S&P Capital IQ

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The Hartford Financial Services Group, Inc. NYSE:HIG

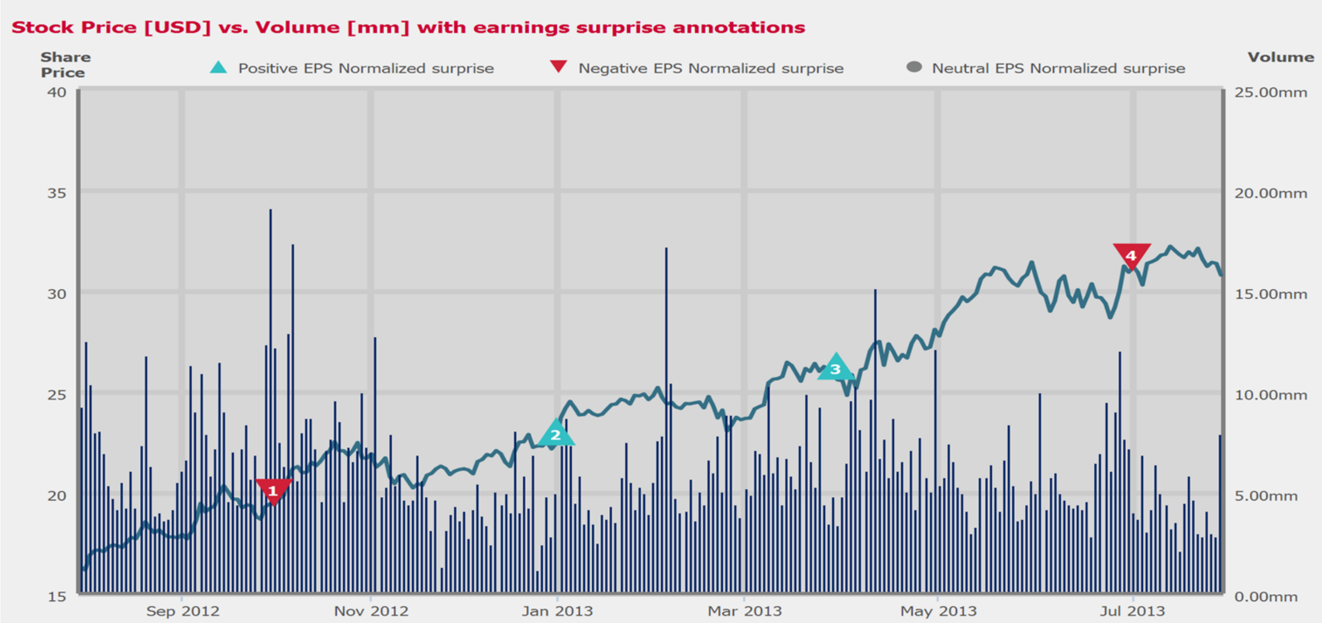
FQ3 2013 Earnings Call Transcripts

Tuesday, October 29, 2013 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2013-			-FQ4 2013-	-FY 2013-	-FY 2014-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.83	1.03	▲24.10	0.90	3.47	3.65
Revenue (mm)	3860.00	5641.00	▲46.14	4092.42	22657.77	17445.52

Currency: USD
Consensus as of Oct-29-2013 12:26 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2012	0.82	0.78	▼(4.88 %)
FQ4 2012	0.35	0.54	▲54.29 %
FQ1 2013	0.83	0.92	▲10.84 %

FQ2 2013	0.71	0.66	(7.04 %)

Call Participants

EXECUTIVES

Andre A. Napoli
Former Executive Vice President and President of Consumer Markets & Enterprise Business Services

Beth A. Bombara
Chief Financial Officer and Executive Vice President

Christopher John Swift
Chairman & CEO

Douglas G. Elliot
President

Liam E. McGee
Former Chairman

Sabra R. Purtill
Senior Vice President of Investor Relations

ANALYSTS

A. Mark Finkelstein
Evercore ISI, Research Division

Brian Robert Meredith
UBS Investment Bank, Research Division

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

Erik James Bass
Citigroup Inc, Research Division

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Jay H. Gelb
Barclays PLC, Research Division

John Matthew Nadel
Sterne Agee & Leach Inc., Research Division

Thomas George Gallagher
Crédit Suisse AG, Research Division

Presentation

Operator

Good morning. My name is Melissa, and I will be your conference operator today. At this time, I would like to welcome everyone to The Hartford Third Quarter Financial Results Conference Call. [Operator Instructions] Thank you. I would now like to turn the call over to Ms. Sabra Purtill, Head of Investor Relations. You may begin your conference.

