S&P Global
Market Intelligence

The Hartford Financial Services Group, Inc. NYSE:HIG

FQ3 2009 Earnings Call Transcripts

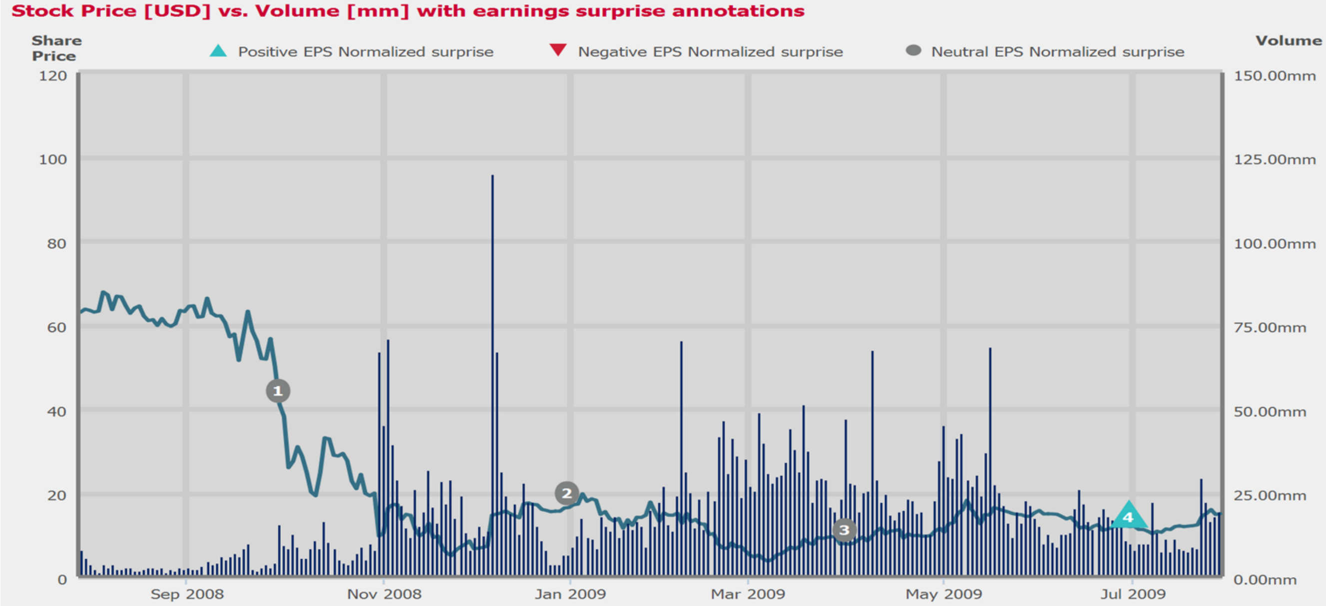
Wednesday, November 04, 2009 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2009-			-FQ4 2009-	-FY 2009-	-FY 2010-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.42	1.56	▲9.86	0.88	0.63	3.79
Revenue	-	-	▲(14.68 %)	-	-	-
Revenue (mm)	6130.00	5230.00	-	6206.00	26018.00	25008.00

Currency: USD
Consensus as of Nov-04-2009 12:42 PM GMT

Stock Price [USD] vs. Volume [mm] with earnings surprise annotations



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2008	(1.45)	(1.40)	NM
FQ4 2008	1.30	(0.72)	NM
FQ1 2009	(3.14)	(3.66)	NM
FQ2 2009	1.16	1.90	▲63.79 %

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Call Participants

EXECUTIVES

Greg McGreevey

John Walters

Juan Andrade

Liam McGee

Liz Zlatkus

Rick Costello

ANALYSTS

Ed Spehar
Bank of America/Merrill Lynch

Eric Berg
Barclays Capital

Ian Gutterman
Adage Capital

Jay Cohen
Bank of America/Merrill Lynch

Jeff Schuman
Keefe, Bruyette & Woods

John Nadel
Sterne Agee

Paul Ferrian
No Company Listed

Tom Gallagher
Credit Suisse

Presentation

Operator

Welcome everyone to The Hartford third quarter 2009 earnings conference call. (Operator Instructions) Mr. Costello, you may begin.

Rick Costello

Good morning and thank you for joining us for The Hartford's third quarter 2009 financial results conference call. Our earnings release, 10-Q and financial supplement were issued yesterday. In addition, the slide presentation for this morning's call is available on our website. Liam McGee, our new Chairman and CEO and Liz Zlatkus, CFO, will provide prepared remarks this morning and we will conclude with Q&A.

