S&P Capital IQ

CONTENTS

CNA Financial Corporation NYSE:CNA

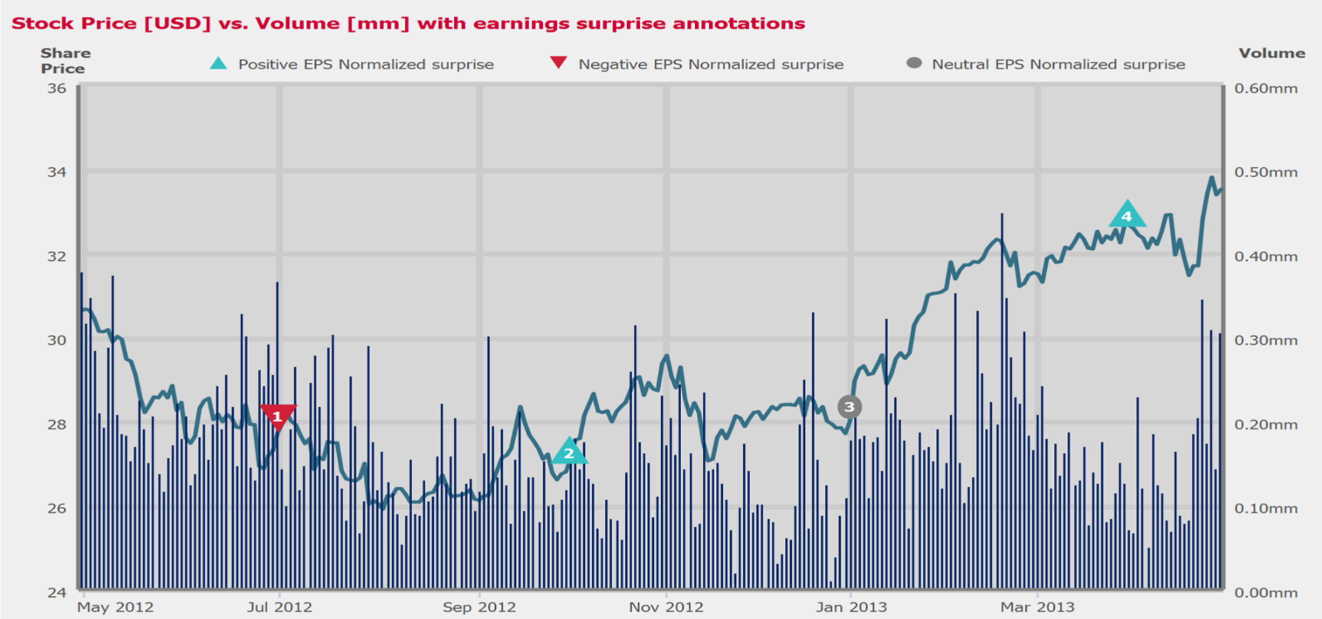
FQ2 2013 Earnings Call Transcripts

Monday, July 29, 2013 2:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2013-			-FQ3 2013-	-FY 2013-	-FY 2014-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.64	0.75	▲17.19	0.72	3.00	3.09
Revenue (mm)	-	1720.00	-	-	-	-

Currency: USD
Consensus as of Jul-29-2013 12:35 PM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ2 2012	0.59	0.56	▼(5.08 %)
FQ3 2012	0.65	0.80	▲23.08 %
FQ4 2012	0.22	(0.03)	NM
FQ1 2013	0.71	0.86	▲21.13 %

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Call Participants

EXECUTIVES

D. Craig Mense
Chief Financial Officer and Executive Vice President

James M. Anderson
Senior Vice President of Financial Planning & Analysis and Corporate Development

Thomas F. Motamed
Former Chairman and Chief Executive Officer

ANALYSTS

Amit Kumar
Macquarie Research

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

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Presentation

Operator

Good day, and welcome to the CNA Financial Corporation's Second Quarter 2013 Earnings Conference Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to James Anderson. Please go ahead.

James M. Anderson
Senior Vice President of Financial Planning & Analysis and Corporate Development

Thank you, Lexi. Good morning, and welcome to CNA's discussion of our 2013 second quarter financial results.

By now, hopefully all of you have seen our earnings release, financial supplement and presentation slides. If not, you may access these documents on our website, www.cna.com, under the Investor Relations menu.