Sabra R. Purtill
Senior Vice President of Investor Relations

Thank you. Good morning, and welcome to the Hartford Third Quarter 2013 Financial Results Conference Call. Our speakers today include Liam McGee, Chairman, President and CEO; Doug Elliot, President of Commercial Markets; Andy Napoli, President of Consumer Markets; and Chris Swift, Chief Financial Officer. Other members of our executive management team are available for the Q&A section of this call, including Beth Bombara, President of Talcott Resolution; and Jim Davey President of Hartford Mutual Funds. As described on Page 2 of the slides, today's presentation includes forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995. These statements are not guarantees of future performance, and actual results could be materially different. We do not assume any obligation to update forward-looking statements, and investors should consider the risks and uncertainties that could cause actual results to differ from any forward-looking statements. A detailed description of those risks and uncertainties can be found in our SEC filings, which are available in the Investor Relations section of our website.

Finally, please note our presentation includes several non-GAAP financial measures. Explanations and reconciliations of these measures to the comparable GAAP measure are included in our SEC filings, as well as in the earnings release and financial supplement. I'll now turn the call over to Liam.

Liam E. McGee
Former Chairman

Thank you, Sabra. Good morning, everyone, and thank you for joining us. The Hartford delivered very good third quarter results, with core earnings up 17% to $505 million or $1.03 per diluted share. This performance reflects the significant progress we've made transforming The Hartford. This quarter, we saw strong execution in our go-forward businesses and an acceleration of Talcott Resolution's runoff, further reducing the overall risk profile of the company. With this performance year-to-date, we expect full year 2013 results to exceed the outlook provided during our April Investor Day.

In P&C Commercial, Doug and his team are executing on their strategies to improve margins. Written premiums rose 1% overall, with growth of 2% in both Small Commercial and Middle Market. Strong pricing gains of 8% in Standard Commercial lines were consistent with the prior 4 quarters and included increases of 9% in both Middle Market worker's compensation and property.

For the quarter, the combined ratio was 93.3, excluding CATs and prior year development, 4.2 points better than the prior year. Profitability in workers' compensation has improved dramatically over the past 2 years, as you can see in our Middle Market results.

I am encouraged by our continued success in the Middle Market in broadening product reach across workers' compensation, property and general liability, which is providing new growth opportunities for us. Recent feedback from key distribution partners at the CIAB Annual Meeting confirmed our forward momentum in the P&C Commercial marketplace. We have meaningfully improved profitability in Group Benefits, with core earnings margin rising to 3.9% this quarter, driven primarily by improved disability loss ratios and pricing actions.

I am confident in the favorable underlying profit trends of the business and pleased to see 2 consecutive quarters of new sales growth. Consumer Markets also had a successful quarter, expanding underlying margins and growing written premium by 3% over the prior year. The combined ratio, excluding CATs and prior year development, improved to 91.1, more than 2 points better than the prior year period. Andy and his team have repriced this book of business and our position to balance growth and margin expansion going forward. I'm also pleased that, in September, we extended the AARP partnership by 3 years to January of 2023.

Mutual Funds is trending in a positive direction, with solid fund performance and sales growth of 35% for the quarter.

In Talcott Resolution, Beth and her team continue to reduce the size and the risk of the legacy annuity blocks. The Japan VA block is in a fundamentally different place today than a year ago. Over the past year, 18% of Japan VA contracts have surrendered. In the third quarter, the annualized surrender rate remained elevated at 31%. This is a permanent and meaningful reduction in the risk of that block. In the U.S., the full VA surrender rate increased, again in the third quarter to 20%, driven by rising markets and policyholder initiatives like the Enhanced Surrender Value program. Over the past year, 14% of U.S. VA policies have surrendered.

We continue to evaluate potential transactions that can permanently transfer these exposures and accelerate a release of capital. There is a growing interest in the marketplace for runoff blocks of annuity liabilities. We would pursue those transactions that are attractive in terms of sales price and the capital that would be released compared to the underlying economic value of the business. We are executing our capital management plan, with $241 million of equity securities repurchased in the third quarter and $408 million through the third quarter since announcing the program in February.

As additional capital becomes available over time, we will take accretive capital management actions to create value for shareholders.

The Hartford has undergone a significant transformation. The company is more focused with a reduced overall risk profile. The go-forward business' performance is improving, and we are well positioned to generate higher returns for shareholders. We are on track to have a successful 2013 with momentum carrying over into 2014. I am very thankful for the hard work and dedication of all my Hartford teammates.