Also participating on today's call are Juan Andrade, President and COO of our P&C company; John Walters, President and COO of the Life company; Greg McGreevey, Chief Investment Officer; and Alan Kreczko, General Counsel.</TAG>

Turning to the presentation on slide two, please note that we will make certain statements during the call that should be considered forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These include statements about The Hartford's future results of operations. We caution investors that these forward-looking statements are not guarantees of future performance and actual results may differ materially. Investors should consider the important risks and uncertainties that may cause actual results to differ, including those discussed in our press release issued yesterday, our quarterly reports on Form 10-Q, our 2008 annual report on Form 10-K and other filings we make with the Securities and Exchange Commission. We assume no obligation to update this presentation, which speaks as of today's date.</TAG>

Today's discussion of The Hartford's financial performance includes financial measures that are not derived from Generally Accepted Accounting Principles or GAAP. Information regarding these non-GAAP and other financial measures, including reconciliations to the most directly comparable GAAP measures, is provided in the Investor Financial Supplement for the third quarter of 2009, in the press release we issued yesterday and in the Investor Relations section of The Hartford's website, at www.thehartford.com.</TAG>

Now I will hand the call over to The Hartford's Chairman and CEO, Liam McGee.

Liam McGee

Thank you Rick. Good morning everyone and thank you for joining us for our third quarter earnings call. First, it is an honor to take the helm of The Hartford, a 200 year old company with a great heritage and future. I have been warmly welcomed by The Hartford team and have met many talented and dedicated leaders. I also want to thank Ramani for his help in making the transition smooth and constructive.

Having been CEO of The Hartford for just a month I will focus my remarks today on some observations and initial perspectives. Then Liz will cover the third quarter results.

I have spent the last month diving head first into all key areas of the company to develop an understanding of the business, our strengths, the challenges we face and the opportunities we have. I have met with many of our key stakeholders including some of you. What I have found is that this company's operating franchises are stable and performing well. The company today has a strong capital foundation and although we do face some challenges I am confident that The Hartford with its strengths is focused on the path forward to earnings and growth.

The Hartford's third quarter core earnings demonstrate a resilient company that is emerging from the challenges of the last 18 months. As we reported yesterday core earnings were $660 million and many of our new business indicators are showing stabilization or sequential improvement. The third quarter results demonstrate just as we saw in the second quarter that our protection and wealth management businesses are stable and competing vigorously in our markets.

There are other signs of The Hartford's stability. I have experienced firsthand the strength of our distribution relationships and the commitment of our employees. I believe the support and conviction of these two important groups have been key to the resilience and the stability of the franchise.

As an example, a few weeks ago I attended CIAB, a national conference that brings together many of the largest P&C brokers and agencies in the industry. I joined in-depth business reviews with a number of our largest partners and spent time with many more over the course of two days. In doing so I witnessed firsthand the quality and depth of the relationships we have with these critical partners, who are the largest producers in the industry. They have great respect for The Hartford and value our people, products and services and we will continue to invest in and protect these important relationships.

I came away knowing that our partners want to do business with us. In fact, many want to do more business with us and I am confident there are opportunities for us to win more of their business and deepen our relationships.

The morale and winning spirit of our people have contributed to this stability. I have met many of my new teammates not just here in Connecticut but in offices around the country. My general observation is that our employees are of the highest quality and are passionate about The Hartford. They want the company to succeed and for us to win in the marketplace.

In short, our franchise is stable.

Today The Hartford has a strong capital foundation. The company has taken decisive action to strengthen its capital position including the $900 million common equity raise completed in August. It is from this solid base that we are updating our capital plan which we look forward to sharing with you in early 2010. Liz will provide more details about capital in a few minutes.

While I am confident in our strengths, I am also realistic about our challenges. Although there are some early signs of improvement the fundamentals in the economy remain weak and we believe that is not likely to change in the near-term. Therefore, we are assuming a slow and choppy recovery in our planning for 2010 and beyond. Like many in the industry we saw the impact of the economic uncertainty in our results in the third quarter. Companies have reduced payroll and other discretionary expenditures. These conditions negatively impacted premiums results in our commercial P&C and group benefits businesses.

At the same time, personal lines grew written premium 2% in the quarter as we increased our policy count in auto and home. Small commercial new business written premium was up 20% in the quarter. In the Life Company our retail mutual funds business continued to take share with over $3 billion in deposits as we benefit from strong 2009 investment performance across much of our fund family.

