

Selective Insurance Group, Inc. NasdaqGS:SIGI

FQ4 2011 Earnings Call Transcripts

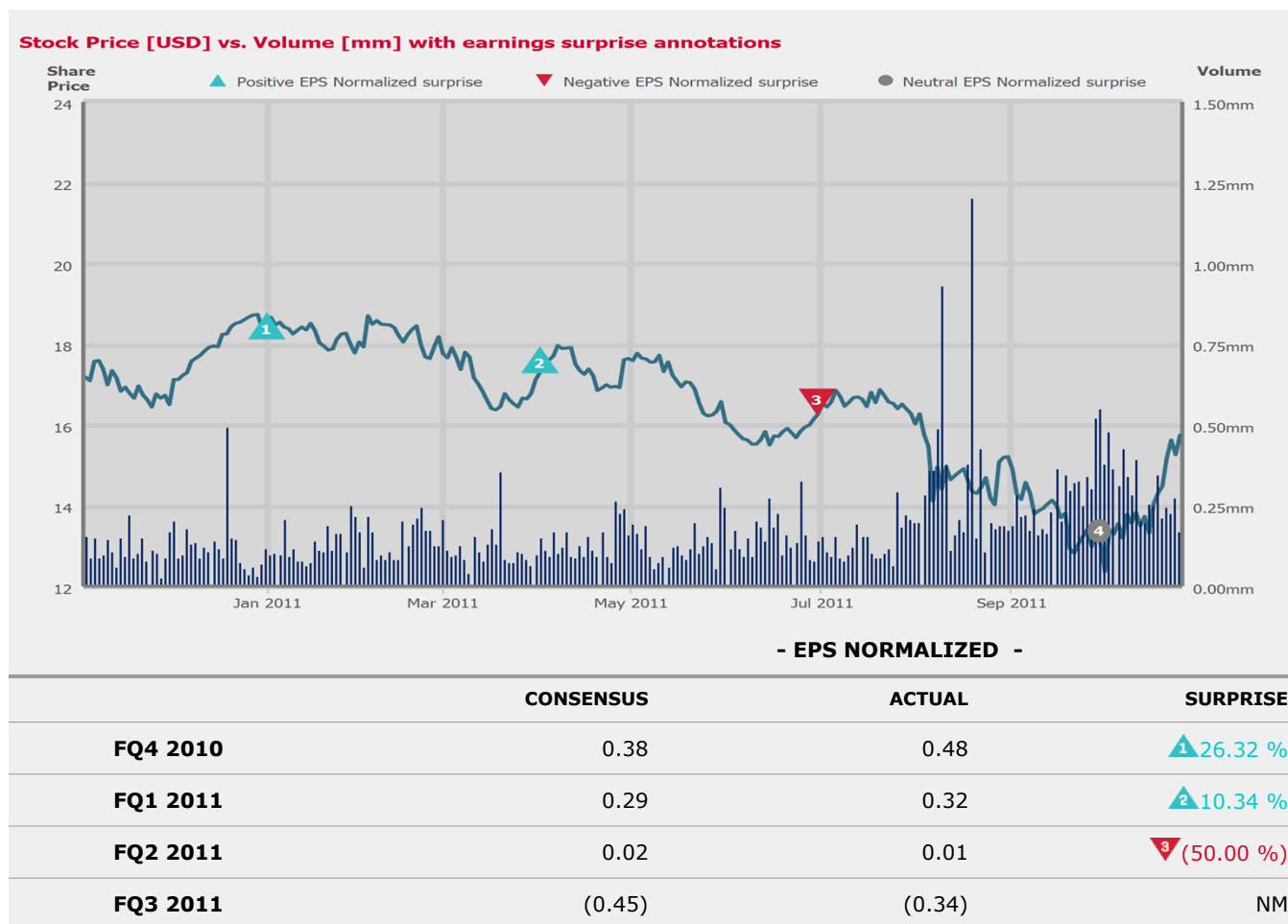
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S&P Capital IQ Estimates

	-FQ4 2011-			-FQ1 2012-	-FY 2011-		
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL	
EPS Normalized	0.31	0.33	▲6.45	0.36	0.32	0.34	
Revenue (mm)	396.34	400.38	▲1.02	409.56	1555.11	1597.48	