Thank you. And with that, I'll turn the call over to Doug, who will review Commercial Markets results.

Douglas G. Elliot
President

Thank you, Liam, and good morning, everyone. Today, I'll cover our P&C Commercial and Group Benefits results for the third quarter of 2013. I'll also provide some insight on various initiatives. I'm pleased to share that our core margin gains continued during the third quarter. Our execution remains steady and consistent, with margin improvement being the focus across-the-board.

Let's begin on Slide 5. P&C Commercial had a combined ratio for the quarter of 98.1. Our results included continued solid underwriting improvement year-over-year, with our current accident quarter loss ratio, excluding catastrophes, at 63.4, 5.4 points lower than 2012. Year-to-date, we posted a 63.1 loss ratio, 3.2 points lower than the same period last year, demonstrating the strong underlying improvement in our margins.

This quarter saw $48 million or 3.1 points of CAT losses. Of that total, $19 million is attributable to current quarter events, with the balance due to increased estimates on late-May wind and hail storms that affected Texas and other regions in the Southwest.

Across commercial lines, we also strengthened our prior year reserves by $26 million. This change reflects releases in workers' compensation, general liability and Storm Sandy, offset by an $86 million addition to commercial auto. A significant portion of our adverse development in auto occurred in our Programs business, which I'll describe more fully in a moment. We also added modestly to our auto reserves in Small Commercial and Middle Market to address the general rise in bodily injury severity trends we've seen across the marketplace. Overall, our combined ratio for the quarter, excluding CATs and prior year development, stands in very good shape at 93.3, 4.2 points lower than the third quarter of 2012. Year-to-date, we've improved 2.9 points to 93.2 versus the same period in 2012.

Let's move to Slide 6. Written premiums of $1.6 billion were up 1% in the quarter. Small Commercial and Middle Market were both up 2%, with Specialty down 4%, primarily related to profit improvement actions in our Programs and Captive businesses.

Written pricing and Standard Commercial remained very solid for the quarter at 8%, generally consistent with prior quarters and well ahead of loss cost trends.

The components of overall pricing shifted slightly, with Small Commercial auto up a point to 7% from 6% and workers' compensation in Middle Market declining to 9% from 10%. All in, I'm pleased with our ability to maintain this pace of consistent pricing gains, given that we still have more work ahead before we achieve our target returns.

Let me now share some specific thoughts about each of our 3 P&C Commercial business segments, starting with our market-leading Small Commercial franchise on Slide 7.

Written premiums of $740 million were up 2% in the quarter. Retention and pricing remain very steady, and new business of $115 million was up 6% versus third quarter of 2012.

Our market momentum in Small Commercial has picked up over the last 4 to 5 months. We continue to see very positive returns from the rollout of our new quoting platform, ICON, for our business owner's policy. Feedback from our agent partners tell us that we've hit a home run here. Average quote time for a new policy is down to 5 minutes or less. Quote flow is up 10% in the quarter and our yield ratio is improving as well. We've embedded new support tools, increased our straight-through processing flow and delivered a world-class user experience to our agents. We now have both workers' compensation and our business owner's policy on this platform, and we'll complete the full product suite next year when we roll out commercial auto.

To conclude on Small Commercial, our returns in this business continue to be excellent, with an all-in combined ratio for the quarter of 92.4, and 87.1 excluding CATs and prior year development.

Moving to Slide 8. Our Middle Market segment also had a strong performance, with current accident quarter combined ratio, excluding CATs, of 95.9. Margins continued to improve while we're deepening our market penetration and target segments.

Top line was up 2% in the quarter on the back of strong written pricing gains at 8%, well ahead of our loss cost trends. And new business premiums at $107 million were up 24% compared to 2012.

We're encouraged by improving retention in this business segment. Policy count retention moved up slightly and premium retentions are also improving to stronger historical levels. This is a result of a much healthier book of business in the Middle Market after aggressive reunderwriting actions these last 2 years.

Reviewing our trends, much of the heavy lifting is behind us from an underwriting perspective. However, we've not backed off from our segmentation actions to correct pricing on underperforming accounts, but the good news is that we have fewer of them today. All-in, another quarter of strong progress for Middle Market.

On Slide 9, the performance of our Specialty businesses remains mixed. Success in national accounts continues, with written premium growth of 15% in the quarter. Rate levels remain consistent and we're pleased with our execution.

