trends that we had expected.

The atypical property loss activity, which we had seen in the first two quarters, returned to normal levels this quarter.

On the expense side, after considering the [wind pool] assessments from Hurricane Ike and the timing impact of the agent compensation, our expense ratio is consistent with previous quarters. Overall, we continue to have very solid margins.

Turning to financial, professional, and international insurance on slide 14, premiums were down slightly, minus 2% from last year's quarter. The adjusted combined ratio was a solid 93.8%, but has deteriorated 4.2 points from the same quarter last year. This variance is primarily attributable to a small number of thirdquarter large losses that exceeded expectations in Lloyd's as well as developments on large losses that occurred in the first half of the year.

Although the large loss experience continues to run ahead of normal levels, the activity did mitigate in the third quarter. Additionally, I would note that the surety and professional liability loss ratios were on plan and none of the deterioration is from these businesses.

A brief comment on the quarter's storm activity, estimates of CAT losses are detailed in the appendix and are obviously dominated by losses from Hurricane Ike. Our losses for all these storms were consistent overall with our risk models, our market shares, and assumptions used in our pricing. For a little added context, our Hurricane Ike loss assumes a $3.5 billion event per the Texas Wind Storm Insurance Association.

In summary, we believe our commercial segment performed well and our results remained extremely solid. With that, let me turn it over to Joe Lacher for the Personal Insurance results.

Joe Lacher

As Brian mentioned, our results have exhibited a great consistency in recent quarters. We believe this comes from a focused execution on the key success drivers in our business. I would like to spend a few minutes reviewing how this played out in Personal Insurance starting on page 15.

We reported an operating loss of $64 million in the quarter, which was down $340 million when compared to last year's third quarter. Cash for the activity represents $292 million of this decrease. We also experienced a decline in net investment income of $20 million. As you can see on page 15, our expense ratio in the quarter was 35%. The increase of 7 points versus third quarter of 2007 was driven by a couple of nonrecurring things.

First, about 5.5 points relates to hurricanerelated assessments that flowed through taxes, licenses, and fees and ultimately the expense ratio. Second, just under 1 point relates to the accounting impact of our supplemental commission program.

Outside of all of these items, our results are consistent with prior quarters. You can see this from looking at the change in invested combined ratio for the quarter and yeartodate.

Turning to our production results, written premium was up 5% in the quarter, a bit above the 3% growth level seen yeartodate.

Switching to page 16, let's look at some of the more detailed production statistics. Our property business has been a machine that continues to crank out results despite difficult market conditions. With the broad slowdown in home sales and a tighter credit market, we would typically expect pressure on the property production. Against this headwind, policies in force grew 3%, new business volumes were up nearly 7% versus prior year quarter. Our retention at 86%, renewal price change of plus 6% were strong and consistent with prior quarters.

We remain pleased with the continuing growth of the Quantum Home product and its ability to increase new business volume. Quantum Home policies now represent more than 12% of our policies in force.

We're similarly pleased with our auto results. Our leading product sophistication, our deep and expanding agency relationship, and our strong business platform continue to enable or deliver robust results. New business volume was up nearly 13%, and policies in force grew 3% versus the prior year quarter. Renewal price change increased from the second quarter to plus 3%, and retention remained in line with recent quarters. Quantum Auto policies now represent more than 43% of our policies in force.

Overall, we continue to make investments in our business infrastructure and distribution capabilities to fuel our longterm profitable growth.

Turning briefly to page 17, auto loss trend results remain generally consistent with recent quarters. Excluding the impact from the broader risk profile of Quantum, our total loss trend in the quarter was essentially flat. Our frequency declined slightly, and our total severity trend increased slightly.

Overall, we remain pleased with the fundamentals of our Personal Insurance business and look forward to building on that success. With that, I will turn it back to over to Jay.

Jay Fishman

Page 18 provides updated information concerning our guidance for the full year 2008. We now expect fully diluted operating income per share will be in the range of $4.90 to $5.10, which incorporates actual yeartodate results and translates into an operating return on equity of approximately 11.5% to 12%. We're assuming the continuation of current lower shortterm interest rates and the more challenging environment we experienced in the third quarter for nonfixed income investment return.

Also, notwithstanding our financial strength and liquidity, we are planning for a reduced level of share buyback activity in the fourth quarter. It feels prudent to allow for some additional capital formation in this volatile environment. However, depending on market conditions and how our share price performs, we may change our plan. This is not to be taken as a significant shift in our capital management strategy.