Currency: USD

Consensus as of Feb-03-2012 4:07 AM GMT



Call Participants

EXECUTIVES

Dale A. Thatcher

*Former Chief Financial Officer,
Executive Vice President and
Treasurer*

Gregory E. Murphy

*Chairman and Chief Executive
Officer*

Jennifer W. DiBerardino

*Former Senior Vice President of
Investor Relations*

John J. Marchioni

*President and Chief Operating
Officer*

ANALYSTS

Douglas Robert Mewhirter

*RBC Capital Markets, LLC,
Research Division*

Robert Edward Farnam

*Keefe, Bruyette, & Woods, Inc.,
Research Division*

Ronald David Bobman

Capital Returns Management, LLC

Presentation

Operator

Good day, everyone. Welcome to the Selective Insurance Group's Fourth Quarter 2011 Earnings Release Conference Call. [Operator Instructions]. At this time for opening remarks and introductions, I would like to turn the call over to Senior Vice President, Investor Relations and Treasurer, Jennifer DiBerardino. Ma'am, you may begin.

Jennifer W. DiBerardino

Former Senior Vice President of Investor Relations

Good morning, and welcome to Selective Insurance Group's fourth quarter 2011 conference call. This call is being simulcast on our website and a replay will be available through March 3, 2012. A supplemental investor package, which contains GAAP reconciliations of non-GAAP financial measures referred to on this call, is available on the Investor's page of our website at www.selective.com.

Selective uses operating income, a non-GAAP measure to analyze trends and operations. Operating income is net income excluding the after-tax impact of net realized investment gains or losses, as well as the after-tax results of discontinued operations. We believe that providing this non-GAAP measure makes it easier for investors to evaluate our insurance business.

As a reminder, some of the statements and projections that will be made during this call are forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties. We refer you to Selective's Annual Report on Form 10-K, and any subsequent Form 10-Qs filed with the U.S. Securities and Exchange Commission for a detailed discussion of these risks and uncertainties. Please note that Selective undertakes no obligation to update or revise any forward-looking statements.

Joining me today on the call are the following members of Selective's executive management team, Greg Murphy, CEO; Dale Thatcher, CFO; John Marchioni, EVP, Insurance Operations; and Ron Zaleski, Chief Actuary.

Now, I'll turn the call over to Dale to review the quarter results.

Dale A. Thatcher

Former Chief Financial Officer, Executive Vice President and Treasurer

Good morning. In an otherwise difficult year, we're pleased with our fourth quarter results. We took advantage of the positive pricing momentum exhibited in the market and achieved our 11th consecutive quarter of positive commercial lines price.

Two key points to remember about our pricing strategy are, one, its consistency; and two, we're earning commercial lines rate above last trend. Also in the fourth quarter, we closed on the Montpelier E&S acquisition, rounding out our new E&S platform.

Industry-wide, 2011 was a record catastrophe year with a heavy East Coast impact from which we were not immune. This was a second consecutive record catastrophe year for us, but cat losses in the fourth quarter were in line with our expectations at approximately 2 points.

For 2011 in total, cat losses were almost \$119 million or 8.3 points on a combined ratio. For the quarter, we reported operating income per diluted share of \$0.33 compared to \$0.48 a year ago. Favorable prior-year reserve development contributed the results, partially offset by lower net investment income and higher expenses due to the MUSIC acquisition.

The fourth quarter statutory combined ratio was 98.7%, 4 points better than a year ago. Favorable prior-year casualty reserve development of \$10 million or 2.7 points, an improvement in year-on-year non-catastrophe property results drove the results. Total statutory premiums were up 17% in the quarter, driven by 20% commercial lines net premium written increase, our third sequential quarter of growth.

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Commercial lines growth included E&S business, which contributed \$15.7 million in the quarter, along with audit and endorsement premium of \$11 million in the quarter. Audit and endorsements have now been positive for 3 quarters.

2011 marked the first year of overall net premium written growth for Selective since 2007 with a 7% increase. For the full year 2011, audit and endorsement premium added \$14.5 million to commercial lines growth versus returned premium of \$47.9 million in 2010. The commercial line statutory combined ratio was 98.2% in the quarter. Commercial property and commercial auto continue to perform well in the quarter, reporting combined ratios of 75% and 96.3% respectively.