With us on this morning's call are Tom Motamed, our Chairman and Chief Executive Officer; and Craig Mense, our Chief Financial Officer. Following Tom's and Craig's remarks about our quarterly results, we will open it up for your questions.

Before turning it over to Tom, I would like to advise everyone that during this call there may be forward-looking statements made and references to non-GAAP financial measures. Any forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from the statements made during the call.

Information concerning those risks is contained in the earnings release and in CNA's most recent 10-K and 10-Q on file with the SEC. In addition, the forward-looking statements speak only as of today, Monday, July 29, 2013. CNA expressly disclaims any obligation to update or revise any forward-looking statements made during this call.

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

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

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thank you, James. Good morning, everyone, and thank you for joining us. I am pleased to report on a very good second quarter. Our margins, as defined by the combined ratio, excluding catastrophes and development, improved 3.4 points as compared with the first quarter of 2013 and 3.6 points as compared with 2012's second quarter, reflecting meaningful improvement in both loss and expense ratios.

Our overall growth momentum continued. Net written premiums increased 7%, driven by Hardy, Specialty and rate increases. We continued a meaningful level of rate achievement, and it was consistent with the first quarter for both Specialty and Commercial. We produced solid operating income and operating ROE. We received an upgrade in our financial strength and unsecured credit rating from Standard & Poor's. We believe these results reflect the meaningful progress we are making in the execution of our strategic priorities. We are seeing real demonstrative benefits from our focus on targeted customer segments and products, as well as disciplined expense management and, of course, from improved market conditions.

As you know, we have been actively managing our Property & Casualty portfolio. This is evident in our progress in targeted customer segments, trimming exposure in classes outside of our appetite, and strong rate achievement. We are taking aggressive and appropriately differentiated underwriting and pricing actions on our businesses that we believe are necessary in order to improve margins.

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In the second quarter, for our targeted customer segments, we are achieving 8% rate and 81% retention. For business outside of our targeted segments, we're obtaining higher rates, 11%, and retention is 10 points lower at 71%. We continue to stick to our guns and push rate over retention in order to improve our margins. In addition, in the fourth quarter, we decided to exit a transportation program. And this quarter, we've decided to exit a recreational watercraft program. These actions are consistent with our strategy to focus on customer segments and products with attractive growth and profit prospects, and to move away from areas that do not match our appetite or expertise.

Our Specialty business continued to deliver solid underwriting results with a combined ratio of 90.4. Excluding catastrophes and development, the combined ratio was 95.6. Net written premium growth was 5%. Rate and retention remain strong. Rate was 7% in each of the last 2 quarters and retention was relatively constant.

The Commercial combined ratio was 111.7, which included 7.1 points of catastrophes. Excluding catastrophes and development, the combined ratio was 101.2. Second quarter rate at 9% is strong and consistent with the prior quarter. Revenue and retention declined in line with our rate stance and underwriting decision making.

Hardy reported a net operating loss of $2 million in the second quarter, or net written premiums of $138 million. The combined ratio was 98.4. The combined ratio, excluding catastrophes and development, was 81.

I am now going to turn the call over to Craig. Craig?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Thanks, Tom. Good morning, everyone. Before I get into the results, let me remind you that presentation slides have been posted on our website to provide additional perspective on our financial and operating trends.

Second quarter net operating income improved to $204 million, a 34% increase over the prior year period. This produced an operating return on equity just under 7%. Operating income available to common shareholders was $0.75 per share, up from $0.56 per share in the second quarter of 2012. Net income was $194 million or $0.72 per share, which also compares favorably to the prior year period.

We are encouraged by the improved underwriting margin generated across our core P&C businesses, reflecting targeted underwriting actions and broad-based rate increases. Our core P&C Operations produced net operating income of $258 million in the second quarter, up 58% as compared with the prior year period. Improved net investment income and non-cat accident year underwriting results drove the increase.

Our second quarter P&C Operations loss ratio was 68.4% compared with last year's second quarter at 67.9%. Excluding catastrophes and development, the loss ratio was 64.5%, a 2.9 point improvement over last year's second quarter.

