S&P Capital IQ

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CNA Financial Corporation NYSE:CNA

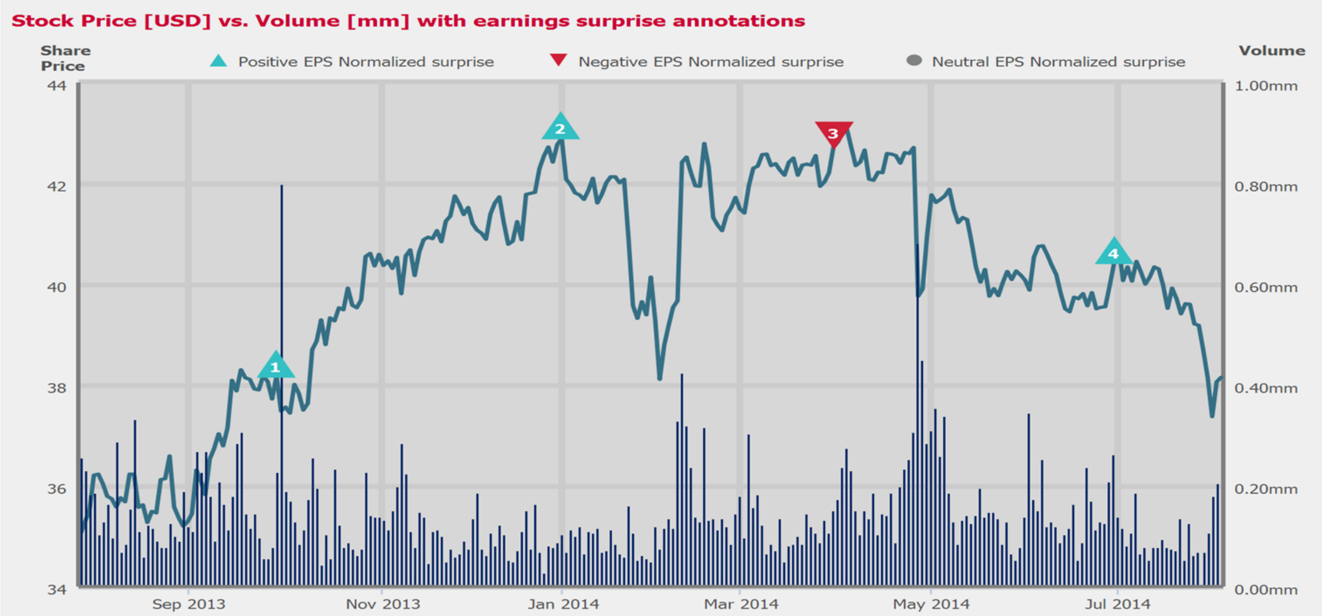
FQ3 2014 Earnings Call Transcripts

Monday, November 03, 2014 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2014-			-FQ4 2014-	-FY 2014-	-FY 2015-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.78	0.68	(12.82 %)	0.88	3.44	3.66
Revenue (mm)	1895.68	1560.00	(17.71 %)	1902.03	7618.21	7903.20

Currency: USD
Consensus as of Nov-03-2014 12:39 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ3 2013	0.76	1.00	1 31.58 %
FQ4 2013	0.87	1.24	2 42.53 %
FQ1 2014	0.83	0.70	3 (15.66 %)
FQ2 2014	0.82	1.00	4 21.95 %

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

Adam Klauber
William Blair & Company L.L.C., Research Division

Christopher Martin

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Joshua David Shanker
Deutsche Bank AG, Research Division

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Presentation

Operator

Good day, and welcome to the CNA Financial Corporation's Third Quarter 2014 Earnings Conference Call. Today's call 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, Noah. Good morning, and welcome to CNA's discussion of our 2014 third 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.

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 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, November 3, 2014. 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 been provided in the financial supplement. This call is being recorded and webcast. During the next week, the call may be accessed on CNA's website.