Workers compensation result showed further improvement in the quarter with a statutory combined ratio of 111.9% versus 123.8% a year ago. Again this quarter, workers compensation results had no prior year development. We continue to address profitability in this line through a combination of rate increases, underwriting improvements and claims initiatives.

The BOP line reported fourth quarter statutory combined ratio of 80.7%, including \$4 million or 22.5 points of favorable prior-year casualty development. In our standard quarterly reserve review, we determine the BOP reserves to be developing a redundancy that required action. Recent actuary year combined ratios have been running in the 110% to 115% range, which includes the more normalized catastrophe load and is more representative of current results in this line.

Personal line statutory net premiums written were up 6% in the quarter and the statutory combined ratio was 101.5%. We achieved renewal rate increases of 6.1%, while underlying results showed improvement in the quarter, there are still not where they need to be.

To improve personalized profitability, we continue to focus on driving rate and mix of business changes across our personal lines book. We successfully renewed the property catastrophe reinsurance in January. The program structure remains \$435 million in excess of \$40 million retention.

Pricing was up consistent with exposure change in recent market trends due to increased global catastrophe losses and reinsurers focus on RMS 11. The result was a \$3.5 million increase from 2011 in seeded premium to \$22 million. The diversification of the program remains strong and is comprised of a group of financially solid reinsurers with an average-A rating from A. M. Best.

Fourth quarter after-tax net investment income declined 27% from a year ago to \$22.6 million. This decline was largely driven by alternative investments which produced a \$3 million pre-tax loss versus income of \$9 million in the 2010 fourth quarter.

For the year overall, our alternative investment portfolio generated a 17% return or \$21 million in income primarily from increased distribution. The after-tax yield on fixed maturity securities was 2.8%, flat with last quarter, but down from 2010 levels. Lower reinvestments rates will place ongoing pressure on the total yield generated on our fixed income portfolio.

We maintained a well laddered investment portfolio, but as bonds mature and reinvest at current depressed market rates, we expect the yield on our portfolio to remain under pressure. Invested assets increased 5% from a year ago to \$4.1 billion. Our fixed income portfolio has an overall credit rating of AA-minus and the duration of 3.1 years including short term investments. After suspending purchases of municipal securities in 2011, we're now selectively buying high quality municipal bonds for the portfolio which will slightly extends duration.

We continue to invest primarily in high quality corporate bonds while maintaining an overall duration of just over 3 years. The only Eurozone sovereign debt exposure in the portfolio is to Germany and Finland, and it totals less than \$13 million. Our total exposure to the Eurozone is \$63.9 million which includes \$30.9 million in bank fixed income, \$19.4 million in corporate fixed income and \$1.1 million in equity exposure to one Eurozone consulting firm.

All of our securities are monitored closely and we are comfortable with the minimal exposure we have at the present time. The increase in our short term investment position in the quarter was due largely to the assets acquired with the MUSIC transaction.

In the fourth quarter, we reduced our held-to-maturity fixed income portfolio by approximately \$100 million due to changes in the credit quality on certain securities as a result of rating downgrade that took AA rated securities to AA-.

We had an unrealized gain position of \$150 million pre-tax at the December 31, 2011 up from \$83 million a year ago. The unrecognized gain position in the fixed income held-to-maturity portfolio was \$46 million pre-tax or \$0.55 per share after-tax.

As previously disclosed, the deferred acquisition cost or DAC accounting change went into effect on January 1, 2012. This was a onetime \$51 million after-tax adjustment to stockholders equity and the corresponding \$1 decrease in book value per share. Book value as of March 31, 2012 will reflect this change.

On Page 8, of the investor packet we have provided an exhibit detailing the impact of a DAC accounting change on our balance sheet and income statement including retroactive application of a change for prior periods. We completed our acquisition of MUSIC on December 31, which rounded out the earlier E&S renewal rights transaction with Alterra.

The structure of these transactions allowed us to remove the uncertainty around prior reserves and development by not taking the liabilities of the business and allowing us to select business based on our underwriting guidelines on a go-forward basis. As a result, no unearned premium was transferred culminating in a significant difference between written and earned premium this year. This will put modest pressure on our overall GAAP expense ratio in the first year, especially under the new DAC rules.