Our guidance assumes fourth quarter CAT losses of $92 million pretax or $60 million after tax or $0.10 per share after tax; no further prior year reserve development, either favorable or unfavorable; no significant change in average investment assets excluding FAS 115 and after approximately the $2.1 billion of share repurchases for the full year; and a revised weighted average diluted share count of approximately $610 million after the share repurchases and employee equity awards. With that, let me turn things back to Jay.

Jay Benet

Just one clarification in my prepared comments, please. I made reference to a net realized investment loss of $133 million after tax. That, of course, is the yeartodate number. The number for the quarter is $116 million after tax. I certainly didn't mean to confuse anyone. So I am correcting that for the record. With that we can open it up and take questions.

Question and Answer

Operator

(Operator Instructions) Your first question is from Josh Shanker Citi.

Josh Shanker Citi

Back before the merger of Travelers and St. Paul, St. Paul had a reputation for writing some larger commercial business. I am wondering, given what's going on in the marketplace, whether the new Travelers has this capability in this way and you're looking at what could be a market opportunity, what that means for you.

Jay Fishman

First, I will make an observation. That may have been a reputation; I have not heard it before. It's not a correct one. St. Paul was a middle market and small commercial underwriter with a focus more on specialty businesses than general commercial. But it was not a large account casualty and, frankly, when I got there, I am not even insure it had a national account property business. That was not the case.

As it relates to the company today, our sweet spot remains middle market accounts and small commercial accounts in the commercial arena. We are not a large account casualty writer, broadly speaking that is. The reason for that is that we find it difficult to understand how we can achieve a portfolio outcome when you are dealing with large account casualty business. Risks tend to exist on an individual main basis and we struggle to get to a portfolio with that. We do write large account property business.

We're a significant writer of large account property business. Of course, we do a fair amount of servicing. A large amount of servicing for workers comp exposure to some of the largest, obviously, U.S.based accounts, workers comp being a U.S. phenomenon. I don't think that we would change our culture and our DNA to embrace a line of business that we have struggled with.

We don't dispute that other people have been successful at it and we certainly don't dispute that other people seem to have figured out a way to manage that business over a long period of time, but it's really eluded us. It's eluded us for a long period of time. So, we don't have a great focus of expanding our business orientation into the large account casualty world, particularly any more aggressively than we currently do. Brian, do you want to add anything?

Brian MacLean

I will admit, I am also a little concerned when we broad brush where we are in the market. So we do stuff for large accounts, but as Jay said, it's property, it's heavily focused on the casualty side. On servicing, we take some risks. In the aggregate, we are much more of a modest player there. Our sweet spot is clearly middle market business and small commercial.

Broadly, to your question, I think there's going to be a lot of opportunity in the marketplace we go forward. Many of which will be in markets and in products that we are very comfortable with and are anxious to look at and to look to expand. We are not fundamentally looking to change who we are and venture out into things that are on the outer limits of what we excel at.

Josh Shanker Citi

I appreciate that. The second question, which might be for Jay Benet, might be quick to answer. Any interest in expanding your willingness to take risk on the left side of the balance sheet?

Jay Benet

I will turn it over to Bill Heyman in one second. I think the answer broadly is that, as I mentioned in my comments, we are a risk and return oriented organization. To the extent that returns move to a level that make taking additional risks more appropriate, we are certainly openminded to doing so. But it will always be done in the simple and straightforward way that we have so far.

Bill Heyman

I think notwithstanding all that has occurred in the market, as we look out across the opportunities we see each day, we find the market to be pretty efficient. There are not a lot of free lunches being offered. Obviously if we see one, we take it. While corporate strength has widened, treasury rates, if anything, have stayed historically low. Absolutely fixed income securities are, by historical standards, not very attractive. We look at a number of asset classes where we have only toeholds and would like to get bigger. They, too, have been priced pretty efficiently. The other small bank loan portfolio and the bank loan market has been decimated. A lot of the loans are credit one wouldn't want, even at these prices. We are doing pretty much every day what we have done every day for the last five years. See what comes across the transom that meet some absolute standards of risk and reward.

Operator

Your next question comes from Jay Gelb Barclays Capital.

Jay Gelb Barclays Capital

Jay, I had a broad question on the cycle turn. I've heard some chatter among the reinsurers that the combined impact of AIG's dislocations and the broader financial issues in the market, plus catastrophe losses, are going to lead to a cycle turn in reinsurance as of 1/1. Do you subscribe to that view? I am not sure what your views are on the reinsurance side, but on the primary side you can address that. Do you think there's enough capital that's come out to cause a cycle turn?