Turning to our Programs business, we are disappointed at the further deterioration to our results. We recorded a $60 million addition through our auto liability reserve this quarter, largely in connection with 5 transportation programs. Over the past year, we've exited 4 of the 5 transportation programs, and we will discontinue writing new and renewal business on the final program effective January 1, 2014.

Earned premium from these transportation programs will decline rapidly as expiring business moves to other insurance markets throughout 2014. We did not react quickly enough to the early signs of adverse trends in this book. Our profit actions have increased significantly in speed and intensity over the past 6 months. I'm confident that we are addressing the areas that have caused these adverse financial outcomes. More importantly, I'm confident that we're building a data-driven risk management culture that will act with greater speed and decisiveness moving ahead.

Let me now shift over to Group Benefits business summarized on Slide 10, which had an outstanding quarter. We've been very disciplined in our management actions and the results are clearly paying off. Core earnings for the quarter were up 57% over prior year, achieving an after-tax margin of 3.9%. Year-to-date, core earnings are up 66% over 2012, driving an after-tax margin improvement of 1.7 points. Our improved core earnings are largely attributable to a lower disability loss ratio, which came in at 87.9% for the quarter, favorable to last year by 3.6 points.

We've commented previously that our claim recoveries were improving across our long-term disability book and this trend continued in quarter 3. In particular, actual recoveries for accident years '11 and '12 have emerged better than our previous expectations. This has caused us to update our reserve assumptions for claim recoveries in accident years '12 and prior, which contributed to our loss ratio improvement in the quarter. This also gives us high confidence in our projection for accident year 2013 and confirms that we're making great progress on our pricing and claim initiatives.

Heading to the favorable outlook, we're encouraged by continued signs of declining incidence rates. As you recall, incidence rates have been stable for several years but at historically elevated levels. As our 2012 data has matured, and now with a very early look at 2013, we have continued to see a modest but consistent decrease in incidence rates, approaching levels more in line with long-term patterns. Looking to both recovery and incident trends, we believe they established a strong profit driver for us moving forward.

Shifting to the top line. This is the second consecutive quarter of year-over-year growth in new sales, posting $63 million this quarter, up 15% from 2012 as conditions in certain sectors of the new business marketplace have improved. We're also working aggressively on our January 2014 renewal block, which is particularly important for the National Accounts segment. We're maintaining our disciplined approach to pricing and underwriting on our multiyear contracts. Our execution on renewals and new sales, in conjunction with favorable emerging trends in our book of business, indicate that we are well along our journey to achieve target profitability levels.

Stepping back from the details, this was a solid quarter for Commercial Markets. Our performance was consistent with the strong start in the first half of 2013, and we continue to see the positive results of underwriting and pricing decisions made over the last few years. Overall, written and earned pricing is still outpacing our loss cost trends and driving margin improvement across our businesses. We still have much work ahead, but I'm excited about our progress.

Let me now turn the call over to Andy Napoli.

Andre A. Napoli
Former Executive Vice President and President of Consumer Markets & Enterprise Business Services

Thanks, Doug. Good morning, everyone. Before we get into the details for the quarter, I'd like to briefly discuss our broader strategy.

First, we couldn't be more pleased with the 3-year extension of our contract with AARP. This long-standing partnership is the core of our business and has produced strong results over the last 30 years, and we expect that to continue.

Our AARP program, historically a direct model, has gained significant traction in our agency channel, which came at a good time as we work to reposition the non-AARP or other agency portfolio. That effort continues to pay off as we've achieved significant combined ratio improvement in that channel over the past couple of years. And we now view this channel as a more significant source of profitable growth as we move forward. More to follow as this strategy unfolds.

Now turning to our results for the third quarter on Slide 12. We had another quarter of expanding margins while improving growth. In both auto and homeowners, earned pricing exceeded loss cost trends, and we were able to accomplish this while maintaining premium retention. Growth was driven primarily by strong new business production in our AARP Direct and AARP Agency channels. But especially noteworthy was 2% growth in other agency new business. The combination of new business and policy retention, particularly in auto, led to our third consecutive sequential quarter of in-force policy growth.

Core earnings for the quarter were $68 million, which included a 2.2-point improvement in our x CAT, x prior year combined ratio. The quarter's core earnings were also impacted by a higher level of CAT losses and a lower level of favorable prior year development than in the third quarter of 2012. Current accident year CAT losses in the quarter were $18 million, primarily related to wind and hail events in Colorado and other Midwest states. The $18 million is above last year's levels, but as the third quarter is typically a seasonally high quarter for CATs, this was well below expected levels.