Surplus remains strong at \$1.1 billion at December 31, while stockholders equity increased 3.6% from a year ago to \$1.1 billion. Book value per share increased to \$20.39 from \$19.95 a year ago, partially offset by an \$11 million pension plan charge as a result of lower discount rate assumptions. Our premium to surplus ratio was 1.4 to 1 at year end. And rule of share repurchase activity we deployed access capital in 2011 on the strategic acquisitions of our E&S platform to build long term shareholder value.

Now I will turn the call over to John Marchioni to review insurance operations.

John J. Marchioni

President and Chief Operating Officer

Thanks, Dale, and good morning. Pricing in the commercial lines marketplace continue to gain momentum in the fourth quarter as more competitors began driving higher renewal rates, while we achieved our 11th consecutive quarter of renewal price increases with a positive 3.4%. This a market improvement from the prior quarters in 2011, in which rate increases average 2.7% and we believe reflects the improving market. While we were the only company to consistently achieve positive commercial lines renewal rate over the past 3 years, in the fourth quarter, we began to hear more broadly that other carriers are starting to underwrite for higher rates. Our 3.4% increase in the fourth quarter and even more importantly the 4.5% we achieved in January of 2012, reflects our pricing success in the hardening market.

Our pricing strategy that started in 2009 was to maximize rate by utilizing our underwriting tools that allow granular pricing capabilities. However, in mid-2010, we modified our approach to more carefully balance retention with rate. With this approach, we established clear walk-away pricing for the lesser quality accounts, while focusing on retention of the highest quality accounts.

As other carriers were actively marketing our renewals, our strong agency relationships protected our renewal business, but we did experience a slowdown in new business. As more of our competitors have recently started to drive rate, mostly in a socialized manner, we continue to use our granular pricing tools to move our target rate levels higher.

This is a time when having excellent agency relationships is a key. The understanding and support of our pricing strategy is one of the most important aspects of our 1,000 agency relationships. The agency that helped protect us throughout the soft market, are now giving us more opportunities to write new business, as other carriers push rate across the Board.

As customers react to the socialized rate approach of other carriers and shop their business, our granular pricing strategy creates the opportunity for us to win new business at actuarially appropriate rates. In fact, new business for January was strong, while also meeting our expectations on quality and pricing, as we capitalized on this trend with our agent partners.

Commercial lines direct new business was up 21% compared to the fourth quarter 2010, driven by our middle-market and large account business, which grew 36% from a year ago. The \$36.8 million in new middle-market and large business is not extraordinary, but is consistent with historical new business levels. Our new and enhanced products in this market segment continue to generate good growth.

Commercial lines new business was flat for the year. One & Done automated new business was down 15% to \$63 million, while middle-market and large account business was up 9% to \$149 million. The majority of our new middle-market business is agent controlled. In other words, this business was in the agent's office with another carrier, so the agent has a better sense of loss history and quality of management controls, which gives us valuable underwriting insight.

Personal lines net premiums grew 6% in the quarter, while new business was down 24%. A total of 46 rate increases added the potential for \$18 million on our in-force book in 2011. Renewal pure rate increases were 6.1% in personal lines and retention increased almost 2 points to 86.9%. We remain focused on improving the quality of our personal lines book through writing more low frequency, high retention business and continuing to push rate on both homeowners and personal auto.

The flood book is performing very well with revenue up 16% and net income of 51% for the year. In 2011, we experienced a record number of flood claims at almost 10,000. This claims volume put stress on our organization and the NFIP. The flood team rose to the occasion and provided the best customer service possible to address those losses.

We are pleased with the \$15.7 million in E&S premium written in the fourth quarter from the Alterra renewal rights transaction, which we've rebranded as Stonecreek Specialty Underwriters for a total 2011 E&S premium to \$24.1 million.

In January, we began writing business in MUSIC and added the company to the Selective pool, resulting in an A+ rating from A.M. Best. We look forward to renewing as much as feasible of the \$120 million combined book-of-business in 2012.

We're also looking to tap into the \$300 million to \$400 million in contract binding authority business through our retail agency base. This is lower hazard, low limits, E&S business that is being underwritten by seasoned professionals in Stonecreek and MUSIC.

We are fully committed to our strategy to introduce new and expanded product to our agents and customers. Initial feedback has been positive, as this type of small contract binding authority business is a natural fit with our current book-of-business.

Now, I'll turn the call over to Greg.