While the top line has been affected by the economy, core earnings remain strong due to our disciplined pricing and risk selection. You can see that in our results. We continue to work through the challenges in our investment portfolio. A handful of asset classes, primarily structured securities backed by residential and commercial real estate and financial corporate still trade well below our estimate of economic value. Importantly, however, our investment portfolio is improving. With a sharp recovery in the credit markets in the third quarter our net unrealized loss position improved about 50% to $5.8 billion.

Over the past month a dedicated team has accelerated its work to optimize the management of these particular asset classes. We have re-underwritten some of the highest risk securities and we continue to evaluate our options with our eye on maximizing long-term economic value.

The Hartford is focused on moving forward by leveraging our strengths and developing new approaches to winning in the marketplace. We had a few examples in the third quarter. In the wealth management business we were pleased with the launch of our personal retirement manager variable annuity in October. We believe this is an innovative, first mover approach to the growing retirement market, one that effectively offers guaranteed income to clients in a simple way and with greater value. This product is good for our customers and good for The Hartford. It has an improved risk profile because the income guarantee is not tied to movements in the equity markets and initial third-party feedback has been positive.

In the auto and homeowner lines, the strategy to sell our AARP product to the agency channel continues to go well. The product was in 14 states at the end of September and we will roll it out to 6 more states in the fourth quarter. We are excited about the growth potential of this initiative.

Finally, we have completed the strategic review of the various institutional life businesses. We will focus on a smaller group of core businesses; payout annuities, institutional mutual funds and corporate owned life insurance which will be incorporated into existing businesses and managed for profitable growth. The remaining institutional life businesses which are non-core will be wound down over time.

Now I want to close with actions I am taking and to make clear what you can expect from me. My first priority is to deliver superior returns to shareholders. So I will continue with my comprehensive evaluation of all key areas of the company in order to create the go-forward plan for The Hartford. We will communicate our plan in early 2010 including details on our business portfolio, capital strategy, risk management and how we will deliver sustainable, profitable growth over the long-term. As investors and analysts who cover us you should expect from my team and me transparency, clear goals and metrics and accountability.

Improving risk management is one of the most important properties of The Hartford. As you know, we announced last week that Liz Zlatkus will assume the Chief Risk Officer role. The creation of a separate risk management function with enhanced management and governance particularly on aggregate enterprise risk and with increased board visibility and transparency is an important first step. I am pleased that Liz with her deep industry and company knowledge along with her finance and operating experience will be leading that effort.

Liz will continue as CFO until a new person is hired. We have retained a search firm and the search is underway. The Hartford has tremendous potential and I am confident we have the capabilities and opportunities to create great value for our shareholders, customers, partners and employees.

So in summary, our franchise is stable and performing well. The company today has a strong capital foundation and although we do face challenges The Hartford is focused on delivering superior returns through sustained, profitable growth. I am excited about the opportunities ahead.

With that, I will turn the call over to Liz.

Liz Zlatkus

Thank you Liam and thank you for your comments. Good morning everyone. Let’s begin on slide three. Book value per share jumped to $37.90, an 18% sequential increase driven by spread tightening on our fixed income investments and a decline in interest rates partially offset by additional shares from our equity raise in August.

We reported a net loss of $220 million in the third quarter driven by an after-tax net realized capital loss of $885 million. The primary component of the realized loss in the quarter were after-tax impairments of $336 million and a $435 million mark to market after tax loss in our variable annuity hedging program. Rising equity markets would typically benefit our statutory capital position caused most of the [GAAP] hedging loss.

Third quarter core earnings were $650 million or $1.56 per diluted share as both our property and casualty and life operations generated sequential earnings growth. Core earnings benefited from a $232 million DAC unlock reflecting positive equity market performance particularly in the United States.

Now please turn to slide four. Our property casualty businesses are executing very well. P&C earnings for the quarter were quite strong as disciplined underwriting continued to drive profitability. For the quarter we reported core earnings of $246 million, 16% higher than the second quarter and significantly higher than the prior year period. Our third quarter results reflected very solid X-CAT current accident year combined ratio of 93.8%. Year-to-date that ratio stands at an excellent 91.4%.

Now there were a lot of puts and takes in the quarter in terms of cats, prior quarter and prior year reserve development and other adjustments. Netting all of those results gets you the reported combined ratio of 93% for the quarter, a solid result.