We believe that comparing year-to-date loss ratio performance with where we ended the full prior year is a better measure of our progress. On that basis, our 2013 year-to-date loss ratio, excluding cats and development, of 65.7%, is 2 points better than full year 2012. Our second quarter expense ratio also improved to 32.9%. This reflects our expense management discipline and the growth in earned premium. Improving our expense competitiveness continues to be a major focus for us this year.

Specialty second quarter net operating income improved to $148 million with a calendar year combined ratio of 90.4%. Specialty's result benefited from 5.9 points of favorable development. Excluding catastrophes and development, Specialty's loss ratio was 65.8%, a 1.3 point improvement over last year's second quarter. The year-to-date loss ratio of 66.4 is also 1.3 points better than full year 2012. The improvement was driven by both rate achievement and targeted underwriting actions that continue to refine the portfolio mix. The Specialty expense ratio improved to 29.7%, well under the prior year period.

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Commercial's second quarter net operating income significantly increased to $112 million, up 96% from the prior year period. Commercial's results were affected by 2 one-time events. The first is $35 million of pretax adverse loss development in workers' compensation related to the New York Fund for Reopened Cases legislation. Adjusting for the impact of this law change, Commercial's prior year loss development would have been slightly positive.

The second event involved the beneficial $46 million pretax legal settlement related to workers' compensation residual market litigation. This benefit is reflected within other revenues and is not included in the Commercial combined ratio. Excluding cats and development, the Commercial loss ratio was 66%, a 1.7 point improvement over last year's second quarter. Comparing the year-to-date loss ratio of 67.3% with full year 2012 shows an improvement of 1.3 points.

Rate and retention trends, as shown in the presentation slides on Page 10, reflect our disciplined risk selection and strong rate achievement. Commercial has attained 9% rate in each of the first 2 quarters of 2013, following 7% rate in each of the preceding 3 quarters. Retention of 75% in the second quarter is reflective of targeted underwriting actions on portions of the portfolio, as Tom discussed.

Our Non-Core Life & Group segment produced a $36 million operating loss in the quarter, primarily due to higher individual long-term care claim frequency. We continue to evaluate the pricing in our long-term care business and are actively seeking rate increases where appropriate.

Our Corporate segment reported an $18 million second quarter net operating loss, compared with a $14 million loss in the prior year's second quarter. We continue to build on our balance sheet's financial strength and stability. Our capital adequacy metrics remain at or above our targeted levels, and our liquidity profile remains very strong. Book value per common share decreased to $44.29, down 3.7% from the end of the first quarter. Our investment portfolio's pretax net unrealized gain stood at approximately $2.5 billion at quarter end, a decrease of approximately $1.8 billion from the end of the first quarter 2013. Approximately $900 million of the decline's impact on book value was offset by a decrease in Shadow reserves related to our Life & Group run-off business. In addition, I would note that while the increase in interest rates had an adverse impact on our unrealized gain position during the quarter, at current interest rate levels, it should have a favorable effect on earnings going forward.

Our common shareholders' equity, excluding other comprehensive income, was $11.8 billion or $43.81 per common share, up slightly from the end of the first quarter. Our statutory surplus at quarter end was $10.2 billion, up 2% from the end of the first quarter. This was after a $100 million dividend paid to the holding company during the second quarter. We continue to maintain significant dividend capacity at the insurance operating company level.

Cash and short-term investments at the holding company level were approximately $470 million at quarter end, well above our 1 year of annual net Corporate obligations target. In the second quarter, operating cash flow, excluding trading activity, was approximately $340 million. Cash principal repayments through pay-downs, bond calls and maturity were approximately $950 million.

Net investment income was $578 million pretax in the second quarter, up 23% from the prior year period. The increase was driven by our limited partnership investments, which produced second quarter pretax income of $79 million in 2013 as compared with a pretax loss of $35 million in the prior year period. The second quarter rate of return in 2013 was 3.1%.