Gregory E. Murphy
Chairman and Chief Executive Officer

Thank you, John, and good morning. 2011 was a year of extremes. Record weather events, stock market volatility, historically low interest rates, European economic woes and a slow U.S. economic recovery, all made a very challenging year.

We are ready to put 2011 behind us and look forward to executing on our strategies in 2012 and beyond in a commercial lines industry that finally appears to be using more sound underwriting judgments and driving higher rates. We believe this will be a different commercial lines cycle, primarily due to: one, a soft economy; two, the advent of improved and for many first time underwriting and pricing tools; and three, overall excess capital.

The business cycle would have last around 3 years and produce annual price increases between 5% and 8% and a consistent loss trend will facilitate reaching our overall targeted return on equity of about 12%.

We've been successfully driving rate for 11 consecutive quarters and our earning of that rate are slightly higher than our loss trend. As John mentioned, we are now transitioning into a harder market pricing strategy that produced a 4.5% increase in the month of January.

Our commercial lines pricing strategy is a significant part of our overall profit improvement plan, which also includes the following: one, commercial lines underwriting mix and business improvements; two, many claims initiatives that should produce the cumulative 3 point run rate improvement in our loss and expense ratio over the next 2-year period compared to the 2010 base year; and three, significant rate and underwriting improvements in personal lines. For 2012, we expect to file and obtain overall personal lines rate increases of 8.3% with homeowners up about 11.5%. Overall, net premiums written growth of 17% in the quarter.

In order to fully analyze that growth rate you need to look at the component parts. The addition of our new E&S operations added it 5.2 points to growth. Renewal premium price increases for both personal and commercial lines added about 3.4 points of growth. And audit and endorsement premium added about 3.7 points of growth. Plus the underlying growth rate of our core book was about 4.4% for the quarter, mostly driven by a 3 point increase in our commercial lines retention ratio to 82%.

Our agents are very committed to Selective, mainly due to our significant focus on relationships, customer service, technology and consistency in the marketplace. We have responded to agents and customers' needs by increasing our products and services, allowing for deeper agency penetration and stronger agency relationships.

To capture our new business, we have focused on expanding our appetite in commercial lines by adding almost 50 new and expanded products over the past 2-year period. Our field model remains the foundation of our success with agents. We've have expanded our field model in 2011, by deploying field marketing specialist. Field marketing specialists are responsible for small, commercial and personal lines business generation throughout our footprint.

In addition, our agents are excited about our new E&S platform that provides them the capability to consolidate more of their best business with Selective, through our new wholesale agency partners, as we continue to improve the contract binding authority service model. As John said, our agents control approximately \$300 million to \$400 million of this type of business, which for the most part is placed in a highly fragmented manner.

Our investment portfolio is very high quality and our investment strategy has not wavered. We address the low interest rate environment in 2011, by deploying high dividend yield-equity strategy without materially changing the portfolio risk profile. In addition, we have strategically limited our concentration of risk over the years as demonstrated by our well-diversified corporate and municipal bond portfolios and our minimal sovereign debt exposure.

Now I'll turn to guidance for 2012. Our expectations are as follows: a statutory combined ratio of 101.5% and a GAAP combined ratio of 102.5%, which do not include any reserve development assumptions either favorably or unfavorably; catastrophe losses of 2.5 points, about a point higher than our historical average to reflect the more severe weathering patterns; investment income to be approximately flat with 2011 levels; and weighted average shares outstanding of 55.6 million. Selective has stood strong for 85 years.

We are a growth company and we will grow at the right time, with a right discipline and at the right price. I'm proud of the hard work that our people have accomplished throughout the soft market, to position this company for long-term success. My sincerest thanks to our employees, our loyal agency-force and shareholders for your continued support.

Now, I'll turn the call over to the operator for your questions.

Question and Answer

Operator

Ron Bobman your line is open.

Ronald David Bobman

Capital Returns Management, LLC

I had a couple of questions. One of the gentlemen in prepared remarks was talking about competitors raising rates, and so -- I think the words were used, within a socialized manner. I didn't understand what he meant by that?