Jay Benet

Yogi Berra once said it's really hard to predict and especially so when you talk about the future. I don't know. I can tell you what our mindset is as an individual company. How the overall market responds and how other carriers react to it is for them to speak to. We're not a big enough competitor that any change that we take in the marketplace is going to drive the market in any particular direction. We're approaching the world as a riskier place they than it was 12 months ago. If you recognize that and you try and bring that philosophy to your pricing decisions.

We're always going the support our agents and our brokers and our customers and we're going to compete. We've done, I think, a very effective job at sorting through and finding opportunities that are priced appropriately, even in a more challenging pricing environment. But we sit here as we do every month and think about pricing philosophy and it certainly seems to us to be a riskier world. We will try our best to bring that philosophy to our pricing decisions. But everyone will have their own view and perspective and the market will be what the market will be. I just don't know and I don't know. My crystal ball isn't good enough to predict what's going to be in six months.

Jay Gelb Barclays Capital

Then on the financial leverage side with debttototal capital being right around 20% and that being your stated goal. Does that constrain Travelers from buying back more stock or is there a little leeway there to go higher on debttocapital?

Jay Fishman

As I indicated in my remarks, we have a target range given our target of a double-A rating. Somewhere between 15% and 25%. We have never picked these targets either on the upside or the downside to be at a constraining level. If we were to decide that it would be appropriate to increase leverage by a point or two or three, we certainly have to capacity to do that. But we have been targeting the 20%.

Jay Benet

I would add one other comment to that because I do think it's relevant. We try, because obviously the world changes around us, we have a fundamental philosophy of not running the company on the edge.

What I mean by that is not putting the company in a position from its leveraged capital perspective such that the kinds of events that inevitably happen in the property casualty industry in the ordinary course would cause us to have to do something dramatic.

We want to be comfortable being able to withstand a quarter of Ike and Gustav and Dolly. And we always remember that in 2005, it was Rita, Katrina, and Wilma. The notion that we have capacity to lever up to a higher level, that may be the case, but as we think about how we run our business and the prudent management of longterm shareholder value would dictate that we shouldn't be running it on the edge. I think where we are here is in a very appropriate level and it gives us the flexibility and the capacity to withstand the events that occur in our business.

Operator

Your next question comes from Ian Gutterman Adage Capital.

Ian Gutterman Adage Capital

One quick financial question then a broader strategic question. Have you taken your full statutory dividend capacity for the year? If not, how much do you expect to take in Q4?

Jay Fishman

We have not taken the full capacity from the operating companies up to the holding company through the first three quarters. We do have a planned dividend level in the fourth quarter, but we're not straining the capacity to bring capital up to the holding company.

We're operating the company as we said we have previously, establishing at the operating companies target levels of capital based on rating agency requirements, riskbased capital requirements of the states. We are comfortably at or above the target. Excess capital is swept up. It's flowing and we're not being constrained.

Ian Gutterman Adage Capital

I was thinking the opposite. I was trying to think how much you have used yeartodate just so I have an idea of, if I want to try to model it, how much holding company capital would be going forward?

Jay Fishman

How much has actually come up from the operating companies to the holding company?

Ian Gutterman Adage Capital

Yes, yeartodate.

Jay Fishman

Why don't we have somebody else ask a question, and we'll give you that information.

Ian Gutterman Adage Capital

The broader question is just, there's obviously a lot of distressed properties come up for sale or may be coming up for sale. To the extent you found something just incredibly compelling and the price tag were more than your current excess capital, obviously you have some ability to take the debt up, but you don't sound superinterested in it. I am just trying to think how would you finance something that went beyond your current excess? Would it be that acquisition is a compelling reason to get a little bit closer to the edge? Is raising equity at these levels on the table at all or would it have to be just a supercompelling deal to do that? Then I have a quick followup on that.

Jay Benet

It is a supposition on top of a supposition there. Let me go back and kind of reassert. It's not any different today than it was three or six months ago, what our acquisition philosophy would be. We think it's prudent or any management, every management to be aware of opportunities in the marketplace, to be knowledgeable and to look at everything they can to be aware of what's going on. In our case, we don't need to do anything. We have the ability to meet our mission, to create shareholder value by achieving midteens return on equity over time, with what we've got.

The fact that we're a company that's significantly experienced in effecting acquisitions and effecting them successfully, I think we have a wellearned respect for the challenges that any trade brings about. It brings reserve risk and people risk and culture risk and systems risk. And you go into these things with eyes wide open with a really healthy understanding of what it takes. Our willingness to go ahead and do something would only be with a mindset that something would be compelling in making it easier to meet our mission, easier to meet our mission of achieving shareholder equity with midteens return on equity over time.