I would also like to remind you that presentation slides have again been posted on our website to provide additional perspective on our financial and operating trends.

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 today. In the third quarter, CNA produced net operating income of $182 million or $216 million if you exclude the previously announced $34 million charge related to the reinsurance transaction associated with the sale of our payout annuity business. Our operating return on equity for the quarter was 6%. Without the reinsurance charge, our return on equity would have been 7.1%.

Our Property & Casualty combined ratio for the quarter was 96.1%. Excluding catastrophes and development, the combined ratio was 96.2%, slightly higher than last year's third quarter.

We are pleased with the improvement in our Specialty and Commercial underlying loss ratios. The third quarter loss ratios improved compared with the third quarter of 2013. And the year-to-date loss ratios improved compared with the full year 2013.

Specialty had a strong quarter with a combined ratio of 81.6%, which was helped by almost 11 points of favorable loss development. Specialty's combined ratio, excluding catastrophes and development, was 91.8%. Net written premium for the quarter was down 2% due to the termination of an MGA relationship, as we discussed last quarter. Rates increased 3%, consistent with the second quarter, and retention remains strong in the mid-80s.

Commercial's combined ratio was 108.3% for the quarter, which included 7.5 points of unfavorable prior year development, with higher severity in recent accident years for primary general liability being the largest component.

Commercial's combined ratio, excluding catastrophes and development, was 98.9%. Commercial rates increased 4% overall and 5% in the U.S., consistent with the second quarter. Retention improved 3 points from last quarter to the mid-70s.

With that, I will turn it over to Craig.

D. Craig Mense
Chief Financial Officer and Executive Vice President

Thanks, Tom. Good morning, everyone. As Tom mentioned, the third quarter net operating income was $182 million or $0.68 per share, and the operating return on equity was 6%. Our net income was $213 million. Adjusting for the payout annuity reinsurance charge, earnings per share were $0.80 and the operating return on equity was 7.1%.

Our core P&C operations produced net operating income of $241 million compared with $330 million in the third quarter of 2013. The decrease was a result of lower net investment income and a reduced amount of favorable reserve development.

The P&C loss ratio, excluding catastrophes and development, was 62.9%, essentially flat with last year's third quarter as non-catastrophe losses at Hardy offset improvements in Specialty and Commercial. The year-to-date underlying loss ratio was 63.2%, is now slightly more than 0.5 point better than our full year 2013 results. Our third quarter expense ratio was 33.1%, consistent with full year 2013 results.

We continue to be pleased with the performance of our Specialty business. Specialty's third quarter combined ratio of 81.6%, which included almost 11 points of favorable development, was more than a 3.5 point improvement as compared with the prior year quarter. The loss ratio, excluding catastrophes and development, was 61.6%, more than 2 points lower than last year's third quarter.

On a year-to-date basis, the current accident year loss ratio is now almost 1.5 points lower than where we ended full year 2013. The improvements were due to continued refinement of the portfolio mix as well as earned rate increases in excess of loss cost trends. Commercial's combined ratio of 108.3% included 1.9 points of catastrophe losses and 7.5 points of reserve strengthening, as Tom described.

Commercial's third quarter combined ratio, excluding catastrophes and development, was 98.9%, almost 0.5 point better than last year's third quarter. The underlying loss ratio was 64%, slightly better than the prior year period.

On a year-to-date basis, the underlying loss ratio is now almost 1 point better than the full year 2013. We continue to aggressively manage our Commercial book and pursue rate targets that are built upon differentiated pricing tied to expected profitability of individual accounts. Net written premium was down 7% compared with the prior year quarter, reflective of the underwriting actions we have taken.

Hardy had a net operating loss of $15 million in the third quarter, with a combined ratio of 112.9%, including over 4 points of unfavorable premium development. The loss ratio was affected by large aviation losses, which accounted for approximately 13 points plus higher-than-expected attritional losses in our marine cargo book.

Expense ratio increase was driven by the effect of foreign currency exchange rates as well as by costs related to moving to a service company operating model including real estate costs.