John J. Marchioni

President and Chief Operating Officer

This is John Marchioni and those were in my prepared comments. And what we mean by that is, a socialized rate increasing is across the board, so not differentiated between quality of account. I think as the market started to firm, there is no question, market-wide rates need to go higher. But it's still important that you recognize, which accounts need the greatest level of rate increases and which are -- require a least amount and really just keeping up with loss trends. So we've been very targeted over the last 3 years in terms of how we've done that, making sure that we've targeted the right accounts for rate and making sure we focused on retentions of the greatest quality accounts. And that comment is that you don't necessarily see that with others. And I think the other part of that too, when it ties into the new business commentary, is if that happens, you're starting to see business that despite a multi-year soft market is coming out into the markets that is overpriced. So it's an opportunity to write that, because of that socialized approach to raising prices.

Ronald David Bobman

Capital Returns Management, LLC

And then I think maybe with you, John, as well, I'm not positive. At one point you mentioned that new business suffered, in other words, an adverse impact as far as new business. But then I thought later in your comments that there was positive comment regarding, I think in January or most recently new business. If I heard that right, could you -- is there now sort of a transition or inflection or something like that?

John J. Marchioni

President and Chief Operating Officer

Yes. You did hear that correctly. So the pressure that we had on new business was earlier in our strategy to raise rates. So back in 2009, 2010, when we started to be able to obtain a little bit of rate, 2 points to 3 points, and when the rest of the market wasn't moving, it did put pressure on our producers. And therefore, really did hurt in terms of new business submission activity, as the rest of the market was still very aggressive relative to new business pricing in particular. What we've now seen is, as the rest of the market has started to move towards firming price that these quality opportunities will start to flow again. And that drag on new business has started to turn the corner. I think the other important point to remember, and you've heard this in the prepared comments as well is, from a year-to-year perspective, it does look like a big increase. But from historical new business levels, these are about where we'd expect it to be and they were prior to 2009.

Gregory E. Murphy

Chairman and Chief Executive Officer

Just to give you an idea -- a little background view, because I would tell you that sophisticated underwriting and granular pricing in commercial lines has generally been around or more significantly around for the past several years. And I would say that the difficulty in executing that strategy on a market that continued where break was under pressure, very, very difficult to do, because you need some

momentum in the market to be able to raise and lower prices, and you can't lower prices unless you can raise prices. So you're starting to see a transition now, where we will better be able to execute our granular pricing capability in the marketplace and you need a more firming market to be able to do that. So I hope that's an important concept to garner, because rate in commercial lines, there is a whole lot of mispriced business out of there. And what sophisticated underwriting and granular pricing gives you, is the capability to better identify that. But it's going to take a while to work through that. But this is the first part of the cycle that you're starting to see that execution happening.

Ronald David Bobman

Capital Returns Management, LLC

Okay, you have it -- the deck is great, the PowerPoint -- you have one slide in here, the number is 27 or 39. Is that retaining our best commercial business, basically retention rates, and you've got it straddled by diamond. I don't think there is a slide in here as far as retention -- Q4 '11 versus Q3, sort of the linked quarter change in retention. Do you have any figures you could share with us about what retention has done in the last couple of quarters, either for all diamonds or like stratification?

Gregory E. Murphy

Chairman and Chief Executive Officer

I have it right here in total. I could tell you that the fourth quarter by itself was 82, up 3 points.

Ronald David Bobman

Capital Returns Management, LLC

And it's 79 in Q3?

Gregory E. Murphy

Chairman and Chief Executive Officer

Yes, we do track retention by diamond, and I don't know, John, or anybody...

John J. Marchioni

President and Chief Operating Officer

It's up 3 points compared to a year ago.

Ronald David Bobman

Capital Returns Management, LLC

That's year-over-year.

John J. Marchioni

President and Chief Operating Officer

Not sequential quarter. It's again drifting upwards over the course of the year.

Jennifer W. DiBerardino

Former Senior Vice President of Investor Relations

And, Ron, you're looking at our Investor Packet, which hasn't been updated since the third quarter, at our investor presentation. We have an investor packet out there that if you access that has more excel-length tables that has data in it. We'll be updating the PowerPoint shortly.

Ronald David Bobman

Capital Returns Management, LLC

And if we switch to personal lines, it seems generally at least on the homeowner side that the order of magnitude of rate increases is even steeper than commercial lines. But your retention has even improved more dramatically, I think in the personal lines of that. Can you just talk about what's going on there? It seems that it's even a firmer market there and more uniformly. So I guess retentions are not being impacted by these rate increases. I don't know, John, can you talk about personal lines? That's it for me.