My presumption would be that any transaction that would meet that threshold that would be so compelling, it would be not difficult to finance it one way or another. I think the more challenging issue is, yes, there may in fact be a lot of properties that come up for sale. It's possible. The real challenging issue was do any of them matter? Do any of them make it easier for us to me our mission? Once we believe that, then I think the financing ultimately stands on its own. We know how to finance it in ways that are thoughtful.

I think you get into trouble trying to finance transactions that you can't figure out how they actually add to shareholder value, and then you end up to some extent chasing your tail. I would love to start off with an opportunity that's compelling, and compelling in a way that makes it easy for us to address the financing issue.

Ian Gutterman Adage Capital

I totally agree with that. I guess what I am thinking is we might be in that special environment now where some properties you thought you would never see or if you had seen it pay two times book, maybe you can get them for a shade over book. Just because they're subsidiary of their companies that have to raise capital. To be honest, my main concern is, unless it was just an absolute steal, I would hope given where your stock is trading at, raising equity is off the table.

Jay Benet

We have a very healthy regard for the cost of equity. We have at least a healthy regard for the cost of equity as any owner or analyst of our share price. We get it. We are all owners. We are all option holders. We all have a meaningful and significant stake in the company on an individual, as well as a professional level. We understand it. If anyone has any concerns that we have a disregard for the cost of capital, cost of equity, it's not us.

Ian Gutterman Adage Capital

That's what I wanted to hear. Then related to that to finish it off, given that some of these opportunities may arise or maybe you just want to be more cautious in case the markets get worse or there's a CAT or something along those lines. It would seem, frankly, the cheapest way of prefunding any of these concerns is to go buy more reinsurance, given you're taking your [retouches] up and reinsurance is still relatively cheap. It's certainly the cheapest form of capital in the world today. Are you considering as you go to 1/1 that maybe you start buying back down again in certain line of business to give you more capital flexibility for the unknown and whether it be a positive or negative unknown?

Jay Benet

We're, first of all, as it relates to our catastrophe cover, we're a July 1 company. Our CAT cover broadly won't come up until we get into the second quarter of next year.

Ian Gutterman Adage Capital

I was thinking more of the nonCAT treaties.

Jay Benet

The way, maybe we should challenge ourselves to make sure that the logic still remains in tact. But we see reinsurance as a longterm cost rather than as a longterm profit opportunity. If someone can find a dumb reinsurer and introduced them to me, I would be happy to make lunch with him. My experience is that reinsurers are pretty smart and sophisticated and they know what their product is worth and they charge appropriately for it. Ultimately, what we're doing is conveying the share of the profits of our business with a capital providing partner. If we believe that, then what we want to buy is that which, when you think of your homeowner's, your automobile insurance, you make the same decision that we do. We want to convey the volatility to someone else that we're not prepared to withstand.

I think given our capital position, our earnings profile and our size, we don't have to worry about conveying more of that volatility to anybody else. I feel very comfortable with our overall profile to the extent that we thought that some additional capital was needed, I think the kind of thing that we're doing in the fourth quarter, which you mean scaling back our share repurchases, is the least costly and least permanent way of effecting that. If someone were to ask, why are we doing it? I am not even sure I can give you a clear answer, other than to say it just feels right in these volatile times to allow for a little more capital formation rather than a little less.

Ian Gutterman Adage Capital

Agreed. To that point, since you bring it up, wouldn't it be a good trade? It doesn't say the reinsurers are dumb so much, but wouldn't it be a good trade to buy reinsurance at a low to midteens cost of capital and be able to buy back your stock well below book, which is probably a 20%30% return on capital?

Jay Benet

Again, there's a presumption in that statement that buying back that reinsurance is a capital-producing event. It may be a capital wasting event. You just don't know. Ultimately if you're buying insurance, then the coin is flipped. Maybe it comes up heads and maybe it comes up tails. Maybe the losses turn out to be better than you anticipate, and you've actually spent capital. I just struggle with coming to the conclusion that reinsurance buying is fundamentally capital generating. It may turn out to be, but ultimately if the reinsurer is doing their job well. My experience is they do their jobs well. The actuarial price that you're paying for it, is at least more than what it's worth.

I think to your point there has been a periodic tactic when reinsurance gets particularly cheap some people go out and aggressively buy more. That's a tactical decision on the premise that the losses that you're avoiding are more than the premium that you are paying for the reinsurance. That may or may not turn out true. At least as we stand right now, it's not apparent to me that reinsurance is anything now but actuarially properly priced, not cheap. I have some trouble getting to the conclusion that capital is created.