The Life & Group segment produced $42 million net operating loss in the quarter, which includes the $34 million charge attributed to a reinsurance transaction tied to the sale of our structured settlement annuities.

As I explained last quarter, in addition to the sale of our life company, CAC, we reinsured a block of annuities from our Bermuda subsidiary to Wilton Re. The transaction was structured on a funds withheld basis, meaning that we maintain legal ownership of the assets associated with the transaction but Wilton Re assumes the economic risk.

At the inception of the contract, the market value of the assets was $34 million higher than the $150 million book value, causing us to recognize a $34 million loss. Over time, we would expect the $34 million loss on reinsurance to unwind as the assets are sold or mature and their gain or loss is recognized.

Excluding the impact of the payout annuity reinsurance transaction, the Life & Group loss for the quarter was $8 million compared with the $33 million loss in the third quarter last year. The improvement was driven by improved results in our long term care business, which was favorably affected by morbidity, rate increase actions and persistency. Results also benefited from higher net investment income due to a higher invested asset base.

Our Corporate segment, which primarily includes corporate expenses, produced a net operating loss of $17 million compared with a $26 million loss in the third quarter of 2013. The improvement was driven by a reduction in the allowance for uncollectible reinsurance receivables.

Our investment portfolio's pretax net unrealized gain stood at approximately $3.2 billion at quarter end, roughly equivalent to the end of the second quarter. Our statutory surplus at quarter end was $11.4 billion. 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 $1 billion at quarter end, up significantly from 2013 year end due to the proceeds for the February debt offering to prefund our upcoming December maturity.

In the third quarter, operating cash flow, excluding trading activity, improved to approximately $460 million. Cash principal repayments through pay downs, bond calls and maturities were approximately $950 million.

Third quarter after-tax net investment income of $346 million decreased $40 million from the prior year results, driven by limited partnership income, which returned 1% versus 3.5% in the same period last year. Overall, portfolio allocation did not change significantly in the third quarter.

Average credit quality of our fixed maturity portfolio remained at A. Fixed income assets that support our long-duration lifelike liabilities had an effective duration of 11.1 years at quarter end. The effective duration of the fixed income assets which support our traditional P&C liabilities was 4.1 years at quarter end. These durations are both in line with portfolio targets.

Overall, our investment portfolio remains well diversified, liquid, high-quality and aligned with our business objectives.

Before turning it back to Tom, I want to highlight a pension settlement charge that will flow through our fourth quarter financial results. We recently offered a lump sum payment opportunity to about 11,000 vested pension plan participants who are no longer employed by CNA. The high end of the estimated range of the after-tax charge, which is dependent on the participant acceptance rate of the offer, is approximately $65 million. The charge will be recognized when the lump sum payments are made from the pension plan assets in December.

The corresponding charge associated with the settlement will have no effect on shareholders' equity as the settlement charge represents immediate recognition of the proportional share of prior unrealized actuarial losses already reflected in shareholders' equity.

With that, I will turn it back to Tom.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Thank you, Craig. Before we take your questions, I would like to offer a few comments on the current state of the market and on our European operations.

Since we spoke in August, there has not been a change in our view of the market. We continue to see limited exposure growth and competitive pricing with some lines of business more aggressive than others. However, our strategy has not changed. And more importantly, our underwriting improvement in recent years is not solely based on rate increases.

We continue to achieve underlying loss ratio improvement in Commercial and Specialty as we shift our book to higher-margin business and exit poor performing accounts and classes. For example, since 2011, we have successfully changed our mix of business in the U.S. from 73% in our focus segments to 80% so far this year.

We have also demonstrated discipline in our approach to new business where our reduced volumes reflect our willingness to avoid inadequately priced opportunities.