John J. Marchioni*President and Chief Operating Officer*

You pick those pieces, or put those pieces together appropriately. The market in homeowners in particular has been firming for a lot longer than we've seen in commercial property or commercial lines generally, and we've certainly experienced that. When you look at a lot on the catastrophe activity over the last couple of years and the smaller events, but the higher frequency of smaller events, the market has certainly moved in that direction. Now, if you look at our retention, our new business has been under pressure the last year or so, and with less first year renewals flowing into the renewal book, that will help your retention improve as you go forward. So as you saw in the prepared comments, we anticipate a little over 11% of rate in 2012 on that line and would anticipate retentions continuing to be strong. And then a final point of note there is that 11.5%, or even if you look at our rate for 2011, those are not across the board. We've targeted them based on risk characteristics and I think that's also kept our retention solid overall, while making sure that retention on those targeted segments would be a little bit lower than the average.

Ronald David Bobman*Capital Returns Management, LLC*

Since I have waited so long, one more question on reinsurance. You gave us -- I guess the sort of nominal seeded premium went up about 20%, roughly \$18.5 million to \$22 million, \$3.5 million, nearly 20%, but obviously the expected loss change by virtue of the models. I was curious did you cede any losses last year to your reinsurers on this program? And did you have any sort of aggregate cover that you did not purchase this year or you just have the same \$435 million over \$40 million?

Dale A. Thatcher*Former Chief Financial Officer, Executive Vice President and Treasurer*

We did not have an aggregate program in place, either last year or in the future for the current year. The program remains unchanged from last year with \$435 million in excess of \$40 million retention. Hurricane Irene did slightly breach our \$40 million retention. The gross losses from that were \$46.5 million. So it was very small session to our reinsurers and that was the first session on our cat program since 1989 with Hurricane Hugo. So for all facts and purposes, we treated more like a loss free account as opposed to one with heavy losses.

Ronald David Bobman*Capital Returns Management, LLC*

But still clearly a significant increase in rate, so I guess sort of telling about the reinsurance market.

Dale A. Thatcher*Former Chief Financial Officer, Executive Vice President and Treasurer*

Yes it is.

Operator

Our next question is from Doug Mewhirter of RBC Capital Markets.

Douglas Robert Mewhirter*RBC Capital Markets, LLC, Research Division*

First, it's a very quick question to Dale. I drifted a bit and I missed one figure in the preamble. Could you just give me again the dollar amount of audit premiums in the fourth quarter versus fourth quarter '10?

Dale A. Thatcher*Former Chief Financial Officer, Executive Vice President and Treasurer*

Let me get to that quickly. Did you have another one that we're looking that up?

Douglas Robert Mewhirter

RBC Capital Markets, LLC, Research Division

I guess, generally it's more for Greg and John about the guidance, which is some more complicated.

Dale A. Thatcher

Former Chief Financial Officer, Executive Vice President and Treasurer

It was \$11 million for the fourth quarter, I'm just trying to find it in the -- versus \$5.5 million of return in the previous year.

Douglas Robert Mewhirter

RBC Capital Markets, LLC, Research Division

Greg or John or both, I'm looking at the 2012 guidance and I appreciate you've given those numbers considering how uncertain they are. I just wanted to maybe walk through some of the math and see if that makes -- any of what I'm saying, it makes sense. So if you take the 102.5 and you back out the catastrophe losses, which are going to be there, but it's a hard figure to estimate. You get to about breakeven on an accident year basis, and if that equivalent figure in 2011, there's about 101 if you back out the cat losses and your reserve development. So that implies everything else being equal or roughly rates about 1% over loss cost trends. And considering the rate increases you've been getting and the improvements that we've been seeing, that feels a little light to me. It feels like you might expect a little bit better than that. And I know you try to be conservative after '10. I just wanted to see what your thoughts were on that?