Brian MacLean

Just to finalize the answer to the question about how much capital was at the operating companies that could be brought up without regulatory approval, this is U.S.based companies, we disclosed in our 10K for the year that there was about $4,200,000,000 that was available to be brought up without regulatory approval. Through the first three quarters of the year, we have brought up $3 billion of that.

Jay Benet

That's not $4,200,000,000, that's $4.02 billion.

Brian MacLean

$4.02 billion. Sorry. You're absolutely right.

Operator

Your next question comes from Paul Newsome Sandler O'Neill & Partners.

Paul Newsome Sandler O'Neill & Partners

Two quick questions. One is could you talk about what the impact of the security lending program is on your investment income? Was it really that material? We are just trying to get my arms around this, not just for you, but for other folks who obviously do very similar things.

Bill Heyman

It was not material. It was at its peak about $600 million in magnitude. As we looked at it, our counterparties were people whose credit we were comfortable, but not too comfortable. The collateral we were getting was acceptable, but not as good as we'd like. After all that, we were taking a few basis points. Earlier this year, we took it from $600 million to $15 million. The only reason we left $15 million was we might want to get back into it again. But it was never a material driver.

Paul Newsome Sandler O'Neill & Partners

Second question. You recently sold this Union America to, I believe, a company that runs runoff operations. Could you talk about how that affected your asbestos liabilities? I know there are a billion in gross liabilities. I don't know what the net would be or even round numbers. Does this signal a change in your view towards trying to sell these kind of runoff companies? I know Travelers was among the companies that protested for example [inaudible] sale of its runoff operations a little while ago.

Jay Benet

First, the operations were U.K. based and, as I am sure you know, U.K. transactions of this nature can be done in a way that limit the credit exposure of the company that is selling, receiving company. In this case, we have the ability to X any credit risk to transfer the underlying liabilities to the buyer, obviously subject to the regulatory approval of the FSA. We haven't closed yet. We have a contract. We announced that we have a contract. We haven't actually sold yet. I hope that we will get to a closing. I don't think it speaks to a shift in strategy or policy. This was a situation where runoff liabilities, and this wasn't enormous, it was sizable, but not enormous capture and attract capital. They have to have capital to support them. By conveying these liabilities to someone who views its as a going concern business and is willing to commit the capital to it, it frees up capital for us. The underlying liabilities for all accounts reserved properly and appropriately. It was an opportunistic transaction to move the liabilities to someone who would use it as a going concern, free up capital attached to that business for ourselves, and do so at a fair and reasonable price.

Paul Newsome Sandler O'Neill & Partners

I think it's a good thing. Lastly. I was looking at a survey for the, telling us to put out D&O insurance. That survey suggested that you folks were actually a leader in selling to financial institutions, D&O insurance. Is that true? Is it that big a deal? Maybe you could just talk about that exposure as well.

Brian MacLean

We certainly have a FID&O book and are watching that carefully. Are we a leader? We certainly are playing it. The larger national levels, we've been managing that book carefully over the last year or so, looking at both limits and attachment points.

Alan Schnitzer

I think a key part of that is our limits profile and how closely we manage that. Obviously we are limiting our exposure to any one.

Jay Benet

Let me make sure, I know I have garbled this up before. Our bank exposure, not our financial institution broadly, but our bank exposure, is significantly driven by our community bank program. So far, so good. In that program, approximately 80% of the risks are private, these are nonpublic companies. We actually have more of the characteristics on that. The average size of the limits, it's not, the bank book is not driven by moneycenter banks, investment banks, banks that are actively engaged in the marketing or packaging of mortgage securities. Again, there are other financial institutions. There are insurance companies and there are a host of other things, but our banking exposure is driven by our community bank exposure.

Brian MacLean

I just want to clarify something that's related to the securities lending program. You can get from our balance sheet how much of fixed maturity portfolio was subject to securities lending. It is $15 million as of September 30. The numbers have been considerably higher than that. The June 30 number was $1.6 billion. You can go back and look at what the values were in previous points in time. We have, in this turbulent marketplace, really curtailed [inaudible].

Alan Schnitzer

The point is it was a very small amount of incremental profits.

Jay Benet

We viewed it as a conservatively run and managed securities lending program. Didn't involve leverage. It didn't involve further volume. It was a straightforward, traditional securities lending program. Bill actually came to me early, like in the middle of the quarter, and suggested that the ability to act on the collateral, given the turmoil and dislocation that was then in the marketplace in particular could be challenging. The collateral was okay, but if you had to act on it, it could be challenging. Given the amount of income that it was contributing, Bill made an active decision to say let's bring the program down. It was not a material contributor to our earnings.