Net investment income from our fixed maturity securities in the second quarter was $498 million pretax, essentially flat with the prior year period. While we made relatively minor changes to our investment portfolio sector allocations this quarter, towards the end of the quarter and more recently, we have taken advantage of attractive yield opportunities in the tax-exempt municipal bond market. Overall, the investment-grade Corporate bond sector continues to represent the largest component of our invested assets. The average credit quality of our fixed maturity portfolio remained at A. The fixed income assets, which support our long-duration life-like liabilities, had an effective duration of 11.2 years at quarter end, a slight increase from the prior year quarter and in line with portfolio targets. The effective duration of the fixed income assets, which support our traditional P&C liabilities, was 4.3 years at quarter end, up from

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4.1 years at the end of the first quarter. Overall, our investment portfolio remains well diversified, liquid, high-quality and aligned with our business objectives.

With that, I will turn it back to Tom.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thanks, Craig. Before we open it up for questions, I would like to close with some observations.

Operating and net income of $204 million and $194 million increased 34% and 17%, respectively, compared with the second quarter of 2012. Our 2013 year-to-date loss ratio, excluding cats and development, of 65.7, is 2 points better than full year 2012. Our expense ratio declined to 32.9 in the second quarter. We have grown Property & Casualty net written premiums 9% year-to-date. We are actively managing our mix of business and it is seen in our results. We have strong investment results and improved capital position, and our book value per share, excluding AOCI, has increased. We are pleased that Standard & Poor's recently announced that it had upgraded CNA's financial strength ratings to A with a stable outlook. This enhances our competitive position in many Specialty and long-tail businesses. S&P also upgraded the credit ratings on CNA Financial Corp. to BBB. These upgrades validate the work we have done to enhance our financial strength. Lastly, we declared a quarterly dividend of $0.20.
And with that, we would be glad to take your questions.

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Question and Answer

Operator

[Operator Instructions] And we'll take our first question from Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

I guess the first question, maybe I'm misinterpreting. I'm sensing maybe an increased sense of urgency, for a lack of a better word, on your behalf to improve margins. You saw the -- in the standard business, you saw the growth slip quite a bit. You seem to be more focused on your better businesses. Am I misreading that?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

No. I think we've been focused on improving margins for a long time, but it's a complicated process, particularly when you change your underwriting strategy, you're changing your mix. There are a lot of things that have been in play over the last, whatever it is, 3, 4 years. So I don't think it's a greater sense of urgency, Jay. I think it's always been there, but you know it's pretty hard to turn numbers around in this business overnight. And we think we've put a lot of things in place that are starting to reap those kind of benefits on margins. And clearly, if you look at the strong written rate in Commercial and Specialty, we are improving margins. So we're pretty pleased with that, and we expect that that's going to continue.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

That's helpful. You did notice that the renewal retention on the standard business did slip, and I think it's a reasonable trade-off. I'm wondering if you can qualitatively describe the market conditions and what you're seeing. Are you seeing any increase in competition among your competitors?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Okay. Let me kind of first comment on the -- as you've described, the premium decline in Commercial. We exited a personal watercraft program that I mentioned in my remarks. We actually transferred the earned premium reserve to another underwriter. That was 5 points of the negative growth, if you will. And the transportation that I also cited in my remarks was 2 points. And we have been, over time, reducing our exposure to what we would call international work comp, that's about 3 points. So if you add that up, that's about 10 points that is based on underwriting decisions that we have taken of, I'll say, fairly recent vintage. But if you take those out, the reality is we were really -- I guess we were up 3 points in Commercial. So we're taking strong underwriting action, and that's what's reflected on the Commercial side. Plus if you look at new business to lost, we're getting a little pickier relative to pricing on new accounts. So we're just getting, I'd say, a lot tougher as we continue to execute and drive margin improvement. As far as competition, it never goes away, and we see plenty of competition both in Commercial and Specialty. I don't think we have seen anything unusual in the second quarter on competition. I think it's been pretty consistent. If there is one thing that I would think has kind of shown is that's some of the underwriters who may have been sticking to their guns have kind of let up a little bit to not lose the business. So people are more picky on new and trying to protect their renewals, where they have knowledge as to the account profitability and performance.

Operator

And we'll take our next question from Amit Kumar with Macquarie Capital.

Amit Kumar
Macquarie Research

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Just a few questions here. First of all, maybe a numbers question. Do you have the paid loss number handy?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes. In Commercial, it was 116%, driven by Sandy. Sandy had at $40 million we paid in the quarter, as well as some large casualty work comp reserves. And Specialty was 91%.

Amit Kumar
Macquarie Research

And was there anything unusual in that or no?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

We just had higher-than-expected reserve releases.