Gregory E. Murphy

Chairman and Chief Executive Officer

I think there is a number of factors that come into that. And I think Dale just articulated the first one. So you have to look at that higher rate needs to subsidize, the higher reinsurance costs. We just talked about the \$3.5 million of higher catastrophe reinsurance. So that needs to get in your number, because that's coming 100% out of your rate. And then there are other planned changes in some of the other reinsurance programs that get renewed throughout the course of the year that you have to compensate on a year-on-year basis for where some of that. And then I think when you get down to it, there's just a number of moving parts in the loss trend. I know that you started out -- if you look at the statutory combine or you go to the GAAP combined ratios, the 102.5 minus the 2.5 points of cat is 100, and that 100 then does not include any development, either favorably or unfavorably, and then you are comparing that into the 2011 number. There are other issues with property losses that can affect that, volatility and property losses year-on-year can impact that number. And I think that we have a fairly comprehensive robust planning model that looks at multiyear in terms of loss trend. And that's how we go through that process and that's how we end up at the end of the day. I don't know if I can add to that other than that in terms of where we are.

Operator

Our next question comes from Bob Farnam of KBW.

Robert Edward Farnam

Keefe, Bruyette, & Woods, Inc., Research Division

So going to the workers comp line, so you've got a bunch of initiatives, trying to improve that profitability. I'm just curious if you have a specific goal, you're trying to get the combined ratio down to in what time period? And if you can go on to what kind of price increases you're getting in that line specifically, are they exceeding the loss cost?

Gregory E. Murphy

Chairman and Chief Executive Officer

Let me start with January. January was a better -- I mean with the January of 2012, it was a better indication. And the rate level in January for comp was 6%. So, yes, we need to exceed rate level. I would say loss trend. We comment on loss trend overall, we're talking about loss trend in the entire book being

somewhere around 2.5%, 2.6% range. Obviously in comp, the trend is going to be much higher than that, because you've got physician services, hospitals and RX in there and all of those are much higher than that. So when you look at trend, you're going to look at trend relative to that line, not relative to trend in its totality. So we have a strategy, obviously, here and it's multifaceted that includes a combination of rate level. It includes the combination of mix of business that we write in terms of hazard structure. And then it has a number of claim initiatives that are specifically targeted to that line. But I would say that our strategy is to try to bring all of our lines into a more profitable arena. As we look down the road and look at possible changes in accounting, coming under IFRS accounting rules. They're going to be very different rules in terms of how lines of business are going to be calculated, in terms of risk margins and which lines are profitable or unprofitable that you have to really start thinking about every line of business and how you get each line of business into a more targeted profitability range. I would say one of the more restrictive elements in that has been getting rate level, and some of the administrative states that we have, that's not a huge amount, but it's a fair amount of our business overall.

Robert Edward Farnam

Keefe, Bruyette, & Woods, Inc., Research Division

So ultimately you want to get workers comp to be profitable on an underwriting basis or on an overall basis?

John J. Marchioni

President and Chief Operating Officer

I would say, given the current interest rate environment, pretty close to that, yes. I mean you can kindly get a sense of where we need to be, yes.

Robert Edward Farnam

Keefe, Bruyette, & Woods, Inc., Research Division

And second question and that'll be it for me. What's the opinion of capital adequacy by the rating agencies? And how much leeway do you have to grow?

John J. Marchioni

President and Chief Operating Officer

Well, I'd say that it's a fluid kind of discussion that you have with the rating agencies. A lot of it depends on the level of profitability, what are achieving, what's really generating the growth to the extent to which you have growth from price increases. It looks a lot different than growth from exposure increases in the discussions with the rating agencies. I mean, generally speaking, our sustainable growth rate to maintain the exact same level of previous surplus is approximately 2 points less than whatever ROE we're generating. So that's one factor to put in there. Right now, we're at 1.4 to 1. We wrote as high as 1.8 to 1 pretty consistently during the last hard market. And I think that that would be tolerated once we get to a level of profitability that supports that. So it remains to be an ongoing dialogue with the rating agencies. But there is certainly not a position of excess capital, because we want to keep our capital and be able to participate fully as the market hardens.

Gregory E. Murphy

Chairman and Chief Executive Officer

And I would say that is why when you sat there and looked at opportunities, we sat there as an organization and felt like this was the time to enter the contract binding authority in E&S space. And I think that's great, in terms of market, market timing and transition in rate. Now, this is where you want to be able to harvest that kind of growth instead of sitting there and doing other things with your capital.

Operator

[Operator Instructions] At this time, there are no other questions.

Gregory E. Murphy

Chairman and Chief Executive Officer

We apologize for the technical issue that we just went through. If you have any follow-up questions, please contact Jen and Dale. Thank you. Bye.

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