Loss cost remained within expectations with the exception of personal lines auto frequency. Like others in the industry we have seen a turn in auto frequency likely due to an increase in miles driven. We have been taking rate and underwriting actions in response.

Finally, third quarter earnings were affected by reserve strengthening and other operations. We conducted our annual environmental reserve study and strengthened net reserves by $75 million on a pre-tax basis as compared to $53 million in the third quarter of 2008. Increased severity and higher loss adjustment costs drove this result.

In terms of the top line written premiums for the third quarter were $2.4 billion. The economy continues to be a challenge to our commercial lines in terms of premium growth as the recession has reduced the industry's exposure base. However, in smaller commercial accounts we are seeing early indications of stabilization in mid-term cancellations and endorsements. More broadly we believe the effects of the economic downturn on written premiums will begin to taper off in 2010. At the same time we are seeing signs of momentum in new business across all segments. This was particularly true in personal lines and small commercial where we reported new business increases of 26% and 20% respectively on a year-over-year basis.

Looking ahead we are committed to executing on the keys to our success; underwriting discipline, developing and enhancing our products and services offerings and positioning the company to take advantage of the opportunities when the market and the economy turn.

Now let's turn to our life results on slide five. Our life operations showed improved earnings in the third quarter. Rising equity markets pushed account values higher and contributed to an 11% sequential increase in assets under management. Core earnings for the quarter were $499 million and benefited from a $231 million DAC unlock. Stabilization in our franchise and rising equity markets have increased the underlying profitability of the company. Core earnings excluding the impact of DAC unlocks nearly doubled from the second quarter of 2009, a positive sign that margins and our equity sensitive businesses are recovering from the market lows earlier this year. We also benefited from favorable mortality in the quarter in our group and individual life businesses.

Now let's move to some of our wealth management businesses. In the third quarter we posted $622 million of VA deposits. Looking forward we expect VA sales to slow somewhat as we transition to the new products that Liam mentioned earlier. In mutual funds we had another excellent quarter with deposits of $3.1 billion. That is two quarters in a row with deposits over $3 billion. Sales momentum is being driven by our strong distribution and superior relative performance with 65% of the funds having outperformed their Morningstar peers year-to-date.

With the benefit of positive net flows and market depreciation we are seeing margin expansion in our mutual fund business with an annualized ROA above 11 basis points in the third quarter, the highest level in over a year.

Turning to our group benefits business, profitability was strong in the third quarter with a loss ratio of 69.4%. We benefited from favorable mortality in the quarter. We are still not seeing any change in claims behavior or severity due to the recession and we are continuing to maintain our full-year loss ratio outlook. However, the top line in GBB has been affected by lower payrolls. Fully insured premiums declined 4% from the prior year. With the unemployment rate approaching 10% carriers are chasing fewer available premium dollars and pricing has become even more competitive. Of course, as you would expect we are maintaining our price discipline in this environment.

Finally, group benefits reported third quarter sales of $122 million, 23% lower than the third quarter of 2008. Persistency remains solid but the next two quarters are likely to be difficult comparisons in terms of new sales due to the pricing environment as well as the strong numbers we posted in the prior year.

In summary, The Hartford's improved capital strength and rising equity markets contributed to strong core earnings and increasing stability in our life operations.

Now I would like to discuss our capital position as of the end of September. I will be working from slides six and seven. These are updated versions of slides we used for our second quarter earnings call. A number of investors found the second quarter slides useful so we have stayed with that format.

In property casualty statutory surplus increased about $400 million in the third quarter to $6.8 billion. This was primarily driven by strong statutory operating income as investment losses were minimal. In our life operations we finished the quarter with statutory surpluses of $6 billion, down slightly from the end of the second quarter. The decline was driven by investment related impacts of about $500 million primarily reflecting impairments. This was largely offset by statutory capital generated by our variable annuities and other life businesses.

Now please turn to slide seven. Slide seven updates our capital sources and potential uses for the second half of 2009. This slide demonstrates two points; first and most importantly we continue to have a capital position able to withstand a sharp decline in the equity markets as well as significant capital impact from our investment portfolio. Second, our capital position was strengthened in the third quarter with the completion of our $900 million equity raise. You can see that in our total capital sources increased to $9.9 billion.

Now move to the potential uses of capital which is shown on the bottom half of the slide. Our estimate for VA impact is about $1 billion, down from the prior estimate of $1.3 billion. This improvement reflects the benefit of a higher year-end S&P assumption partially offset by higher macro hedge costs and higher initial capitalization of our on-shore captives. We are pleased to have recently obtained all of the necessary regulatory approvals for our captives and we expect it will reduce the volatility of our capital requirements in the fluctuating equity markets.