Earlier, Craig discussed our transition to a service company operating model for CNA Europe and Hardy. This was one element of a broader strategy to streamline our international management, which was further enhanced in August by the appointment of David Brosnan as chief executive of CNA Europe and Hardy, with oversight of CNA Canada. This new operating model will facilitate our ability to efficiently serve the Lloyd's market, the European local markets and the unique and expanding needs of multinational customers.
With that, we will be glad to take your questions.

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

A couple of questions. The first is, I've had several quarters now of adverse development in the Commercial segment after years of that segment being, I guess, relatively benign from a loss standpoint in fact seeing favorable development. And I was just wondering if you can talk a little bit more about what you're seeing. And did you make sort of an effort to get all this behind you? Is there a concerted effort in this quarter to say, "Hey, let's try to nip this in the bud?"

D. Craig Mense
Chief Financial Officer and Executive Vice President

Jay, well, the answer to the last question is no. So there's no concerted effort to try to pile on or nip it in the bud. I think what, a similar question was asked of us last quarter. And you could count us, and hopefully, we have a reputation that we act on things as we see them. I think what's kind of plagued us here in Commercial has been, you know, we've gotten out of a number of businesses that we thought were unprofitable. Those have continued to be even a little worse than we thought they were. And that bleed has been little slower, has continued and even contributed a bit to this quarter. This quarter's results in Commercial were driven primarily by general liability severity, which is something that surprised us in terms of the direction, it was headed, as we really shifted our book from less of a premises ops book to things that have more severity. So I think that's a bit of -- that is, was an action to catch-up in our perspective going forward. So we're disappointed by having to report these, and we work hard to get our reserves accurate all the time. And we think we have acted appropriately to bring -- so we're not, certainly, not holding back on anything.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes, I think I would just add to that, Jay, that last quarter, we talked about Commercial auto. And that has popped its ugly head for the industry, so I don't think that was anything unique to us. But we recognize it and we are dealing with it. The good news is, it's a small portion of our book today, gets smaller all the time. The international work comp, which we have exited most of it, we are still paying the price for some of that but once again, it was one of our exit strategies to get out of that business. So I think we're dealing with the things in a timely fashion when they come up. But clearly, severity has been the issue. It has not been frequency. And if you look at our claim counts, our claim counts are dropping both on the outstanding number of claims as well as new arising claims. So I think it's a reflection of the changing mix of business. But we are paying for sins of the past.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Got it. And I guess because a lot of the reserve changes you made were in businesses that you've exited, it doesn't have much of an effect on your current year accident pick then?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, the general liability does, yes. So you're right about the majority in the past and in the past calls. But certainly, the geo -- the look at geo severity does have an effect on our pick in the current accident year. So in other words, it would have improved more if not for the reflection of this severity.

Jay Adam Cohen

BofA Merrill Lynch, Research Division

Got it. And then the second question, I guess we're seeing premiums falling now in all of your segments, and part of that is obviously underwriting discipline, which is what we don't want to see. For many companies when premiums start to fall, which obviously is potentially a negative from a profitability standpoint, the -- one of the options they have is to well, there's a free-up capital, we can buy back stock. That's not much of an option for you. Obviously, you have other capital management leverage you can pull. My question is, does it free up capital for you? As you see premiums going down and your business mix is changing, and that can change your capital needs too, is this affecting your view of how much capital you need?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Yes. So obviously, it's -- that growth or prospects of growth are a significant input to our capital plans and capital perspectives going forward.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Okay. I saw the -- well, that's it for now. I'll circle back if I have other stuff.

Operator

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

Christopher Martin

It's Chris Martin today. So the one question we have is, sort of, as we get closer to 1/1 and what potential changes you might be thinking about for your reinsurance purchase? With the current reinsurance pricing where it is and how some of this pressure and some of the more favorable terms have started to show up in the cash line, may be you start re-thinking about any changes in how you purchase that moving forward?