Operator

Your next question comes from Jay Cohen Merrill Lynch.

Jay Cohen Merrill Lynch

Couple questions. The first is, maybe for Bill Heyman, the change in the unrealized was frankly a lot more modest than we had expected. Given what we've seen and what we did was we looked at different indices for corporate bonds, you know double A corporate bonds, and for even munies, and we came up with a much higher number. You are not privy to our assumptions, but I am wondering if there was something about your business that allowed your unrealized losses to be a lot more modest than we have seen from others.

Bill Heyman

Actually we thought saw your estimate, although not the assumptions behind it. When we saw that number, we felt better having seen your estimate. I think we have tried in every asset class we are invested in to be as high up the food chain as possible in term of credit quality. I think while we have to benchmark ourselves against indices for lack of anything better. The credit quality, the real credit quality of the portfolio was higher than the indices. I think that accounts for most of the difference. Also, we missed some of the big blowups, and most of those would have fallen into the realized category. But nonetheless, there's some credits which have gone down in price and may have got to the point of [inaudible] in which we're underrepresented.

Jay Cohen Merrill Lynch

The second question, maybe for Brian, in the nine months, the underlying combined ratio, X cap, X development, was worse by about 2.4 points. So it's still a reasonable level. I remember initially when you were thinking about 2008, I think you were thinking for that number to get worse by about a point. Then you increased that a bit. It does seem a bit worse than what you've been expecting. One, is that accurate? Secondly, if it is, sit more of a price issue or a claims issue?

Brian MacLean

Absolutely accurate. Let me break it down into the three basic pieces and then Joe or Jay or anybody chime in.

The core underlying assumptions around price loss trend, margins on the business have essentially played out as we expected, across I would say our whole spectrum. This is broad brushing the thing. You can look at our data, pricing has softened a little bit. Pretty much in line with what we expected. We expected some loss trend. Our starting point, our base, has improved a little bit. So net net our margins are about where we thought on the core business. The large loss activity that we saw in the first half of the year in the commercial business, commercial property, running across all of our segments and a little more of that in the third quarter on the international side, is a piece of that number. Then the rest is predominantly weather driven issues in personal insurance. Again, we disclosed CAT. So it's the nonCAT weather losses that we saw run through our personal books. Those would be the major components of it. The weather stuff moves. Sometimes you have better years and sometimes you have worse years.

Jay Cohen Merrill Lynch

So it's nonCAT weather basically.

Joe Lacher

The combination of nonCAT weather and the large losses that we spoke about in the first half of the year, to some extent. Some of that continuing into the third. Those are the two reasons. You got it right. You started out with anticipating 100 basis point deterioration in the combined ratio. We took that up to a point and a half at the end of the first quarter. Getting from that point and a half now to the 2.4 is largely accounted for.

Brian MacLean

Even a piece of the third quarter international large loss stuff was also weatherrelated losses that didn't hit a CAT threshold.

Jay Cohen Merrill Lynch

If I could just squeeze in one more question. If I can't, just say shut up. On your auto business, certainly, there's a big property availability, AIG's personal lines business is for sale. They've said that publicly. You are a potential buyer. One of the pieces there is the direct auto business. You probably can't comment on this specific one, in general, how would you feel about entering a direct response auto business given the potential channel conflicts.

Jay Fishman

I will give it 30 seconds and ask Joe to comment. We already do some direct business. We obviously have for a while through our [inaudible] pity businesses and certain other direct channels. We have also, in certain select states, been advertising in a way to drive some business directly. Not a significant portion of our business yet, but already in place. It's to your point, it's correct. At least historically it's been described as a channel conflict.

I think most of our agents and brokers understand the realities of what the business is going to look like over the next ten years. They understand that and get it. And what successful companies have done, and they're certainly are plenty who have navigated both of those tracks, have done so in a way that leaves the agents and brokers on a level playing field. At least as we understand it, were that to become a more important part of our business, that's an important element. You can't come to market and be adverse to the agents and brokers that have built your business. You have got to keep a level playing field. Again, independent of anything related to AIG, we've already been in the direct business to some extent.

Joe Lacher

I would echo all those thoughts. We had a relatively significant percentage of our, not insignificant maybe would be a better way to describe it, premium that comes from nontraditional agency relationships for some time and continue to do that. We work through all of the conversations with our agents if we bump into each other. But we have an, unfortunately or fortunately, sufficiently a modest market share that those issues don't cause us a lot of problems and we figured out how to work through it this in a way that allows those channels to work together.