You will also see on slide seven we have not changed the $1.6 billion assumption for investment related capital impact for the second half of 2009. Total capital impact recognized in the third quarter were about $600 million. In addition the estimated year-end capital impact of ratings downgrades through the end of the third quarter is about $200 million so we are going to stay with the original $1.6 billion second half provision. Looking to 2010 we would expect significantly lower capital impact from our investment portfolio as compared to 2009.

Moving down the slide we continue to include the expiration of our deferred tax asset permitted practice as a potential use of capital. As many of you know the NAAC may grant industry wide DTA relief. If they grant relief for both the life and P&C industries the capital benefit for us would be about $300 million. The last number that has changed since the second quarter is the estimated incremental capital need in event the S&P were to fall to 700 at the end of the year. This decline from $2.1 billion to $1.7 billion. This improvement was primarily driven by the additional macro hedging and the increased funding of the captives I just mentioned.

Of course there will be changes, potentially positive or negative to our reserves and required capital at the end of 2009 based on capital market conditions and other factors as well as cash flow testing results and the final determination of risk based capital requirements including C3 phase I and C3 phase II. These may cause final results to significantly deviate from these projections.

Now please turn to slide eight to discuss guidance. As you saw in our press release we have increased our full year core earnings guidance to a range of $0.85 to $1.05. This equates to a range of about $0.65 to $0.80 for the fourth quarter of 2009. The fourth quarter range assumes an average of 423 million shares outstanding as the shares we issued in August will be fully reflected for the first time in the fourth quarter.

Our range also assumes $110-120 million in pre-tax losses on limited partnerships and other alternative investments in 4Q driven in part by losses on real estate limited partnerships. The guidance also includes an estimated $30 million after-tax charge in the fourth quarter related primarily to the restructuring of our life operations.

In summary, the third quarter demonstrated the strength of our franchise. We delivered greatly improved core earnings in both life and P&C and with our successful equity raise our capital position is even stronger.

With that I will turn the call over to Rick to begin the Q&A session.

Rick Costello
Thank you Liz. Before we begin the Q&A session I would ask each caller to limit himself or herself to two questions. This will allow us to get to as many callers as possible. Operator you may now open the call to questions.

Question and Answer

Operator

(Operator instructions) The first question comes from the line of Ed Spehar - Bank of America/Merrill Lynch.

Ed Spehar
Bank of America/Merrill Lynch

I have a question on the Japan business. I think a lot of us have been trying to figure out why you took as much of the TARP as you did and I think some speculation has been around the fact that Japan was not hedged. I am wondering, you talk about the additional benefit from increased macro hedging in the U.S. and I am wondering if you could update us on what your thoughts are surrounding hedging in Japan.

Liz Zlatkus

I would look at Japan in two ways. First, we reinsure over 50% of the risk to the U.S. and so our macro hedging does help cover that risk. So when we look at the capital requirements you see in slide seven you can see we have more than enough capital and our hedging results do help the Japan risk.

In terms of what is left in Japan we do have some risk that is left in Japan. The amount of capital we have there is very positioned. In fact if you look at kind of a global equity market decline it would be consistent with S&P falling down to 700 we would still have more than sufficient capital in Japan to cover that. So all in I think we are managing this in terms of hedging on a macro hedge side which does cover a lot of the spanned risk as well as having the excess capital that we have.

Ed Spehar
Bank of America/Merrill Lynch

If you chose to fully hedge, given the fact that you have decided to exit Japan if you chose to fully hedge as best you could the risk in Japan how much additional, what would be the additional expenditure. Could you give us any sense?

Liz Zlatkus

I would say we look at that all the time and what we think is we have the right balance. As you know overall cost of hedging while it declined from the highest levels are still very expensive so I would say we think it is prudent in terms of the amount of hedges we have on the books as well as the excess capital that we have.

Ed Spehar
Bank of America/Merrill Lynch

More expense than keeping as much of the government money as you have now?

Liz Zlatkus

Again we look at the money that we received from TARP as to help manage not just for equity market declines and the Yen strengthening but also as we look at the commercial real estate market and how that will unfold.

Operator

The next question comes from the line of Tom Gallagher - Credit Suisse.