D. Craig Mense
Chief Financial Officer and Executive Vice President

We are certainly actively engaged and paying attention to what's going on in the reinsurance market, but we don't have any -- no plans at this moment to be buying anything differently. Our casualty -- you referenced casualty, you see how profitable our Specialty business is, which is highly casualty, so doesn't seem to make much sense to us to give away that profit. Given the diversification we have in the book, the typical desire of reinsurance purchases is to shed severity and volatility, no reason to think about doing it. So we're in the midst of negotiating or beginning to plan for the negotiations of the renewal of our property cat treaty and we buy a work comp for cat treaty and those are underway. But as we look at it, we don't see anything that would be particularly attractive or add to the value of CNA longer-term in the reinsurance market.

Christopher Martin

Got it. That's really helpful. And then just a second thing. In the Hardy business, you've mentioned, I think you said there were 13 points of -- were attributed to the aviation losses. Can you sort of talk about what may be other lines that you said had higher than average attritional losses?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, the other lines that had higher attrition losses were marine cargo, so had quite a few cash-in-transit type losses over the quarter.

Christopher Martin

And how many points then that would be about?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, that -- the aviation losses -- in total, both of them were about $20 million worth of losses, so whatever the delta is between that, that 13 points.

Operator

We'll take our next question from Bob Glasspiegel with Janney Capital.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

What was the adjustment in the receivables on collectible reinsurance?

D. Craig Mense
Chief Financial Officer and Executive Vice President

It was about $14 million less reduction.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Okay. In the Wilton Re, would you have a pretax number for that?

D. Craig Mense
Chief Financial Officer and Executive Vice President

That pretax was 36. So pre and after are about the same thing, Bob, because it was Bermuda. And I think if you went back and look -- I think we had a slide detailing it in the last quarter.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Okay, will do. How would you handicap the likelihood of a special dividend going forward?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, maybe the best way to answer it is that, sure Jay was trying to get at that earlier that, we sat around and talked about it. We recognize that we start with a very strong capital position at the company. The earnings, even though they haven't been quite as high as we -- Tom and I would like them to be, they've been consistent and very steady. We'd love to see an opportunity to put that capital that we're continuing to accumulate to work, to grow the business, but I would say there's no potential for that at the moment as we're looking out for it. So at the end of the year, we'll complete our review of -- at year end '14 and what the '14 results were. We'll add in what our outlook is for '15. And then we'll decide whether and what to do with the common and/or a special dividend.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

Okay, that's a thoughtful answer. Finally, on long term care, you do a great job in the K and Q of sizing up the various sensitivity analysis. I can't remember if you do a year end review or it comes up periodically. But it seems like you got interest rates lower but experience in pricing improved. If you had a sort of weigh the battle those 2 countervailing forces, does it come out sort of more positive, more negative or stay tuned?

D. Craig Mense
Chief Financial Officer and Executive Vice President

Well, we do -- well first, you're right. We do, do a -- our gross premium valuation review in long term care in the fourth quarter. We did complete the claim review of long term care in the third quarter. And the outcome of that was actually a slight positive change on about $2 billion of reserves. The gross premium review is underway. As you said, the big components are morbidity. I wouldn't, given our results over the last year, I wouldn't expect any adverse from morbidity. Persistency, even though it's been better this year than last, it's still running a little worse than what our expectations would be. And interest rates, as you said, will be the biggest driver. So you know what the -- I mean you can look up, and you can see the difference in the spot rate on the 30th, is almost 50 basis points lower September 30 this year against September 30 a year ago. But we're really looking at the forward curve. We're thinking about it, which would be a bigger delta. So that will be the bigger driver of the outcome. And all things being equal, we'd expect some pressure on margin coming out of that interest rate review. But I can't tell you what the outcome is exactly.

Robert Ray Glasspiegel
Janney Montgomery Scott LLC, Research Division

I thought there was a fourth factor, which is the price increases that you're able to get...

D. Craig Mense
Chief Financial Officer and Executive Vice President

Yes, those [indiscernible] and yes, that's true and those are slightly better than we expected.