Jay Fishman

If we were to embrace the direct marketing strategy in a broader sense, we would obviously be forthcoming with our agents and with the brokers. We would be forthcoming as to what we were doing and we would describe it in a way that enabled us to communicate to them effectively that we are, of course, protecting and watching out for their interests.

Operator

Your next question comes from Alain Karaoglan Bank of America.

Alain Karaoglan Bank of America

I want to congratulate you on the great job that you have done on the investment portfolio, especially Bill Heyman, in avoiding so far some of the issues that have affected other companies.

Bill Heyman

Let me interject, the people in St. Paul, Minnesota, deserve congratulations as well, especially Dave [Roland].

Alain Karaoglan Bank of America

The question that I have relates to the surety and the D&O business. I know you mentioned, Brian, in your comments that the losses are in line with your expectations. How are you thinking in a weakening economic environment about contract and commercial surety? What should be what we are watching out for? Why shouldn't we be that concerned about it? On the D&O front, are you expecting pricing to improve, given all the pain that has been there. Just a numbers question on the tax rate on underwriting. Was this lower than expected? I calculate 27.8%. I may have calculated that wrong and can pick it up be you Gabby afterwards.

Brian MacLean

Let us come back to the tax rate question, maybe Gabby can bet back to you unless there's a quick answer, but we'll look at that. Great questions on the surety side. Clearly we are looking very closely at that book as you all know, we are a major player there. And have been a very successful one. We have spent a lot of time talking about it. Why don't I toss it over the Alan and let him bring you up to speed on our conversation.

Alan Schnitzer

I think the real important point to keep in mind on the surety business is this is something we've been focusing on for a long time now. This hasn't caught us by surprise. We have been looking at this and actively managing that portfolio, and our credit quality of our contract book as we measured it is at a high [inaudible] by historical standards. We feel very good about that business and how it's performing.

Jay Benet

One of the things that we've done is to broaden out the imput into looking at the business and what we've been doing in it. We've actually brought folks from Bill Heyman's organization and Bill [Hannon] who is our enterprise risk person along with people in the surety business now on a more regular basis to discuss in a much more robust way the overall credit profile and credit exposures and how they're being managed.

I think part of this is to recognize that there is real strength in this organization to do credit analysis and credit evaluation and we're bringing all of those resources to bear into the business on a regular basis.

Brian MacLean

You also asked about pricing on the D&O book. Obviously, when you write D&O in lots of lines and it's hard to generalize. If you were thinking about the large FIs, the pricing has improved.

Jay Benet

None of us mean to predict that there will never be a surety loss. This is not to give you assurance that there won't be loss. That would be in effect foolish, but I think we approach the business and the way that we do it in a very thoughtful way. We're mindful of it and have a real healthy respect for the exposure that exists there.

Gabriella Nawi

Alain, I will get back to you on the tax rate.

Operator

Your next question comes from Brian Meredith UBS.

Brian Meredith UBS

I will keep mine to one question. Jay, last time, last quarter you talked a little bit about inflation out there. Looks like it's a little different environment now with oil prices down, commodity prices down. Just curious, what do you think the impact of this current environment is going to have on loss cost trend? What is loss cost trend look like in the commercial line area?

Jay Benet

There isn't anything that we saw in the third quarter that was in any way meaningfully different from what we had in the second. If you remember what we said in the second quarter, was that while we were certainly mindful of the potential for inflation, we certainly hadn't seen anything at this point that would suggest any kind of a significant spike.

That remains true. We haven't seen anything that would suggest a real spike. I do think in the context of, this is part of our responsibility to manage, in the overall environment. We've got an existing deficit that's currently projected to get to half a trillion dollars. We have got U.S. governmental making substantial infusions into financial institutions. Its impact on the deficit, the dynamic of what a different regulatory regime will have, it certainly belongs on the list of issues for us to be extremely attentive to and thoughtful about. I don't think that a reasonable person could dismiss it at this point a notion that the likelihood of any accelerated inflation, whether medical costs or otherwise, isn't a possibility. It remains on our radar screen.

Operator

Your next question comes from Vinay Misquith Credit Suisse.

Vinay Misquith Credit Suisse

Could you expand on the opportunity that you're seeing right now since [inaudible] I think the most [inaudible]. I am curious as to what other opportunities you have seen in the market right now.