Tom Gallagher
Credit Suisse

Another question on hedging. You talked about how you have reduced volatility in part based on macro hedging. Can you talk a bit about how symmetrical the performance you expect of the hedge to be? By that I mean I guess it is encouraging to seeing it down 30 markets, the hit is only going to be $1.7 billion. What is the loss going to be in an up 30 type market? Is it symmetrical or not?

Liz Zlatkus

I would say that some of the convexity has been taken out because again you have put more macro hedging on and in addition we have increased the initial funding of the captive so again that helps to dampen when the markets fall further. As far as when markets go up I would say a few things. Number one, on a statutory basis even including all of the costs of our macro hedging we will still earn money on the overall VA book as markets rise. In terms of the GAAP side, so helping you think about GAAP profits if you looked at some of the information we gave out in the KBW in terms of our overall GAAP earnings for the VA book and then you looked at our macro hedging costs and our [DMWB] program you should expect kind of the quarter if markets stay relatively flat or about 9% you would see about $100 million pre-tax cost for hedging there. So all in you would still make money on a GAAP basis as the markets rise and we make money on a statutory basis but clearly it is dampened because of the hedging.

Tom Gallagher
Credit Suisse

But not to the extent that you would expect to see a loss? You think you would still be profitable even factoring in a loss on the macro hedge?

Liz Zlatkus

The answer to that is yes, subject to the sensitivities we have in the Q. For example, on the [DMWB] we are under-hedged for rates and volatility. So if rates fall and vols rise you are going to have losses in the [DMWB] programs. Short of any shocks to the system you can think about our options on a macro hedging kind of running at about $100 million, again pre-tax, pre-DAC per quarter but then you have to look at the Q for sensitivities for market shocks.

Tom Gallagher
Credit Suisse

Liam, I guess just related to your comment about the wind down of certain institutional life insurance businesses, I don’t know if you or Liz want to answer this, but what size asset pool are you looking at in terms of the liabilities you are thinking about running off? As you do that is there a plan to de-risk the balance sheet at all or are you pretty comfortable with your CRE exposure as it stands today?

Liam McGee

Is your question more of a macro question or is it specific to the institutional life businesses that I mentioned?

Tom Gallagher
Credit Suisse

It is truly two parts. One is specific. How big is the pool of assets and liabilities for the business that you are expecting to run off? A bigger picture question, is there an expectation to de-risk the balance sheet as you do that or should we not expect anything too dramatic?

Liam McGee

On the first question we will take that offline with you and take you through the details so that you can understand it better. In terms of the macro question, as I indicated in my prepared remarks I and the team are going through an exhaustive review of the company and we will communicate in early 2010 what our go-forward plan will be including many of the elements you just described so it would be premature for me to get into any more detail than that.

Operator

The next question comes from the line of Paul [Ferrian] - No Company Listed.

Paul Ferrian
No Company Listed

On the income guidance for alternatives with a loss of $110-120 million for the fourth quarter, that is surprisingly worse than the third quarter which was only $32 million and the quarter before was only $93 million loss. I am wondering if there is something specific that you see coming, causing you to keep that higher guidance. The second question is on the global hedging program I just wanted to ask how you set the target for that program as to what you are hoping to hedge, how you decide how much hedging, etc.?

Greg McGreevey

On the first question regarding the partnership income there is nothing we are seeing right now in the fourth quarter. Let me give you just a bit of backdrop as to why Liz gave the guidance that she did from a partnership standpoint in the fourth quarter. Our loss experience through the third quarter was down about 20% in alternative driven mainly from real estate partnerships. We kept that percentage the same on an annual basis which meant that the fourth quarter results were going to be higher than what we had reported in the third quarter and the second quarter. Typically there is a lag in valuations, as you know, and typically the fourth quarter can have the largest change in valuation. At the end of all that we would expect certainly to not exceed the $120 million number you had referenced and would hope that we would come in [slightly].

Liz Zlatkus

In terms of hedging obviously we look at the cost of hedging which is still relatively expensive. We look at the cost of capital, the availability of capital and many other factors. We chalk our VA business down to 1% and we set targets. I am not going to get into the specifics but again we think that the protection that we purchased now for 2010 was prudent in light of we continue to see a potentially choppy market and that coupled with our very significant amount of capital as you saw in slide seven, we think the combination of our hedging program and the capital we hold is the right balance.

Operator

The next question comes from the line of Jay Cohen - Bank of America/Merrill Lynch.