Operator

We'll take our next question from Josh Shanker with Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

Over the last couple of years, you've obviously focused on weeding out businesses that you -- that CNA didn't have a, necessarily, value-added edge on. When you look at the portfolio today, how far are you in terms of getting -- or weeding out those businesses do you think that you are? Is the CNA portfolio a enviable collection of businesses? And if so, why do you think that the gap is so persistent between your pricing and your peers' profitability on the writing at this point?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes, I think we still believe in the focus segments. We think they are the right places to be, and we're not going to change any direction on that at this time. I would say this, that the industry has gotten rate, and that rate has probably helped everybody to a large degree. But as I said in my remarks and I believe Craig said the same thing, we're really trying to manage the mix of business or think of lines of business within that segment. We're really trying to do a much better job tiering the best customers from the least profitable customers. So it is work in progress, but we think we're getting more sophisticated at it. And as we put more analytics in place to really analyze what the exposures are for these customers, we think it's moving in the right direction. As Craig mentioned, the loss ratio improvement is a little slower than we would like. But it still is improving, and we are throwing out this legacy business, which has hurt us. But we expect we'll continue to push into the segments and we will do better over time. We think we have the expertise to do that.

Joshua David Shanker
Deutsche Bank AG, Research Division

Do you think just that analytics setup there, if the markets generally stayed stable with what you have in place right now, there is margin improvement, you found -- just in letting things play out as you set them up today?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes, I think we told you about rates for the quarter. Rates are still pretty good. Actually in Commercial, September was the best month of the third quarter. And if we looked at October, October looks pretty good.

Joshua David Shanker
Deutsche Bank AG, Research Division

[indiscernible] out rates?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

I didn't hear you.

Joshua David Shanker
Deutsche Bank AG, Research Division

I'm sorry, without rate. Can you achieve margin expansion without rate?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes, that's the whole issue of tiering, in other words, figuring out which are the best accounts and how you keep them. And the ones that aren't that good, you get rid of. That's what you call lost business. So we think there's room there and also managing the mix. So we have accounts that may have hurt us from a workers' comp or auto perspective. And we find ways to try to keep the best pieces of the account, throw out the worse. So all work in progress, would be pretty consistent with what other markets do with their business and how they manage their portfolio. But mix of business is a big deal. One example is, less blue collar work comp and more white collar work comp, which affects the proportion of business we write in some white collar industries, whether that be law firms, financial institutions, et cetera. So that's a lot of behind-the-scenes stuff, but yes, we think that's all going to help and continues to help. We get better at it.

Operator

We'll take our next question from Adam Klauber with William Blair.

Adam Klauber
William Blair & Company L.L.C., Research Division

A follow-up on data and analytics. What are sort of the next steps in 2015, 2016 as far as rolling out better data and analytics?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Well, as you know, it's a very big area. People talk about big data. You got to kind of distill that down to the ground. But we are looking at data and analytics that helps us assess risk, so that's kind of on the underwriting side as well as on the claims side. How can we get people back to work sooner? Or what can we see relative to claims that can be helpful? We do have some pretty good analytics in Specialty, and our Specialty results we're pretty proud of. We have a tool now that we've rolled out on automobile, which is a troubled line for us, so we expect to see more improvement in auto, although it is a small line for us as overall percentage. So auto and work comp are 2 areas that seem to be, as well as some of the Specialty lines, whether you look at lawyers or some other areas. The fact is, these are all things that are going to help us make better decisions as to what business we keep and how we price it.

D. Craig Mense
Chief Financial Officer and Executive Vice President

Adam, this is Craig. So it is a ongoing -- think of it as more ongoing than some fundamental add and replace. So we're probably in second generation of both predictive tools and pricing mechanisms, and this has now become an annual updating and perspective and improvement. So there are some fundamental things we're always building and improving, like we introduced a new property product and new property pricing a year ago and a new GL pricing this year and a new GL product that goes with the property product next year. Together, we do the same with auto, but I think of it really more in terms of the continuous iterative improvement that Tom was referring to. So we're generation 2 and we're actively working on generation 3 and making sure that, that's something that's built into the fabric of the place that we do as part of the regular rhythm rather than as an event.