Jay Benet

First I would go back to even before this immediate quarter. We have spoken for some time that in our middle market business, if you look at some of the middle market construction, and Brian mentioned this again. The actual submission flow is up 50% from where it was two years ago. That's just extraordinarily strong. It really reflects new product development and the fact that we've become a really market of choice. Two, is the advent of Travelers Express in our small commercial business, which is a real breakthrough in speed and technology in our smallest, small commercial arena, as also precipitated a significant increase in deal flow that [inaudible] we just haven't seen. All of those things encourage agents to do more things with us that even extend beyond those two business lines. Our experience has been the more you do with agents and brokers, the more business opportunities you see from them and that is partly what we are seeing.

Specifically, in the quarter, people have asked if we have seen opportunities related to the situation at AIG. I would make a couple of observations. First, our sweet spots really only intercept to some extent. You are right, we're not a large account casualty insurer, and AIG has certainly been one of the best large account casualty insurers in the world and deserve all the credit for really lending a successful business. Where we do have some overlap is in our middle markets business. They are a very good, very strong effective competitor there as are we. We have since the dislocation related to AIG seen an increase in flow of opportunities to quote on business where AIG is currently the incumbent. Our sense is that agents and brokers are looking for additional alternatives for their current AIG clients. Accounts that might have not gone to market and simply been renewed, our sense is that agents and brokers are feeling something of a responsibility to their customers to generate alternatives for them and we have seen an increase in opportunities to quote on business where AIG is currently the incumbent. To the extent it sits in our sweet spot in our middle market business we are obviously doing so.

Operator

Your next question comes from [Terry Shu] Pioneer Investments.

Terry Shu Pioneer Investments

I think most of the questions have been asked, but let me ask one more on personal lines, personal auto, specifically. You have done really well and the industry environment, maybe you can comment on that. Seems like many carriers are able to put some rate increases and right now, with the gaps that people watch, the underlying cost trends versus premiums has narrowed quite a bit. Are we just seeing a much more disciplined market and you're gaining share mostly because there's still rolling out and you still have a smaller book and therefore able to gain share? Can you just comment broadly.

Jay Benet

There's a couple of questions there. I will try to hit them all and nudge me if miss some. We are, as we observe rate activity, all of our competitors in a regulated environment would be put through filed rate increases so we can go through and see what each other have filed. There's been a shift in the recent quarter and recent several quarters towards more increases rather than decreases. I am not sure it's as broad as I sometimes describe it, but I think it's in line with what we're seeing in those same indices that you're describing that look at the aggregate results. You can see it to some degree in our RPC numbers, our renewal price change numbers, which picked up again in the quarter. I do think that's generally happening in the marketplace.

Jay Fishman

That's a little forwardlooking.

Jay Benet

Those are filed rate increases.

Jay Fishman

I am just trying to make sure people understand that dynamics.

<TAG>Jay Benet.

That's what happened. The question of is it a more disciplined marketplace? That becomes the forwardlooking question. And you start to say I don't know exactly what's going to happen. We have had conversations about what were oil prices going to do. What's going to happen with frequency? How is that going to play out in the marketplace? I think that, along with what's going on in the economy, will be somewhat unclear and we will have to see how that works over the course of the next couple of quarters.

Jay Fishman

The only observation there is that the first step is to get filings in place. Filings actually sometimes translate to real increases and sometimes they don't. What we look at there is what I would characterize as a leading indicator and it may or may not develop. You're not declaring.

Jay Benet

I am just saying what we've seen in the observable data that Terry was referencing. There's actual rates going up, rate increases that are actually charged. We've seen our actual RPC, and you know the filings, that's will translate into actual dollars. Who knows what's going forward.

Joe Lacher

From our perspective in our own business, we continue to I believe bring very thoughtful capabilities into the marketplace and we're executing them well. We spent time before talking to you about our expansion of our agency plan into broader geographies. That gives us the capacity with almost in a retail perspective, we're not just dealing with same store sales, we're dealing with new store sales. As we open up those new stores, that gives us an opportunity to grow and outperform what you are seeing others doing in the marketplace without having to be unreasonably aggressive inside of those same stores. We're seeing the results bear fruit. We're confident that we can continue to march forward doing that.

And I hope we get a little bit of the effect that Jay was talking about before, as we bring the strength of our Quantum products to bear, bring Travelers Express to bear, to bring the strength of our middle market to bear. There becomes a halo effect of all of the things we do in place, propelling all of the things we do as a place to be more effective. We see that in all of our businesses.

Gabriella Nawi

It looks like the end for this. Thanks for joining us today. If you have any questions, please contact myself or Andy in Investor Relations.

Operator

Thank you for your participation. This concludes this presentation and you may now disconnect.