Jay Cohen
Bank of America/Merrill Lynch

A question on the property casualty side. Can you maybe flesh out what you are seeing in the auto frequency? If you could quantify that it would be helpful.

Juan Andrade

I think as Liz stated when she was going through the results a little bit ago, what we are seeing is an uptick in auto frequency particularly in auto liability that is clearly driven by an increase in miles driven as gas prices have become more normalized. I think you will recall our third quarter of 2008, this time last year, gas prices were significantly higher. Miles driven came down precipitously and now we are starting to see them come back up.

Jay Cohen
Bank of America/Merrill Lynch

Is this something you should have expected though?

Juan Andrade

Well this is something we have been dealing with and we have been taking rate throughout the year. I think if you look at our rate for auto we are about a plus three for the first nine months of the year so there is something we have been dealing with. What we are seeing, and I think this is something that our competitors have also alluded to is frequency is up low single digits and we need to stay in front of loss costs and we will continue to take price and underwriting action.

Jay Cohen
Bank of America/Merrill Lynch

On the commercial line side can you talk about what you are seeing from a claims standpoint? Claims frequency in commercial lines.

Juan Andrade

From a claims frequency standpoint on the commercial side I think loss costs were very well within our expectations. I think particularly when you look at the comp lines of business frequency continues to be very favorable to the industry as a result of lower payrolls and more experienced workers remaining on those payrolls. So commercial lines we feel very good about where loss costs are right now.

Operator

The next question comes from the line of Eric Berg - Barclays Capital.

Eric Berg
Barclays Capital

I think more than once on this call you have mentioned some degree of cautiousness about commercial real estate. What should I infer from your comments and in particular do you anticipate that commercial property prices will be falling even from here? If so, by how much and relatedly what are the implications, if any, for further property price declines that you envision for your CMBS portfolio which by its very nature is protected by subordination?

Greg McGreevey

Clearly we understand the possibility of further pressure in the real estate market and pressure in two ways; one on further economic deterioration and then on capital flows and refinancing that could happen in that market. What we have done as a result of that is we have continued to re-underwrite and look at our portfolio both the whole loan portfolio and CMBS to come up with what we think are the right fair values and the many capital impacts that could result from that and then we will make appropriate decisions around that either to sell securities, hedge them or in many cases hold securities which is an active decision on our part given that we think our overall portfolio there will still be significantly recovery we will experience in our portfolio overall. We don’t give loss estimates, as you know, overall but I wanted to explain the process, the rigorous process we go through in evaluating our portfolio and the decisions we make.

Eric Berg
Barclays Capital

My second question relates to VA CARVM and I don’t know maybe this is for Liz or a member of her team, but here is the question…my understanding is that the R in VA CARVM stands for reserves and that VA CARVM doesn’t directly affect capital or equity which is what we have been talking about today. As a matter of fact, because the total asset requirements which I guess is sort of laid out in this other accounting rule called C3 Phase II isn’t changing. My understanding is that if the reserves go up as a result of the application of CARVM but the total asset requirement doesn’t change you could have a situation in which VA CARVM actually leads to lower equity or lower capital required rather than more. My question is, given that sort of arithmetic, again higher reserves, total assets unchanged, seemingly lower equity capital, why are you saying and others are too that VA CARVM is going to lead to more capital required? I know that was a lot but I hope it was clear.

Rick Costello

Before we answer, operator could you mute Eric Berg’s line so that we don’t get the interference?

Liz Zlatkus

I think when people in the industry including The Hartford talk about VA CARVM we really are talking about the intersection of VA CARVM with C3 Phase II capital. You are correct that if reserves go up then potentially the total asset requirement would go down. I mean the capital required would go down because total asset requirement would stay the same. So in some cases again the rising equity markets reserves would come down, capital would actually increase and then you have a levering effect. Again, that is why sometimes we talk about rising equity markets we also have capital increases as you can see on our slides.

As markets fall you are right, reserves go up and capital may come down but it is not a one for one. So the capital requirement under C3 Phase II which is the average of the worst 10% can also go up. So I would just look at it and say what is the total required capital including reserves for VA in 2009 and those are the kind of numbers we are talking about. It is including both reserves and capital in terms of how we look at it.

Operator

The next question comes from the line of Ian Gutterman - Adage Capital.