Amit Kumar
Macquarie Research

Okay. That's helpful. The other question, and this sort of goes back to the prior question. As you look forward, I guess in both Specialty and Commercial, and you think about margin improvement, how do you think about margin improvement as it relates to improvement in loss ratio versus improvement in expense ratio going forward?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Well, first of all, risk selection has a lot to do with it. So we are focused on the customer segments which, quite honestly, outperformed the rest of the portfolio. So the more we drive into the customer segments, the better, I'd say, risk selection and pricing. At the same time, we continue to push for rates. They did not fall off in Commercial. In the second quarter, they were, I think we've used the term consistent. But it's kind of interesting. Rates did go up in the second quarter in ocean, marine, automobile, workers' comp, our small package business, fidelity and medical malpractice. So there are some lines that rates are continuing to move up. The other thing that we kind of look at is the range of rate increases. And in Commercial, at the low end, we have 8%, at the high end, 14%. So there's nothing that's getting 1% rate increases. We're getting pretty good, what do you call, high-single digit or low-double digit. And in Specialty, it's kind of running between 6% and 11%, depending on the line, so we think that's all pretty good. And we also are pretty vigilant on rate decreases. We only had 9% of our accounts in Commercial that actually got a rate decrease. Specialty was a little higher than that, about 15%. So we try to minimize the rate decreases. We try to push rates up in every line of business in every segment. And we continue to keep pushing. And as we've traded, we've gotten rate and we've given up some retention. But we think that's the right trade-off going forward.

Amit Kumar
Macquarie Research

And then -- and what about the expense initiatives going forward? Do you think you've sort of squeezed out whatever you could, or could there be more improvement on sort of the expense side?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

We are expecting more improvement over time.

D. Craig Mense
Chief Financial Officer and Executive Vice President

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I think, Amit, this is Craig, that as we looked at our expense competitiveness, we were about 2 or 3 points higher than our better peers who operate similarly. In the expense ratio, we've reduced that gap by about 100 basis points this year. I think you should expect us to probably sustain that current level. This year, we have a number of plans in place, where we would expect to have that difference again in '14.

Amit Kumar
Macquarie Research

Got it. And I guess the only other question, and I will requeue after this. The adverse development in Hardy on the New Zealand and the flooding. Just remind me, what's sort of the delta between now, and I guess, the upward sort of range of the limit? I guess what I'm trying to ask is what is the probability that this could develop further? And why did it develop this quarter?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Let me start with the second part of your question, why. It was a surprise. It came out of actually the non-marine property, so it's not the property reinsurance treaty part that's been fully developed. I wouldn't expect anything further beyond this quarter. And those related really to 2 individual losses that were surprises in terms of the extent of the eventual outcome of the loss.

Amit Kumar
Macquarie Research

And beyond that, you are satisfied with the quality of the book?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Yes.

Amit Kumar
Macquarie Research

And how should we think about retentions on that book going forward?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, as you can see, they are kind of running in the mid-60s now. And I think, clearly, the competitive environment in that book is different, particularly on the International side. So think about how we're very much focused on the Property business, non-marine property and marine and aviation, energy. So there is some pricing pressure on international property and on aviation, which you read about. So I think you should expect that retentions to stay kind of where they are this quarter.

Operator

[Operator Instructions] We'll take our next question from Bob Glasspiegel with Janney.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Your commentary on the various 3 segments seems to make sense with what you're -- it's a square with what you're reporting for Specialty and Hardy. I mean, the rate increases are -- that you've priced through have earned through in underlying improvement. But I'm a little surprised that in Commercial, where you're getting 9 points of rate, you're only getting 1.7 points of margin. Is your underlying loss costs in this segment that's a lot higher than the others, is this adverse selection? Is there some other factor explaining why the rates aren't -- which have been going on for a full year, aren't showing themselves as much in underlying improvement as your other segments?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

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I think, Bob, if you look at Commercial in the second quarter, and I'm rounding numbers here, written rate was about 9%, earned rate was about 7%, loss trends, say, 3%, so that's a 4% margin in Commercial in the quarter. If you look at Specialty in the quarter now, written rate was about 7%, earned rate was about 6%, loss trend about 3%, so margin probably 3%, maybe a little bit more. If you look at it year-to-date, Commercial, 9% written rate, earned rate about 8%, loss trend about 3%, margin probably 4.5%, a little more than that. And Specialty, year-to-date, 7% on the written, 6% on the earned, loss trend about 3%, 3% margin. So I don't know where you came up with 1.7% margin improvement.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

I'm sorry. I was using your combined ratio x cats and development, 101.2 versus 102.9. And that squares sort of with your year-to-date number, that you've been reporting a little bit less than 2 point improvement in combined ratios. So I guess the difference for between the 4 and the 2 is you're looking at what?