Adam Klauber
William Blair & Company L.L.C., Research Division

Okay. And then, do acquisitions become more likely, given 2 things: one, within P&C there's really very, very little growth out there; and two, you continue to do a good job of narrowing your focus. So does that give you more room to do acquisitions more in your focus, probably not out of your focus but in your focus?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Yes, I would say we always have our eyes open as to what might be out there. We have said for a long time that we prefer to do something that is a bolt-on, which we define as less integration risk. So whether that was CNA Surety or that was Hardy, but there really was no chaos around making those acquisitions. So we like things like that. And we've gotten rid of things that didn't fit the strategy going forward. So we keep our eyes open. We have to assess the risk of buying anything. But quite honestly, the first and foremost objective is we want to do a better job with our portfolio. And that's where we're focused. And if something meets our eye and we like it and we think it will help the profitability of the firm, we will make a decision.

Adam Klauber
William Blair & Company L.L.C., Research Division

I guess is there a pipeline of potential deals out there that would make sense? Or is there just not a good group? I mean, there's always deals out there, but is there just not a reasonable pipeline out there?

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Let's put it this way. We got lists. Everybody has a list. We have lists. The question is do they want to sell? Is it the right fit? What is it going to cost? Is it going to increase the shareholder value over time? All of those questions have to be answered. So -- but we have a pretty good idea what's going on out there. And I think as the market continues to become less driven by rate and margins may be become compressed for some, some companies may think about their future differently, and we're willing to talk to people. So -- but I think in this kind of low growth environment, you are going to see more M&A going forward. I think that's true unless all of a sudden rates go up and the economy booms and exposure goes up and all of that kind of stuff. But don't see that myself.

Adam Klauber
William Blair & Company L.L.C., Research Division

Right. And then just one follow-up. I think you said, the competitive conditions really haven't changed. I think you said you're having a good September. Would you say that is the Commercial more competitive than the Specialty or you're not seeing really a differential? I know each line is different but [indiscernible].

Thomas F. Motamed
Former Chairman and Chief Executive Officer

Well, you said that each line is different. Everybody wants to be in the Specialty business. It's got a nice ring to it. So there is a lot of competition in Specialty and somebody nipping at your feet on lawyers, professional or something else. But I don't think it's really changed much. And the one thing I look at is everybody is trying to retain their business. There's very little good new business opportunities out there, at least from our standpoint, what we see coming out is fairly distressed. There really isn't a lot of good stuff. So people are putting their renewals to bed earlier and trying to keep their retentions up and get some rate. And I think that's what we saw in the third quarter and we saw it in the second quarter. And I expect the fourth quarter will look much like the prior 2 quarters.

Operator

[Operator Instructions] We'll take our next question from Jay Cohen with Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Yes. Just from a modeling standpoint, the -- obviously, you made a lot of changes at Hardy from an expense standpoint, and in fact, the underwriting expenses, your overhead expense there have come down quite a bit. Question I have is, is the number we're seeing in the third quarter, is that, in your view, a reasonable run rate to look at going forward or will there still be a downward trend?

D. Craig Mense
Chief Financial Officer and Executive Vice President

There will still be a downward trend but not -- we haven't completed the real estate moves and some other people-related moves that would add some expense to the fourth quarter. But in '15, that expense ratio should start coming down pretty considerably. It is about -- there's an FX impact in that number right now, which is pretty meaningful. There's about 1.5 points, a little less than 1.5 points of those integration combination cost in there this quarter. But that's -- we would expect that to improve considerably but not until '15.

Operator

[Operator Instructions] And with no further questions at this time, I'd like to turn the call back to Tom Motamed for any additional or closing remarks.

Thomas F. Motamed
Former Chairman and Chief Executive Officer

See you in 2015. Thank you.

Operator
This does conclude today's conference. Thank you for your participation.