Ian Gutterman
Adage Capital

I also had a question about the macro hedging. As I understand it, essentially you are buying S&P puts and selling out of the money S&P calls to fund the puts. I guess the latter part is what concerns me as opposed to just buying the puts directly at even costs. [Inaudible] kind of reminds me of what went wrong on the VA product, right? The customer is being sold way out of the money option that no one ever thought would produce a material loss and it did. It seems like you have done the same thing here. You sold way out of the money causing S&P hedging was a cheap way to finance the puts but they produced a loss again. I guess I am just wondering if that whole risk management changes made at the company when you are still selling way out of the money calls and can you just tell me if my understanding this correct and if it is, why is that a good idea?

Liz Zlatkus

The first thing and most importantly is I would say for 2010 that is now all gone. That is the main point. Of course in 2009 we were trying to balance the cost of hedging which is quite expensive and the amount of capital we held and so yes we did do some of that but we were fully aware of it. It was always in our modeling. Again, for 2010 we no longer have that.

Ian Gutterman
Adage Capital

So you are still buying the puts, you are just paying for them directly rather than making it a cost transaction?

Liz Zlatkus

Right.

Operator

The next question comes from the line of John Nadel - Sterne Agee.

John Nadel
Sterne Agee

I am thinking about your guidance relative to the third quarter results and in particular thinking about the property casualty side. Obviously lots of moving parts this quarter but I was interested in what kind of prior year reserve development we should be thinking about as we look at to the fourth quarter and into 2010?

Greg McGreevey

I think as you know we don't outlook reserve developments. We call them like we see them. In the third quarter we did see favorable development particularly in worker's compensation, professional liability, general liability as well and I think it is a testament that our book is aging nicely and the underwriting discipline continues to be very sound. We don't forecast and we don't outlook prior year releases.

John Nadel
Sterne Agee

So just to be clear that is not in your fourth quarter guidance?

Liz Zlatkus

That is correct.

John Nadel
Sterne Agee

Separately, I am just thinking about the life segment. A couple of months back, maybe it is a little bit more recent, Ramani at an industry conference mentioned that the life segment's normalized earnings could return to about $1 billion annually. I guess I have two quick ones on that. First, with the leadership change and the continued review of the business I was wondering if you continue to believe that is the case. Second, over what kind of timeframe should we expect that kind of improvement since it wasn't mentioned?

John Walters

First of all the guidance that we gave at KBW which was that we would expect the life company in 2010 to be operating at $1 billion plus earnings rate, we still see that as very much intact. So we are comfortable with that outlook at this point and we will be providing more guidance as we come into the first quarter of next year.

Liam McGee

The only thing I would add to that is in my time here working with John and his team that I would concur with his description of the earnings potential going forward.

Operator

The next question comes from the line of Jeff Schuman - Keefe, Bruyette & Woods.

Jeff Schuman
Keefe, Bruyette & Woods

Liam, you mentioned having met with a lot of your key producers and coming away with a sense that they wanted to put more business with you and that you had an opportunity to get better penetration. I am wondering what your take is on what needs to happen to kind of close that gap and see that opportunity? Is it a matter of the producers still getting more comfortable with your viability? Are they looking for more product? More service? More price? What do you think you need to do to realize that opportunity?

Liam McGee

What I am alluding to and what I was struck by was the longevity, depth and the two-way loyalty of those relationships and certainly in the context of the challenges of the prior 18 months it was quite striking.
In general, those partners and as I described in my comments I sat through seven business reviews in-depth. So these were fairly in-depth discussions and many other conversations out of that context. I want to emphasize that, they did communicate they saw The Hartford as the best of their partners. I think we need to execute better in the marketplace. Better sales management. Perhaps a little more demanding at times with the things that we do. Leveraging off those to get more chances as well as bringing the end-to-end nature of our product offerings both in things we have in the life business in combination with the things we have in the P&C business and make it easier for them to service their customers at one time. So there are a number of opportunities but I think at the top of the list it is execution.

Jeff Schuman
Keefe, Bruyette & Woods

In the capital discussion I didn't hear any mention about RMBS. Do you have any potential upside from rating rule changes that are possibly pending there?

Liz Zlatkus

As you look at the provision we have for the second half you do see it stayed at $1.6 billion. Just as a reminder, we had $600 million credit impact in Q3 and we also see ratings migration that has already occurred of about $200 million so that gets you to $800 million. In terms of some of the potential changes at the NAIC we do see that they could be potentially favorable to us. I think it is still too early to tell. We really aren't forecasting that in our provision.

Operator

There are no further questions.

Rick Costello

Thank you operator. With that then we will bring the call to a close. Thank you for joining us today.

Operator
This concludes today's conference call. You may now disconnect.