D. Craig Mense
Chief Financial Officer and Executive Vice President

The difference is, Bob, we've been recognizing rate over trend as we earn it quarter-by-quarter. So we haven't readjusted the full year accident year down to what we expect the full year to be. So you should see us, all things being equal, written rate and trend and earned continue at that pace, that we should replicate really double that margin improvement over the -- meaning in loss ratio, over the second half of the year now. And then, remind you that in the first quarter, we did have a non-cat large property loss that added about a point so that -- and there is some residual from that loss in the first quarter, which also has a little bit. So I think if you thought about all those pieces, you'd see the math works.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Okay. So you're saying if we modeled better than 2 point underlying improvements in Q3, Q4, you wouldn't think we were crazy based on terms in Commercial?

D. Craig Mense
Chief Financial Officer and Executive Vice President

I never think you're crazy, Bob, so no. That's a reasonable expectation.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Craig, your speech didn't really make mention about what 70-basis-points increase in interest rates does to long-term care and some of your run-off Life businesses. It seems like you've had a pretty good environmental change. Maybe it just sort of takes one of the bad risk factors you listed in the 10-K off the table. But is there any sort of significant -- and you didn't mention you're going to earn more investment income, which is good for earnings. But you didn't really comment on what this means to your long-term care and annuity businesses.

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, I think what I'd say is -- in May we've asked them, you can't remember whether it was the last quarter, we've been on other calls. But our -- the market yield in our portfolio is now -- and the reinvesting -- the rate we're reinvesting is still about 100, 110 basis points under the current market yield of the book. So that has improved by 60 or 70 basis points from what the outlook was last quarter. So the -- I would say, Bob, that the change is more in terms of its impact on the long-term care and help as it removes or begins to mitigate the risk in that business. And we have been -- as you can see, we have been outearning the increase in reserve discount unwind over the -- keeping pace with over the course of the year. So that will help us as we're moving forward to do that. But I don't think it changes the outlook in terms of on an upside improvement.

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Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

So 70 basis points doesn't change the earnings picture, but it takes the risk factor off your Life in the run off pieces?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Exactly.

Operator

And we'll take our next question from Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

One question on Hardy, and that is the net to gross. You've reported 4 quarters, the number seems to be kind of all over the place. It was much higher than the past 3 quarters. Can you offer any guidance of what that number might look like going forward? Is the second quarter a reasonable number to look at?

D. Craig Mense
Chief Financial Officer and Executive Vice President

I think we kind of expect the net to gross to be something like 70% going forward on a normal kind of run rate.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

All right. Okay. That's what I have in the model, so that's good. Secondly, I guess just a follow-up on Glass' question, who I do think is crazy most of the time, by the way. I'm sure I will hear from him later. The run-off business. Clearly, you've been at least examining ways of permanently reducing your exposure to this business. And obviously, the conditions have not been conducive to doing a deal. I know, structurally, there's some challenges as well. But do higher interest rates make a difference in formulating, potentially, at some point, some sort of transaction that could eliminate that exposure?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, I think the higher interest rates help in every regard, Jay. They help the outlook for the business itself in a meaningful way, first and foremost, and naturally, they would also make any transaction more attractive.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

I assume you're not getting any closer on such a transaction versus what you've said in the past?

D. Craig Mense
Chief Financial Officer and Executive Vice President

No. We don't have anything to really talk about. I mean, we don't -- we make a point of not speaking about future capital actions. But I don't have anything to tell you about or offer.

Operator

[Operator Instructions] And it appears there are no further questions in the queue at this time.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

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Thank you. We'll see you next time.

Operator
And this concludes today's conference. We thank you for your participation.

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