During the quarter, we also lowered operational costs while increasing our AARP Direct marketing. Those actions, combined with premium growth, have kept our expense ratio flat. We are committed to driving down our expense ratio further through additional operational and process improvements.

Turning to Slide 13 and focusing on auto profitability. Our combined ratio, x CAT and x prior year, improved to 96.8, over 3 points better than last year.

Here is our perspective on loss trends. For auto liability, which combined bodily injury and property damage, both frequency and severity are up low-single-digits. This is relatively benign from our perspective. Auto physical damage frequency increased, but primarily with smaller towing claims, so there was a favorable offset in severity. On a net basis, physical damage trend is up, but pricing continues to exceed loss costs.

In homeowners, our combined ratio x CAT and prior year dropped just over a 0.5-point to 77.6, reflecting strong earned pricing exceeding loss trends and continued favorable non-CAT weather and non-weather frequency.

Now let's transition to growth on Slide 14. Written premiums grew 3% for the quarter, in total and individually, for both auto and homeowners. Written premium has grown 2% year-to-date, and we're positioned to maintain that level on a full year basis.

Contributing to the growth were renewal written pricing increases of 5% and 8% in auto and homeowners, respectively, while maintaining policy retention in both product lines.

New business increased 19% to $100 million in auto, and 9% at $35 million in homeowners. New business production was driven in part by a 42% increase in our AARP Agency channel, as well as increased spend and marketing productivity in the AARP Direct channel. Homeowners growth has moderated, following the initial launch of our new Home Advantage product and targeted rate increases in a number of states.

In closing, we're pleased with our results for the quarter and the year so far, and we're positioned to deliver similar results as we close out the year. We'll closely monitor our loss trends, and we'll take the necessary rate to achieve our combined ratio targets while also continuing our growth momentum across all our channels. I'll now turn the call over to Chris.

Christopher John Swift
Chairman & CEO

Thank you, Andy. Good morning, everyone. I have 3 main topics to cover this morning: First, I will review the quarter's results; second, I will cover the performance of the variable annuity books; and third, I'll provide a fourth quarter and updated full year 2013 outlook.

Let's begin on Slide 16. Third quarter 2013 core earnings rose 17% to $505 million. Core earnings were $1.03 per diluted share, an increase of 14%. Commercial markets, which Doug just covered, was a major contributor to the growth. P&C Commercial and Group Benefits achieved higher margins, driving core earnings for those segments up 9% and 57%, respectively. Andy covered Consumer Markets, which had a strong underlying quarter but lower core earnings due to higher catastrophes and less favorable development.

Touching on the other segments. Mutual Funds core earnings decreased slightly from the third quarter of 2012 due to higher expenses for marketing and advertising. Fund performance remains solid, driving sales up 35% over the prior year. Although net flows remain negative, they improved 18% over last year and 78% over the second quarter. Talcott core earnings were up 6% over prior year, higher than our July outlook largely due to $22 million of pretax limited partnership income versus our outlook of $0 million to $5 million for the whole company.

In the Corporate segment, core losses improved $60 million over the prior period, principally due to a total after-tax benefits of $55 million from an insurance recovery and items related to the spin-off from The Hartford's former parent. Including this quarter results, we achieved a trailing 12-month core earnings ROE of 8%, which is at the higher end of our 2013 outlook.

Net income for the quarter was $293 million, a significant improvement from $13 million last year. 2 principal items reconcile core earnings to net income this quarter: First, net realized capital losses totaling $130 million after tax and DAC, principally due to Japan VA hedge losses; and second, an unlock charge of $67 million, mostly due to the annual assumption study, which we had completed this quarter.

Turning to Slide 17, you can see that core earnings included a total benefit of $87 million after tax or $0.18 per diluted share for certain items. The 2 largest items were the $55 million benefit in Corporate that I just mentioned and $43 million in favorable CATs, compared to our outlook of $86 million after tax.

Last year's quarter included $44 million in core earnings from Individual Life and Retirement Plans, which were sold in January of this year.

Turning to Slide 18. In September 30, The Hartford's book value per diluted share was $87.87 -- excuse me, $38.87, up slightly from June. Book value per share reflects a decline in unrealized gains on our investment portfolio due to higher interest rates, which is shown in the table at the bottom of this slide. Excluding AOCI, book value per diluted share was $38.91, up slightly from June.

Book value per share includes the accretion from share repurchases, which totaled $408 million through September. We expect to repurchase about $200 million or so each quarter going forward, subject to legal restrictions and market conditions.

Our principal focus at Talcott is to reduce the size and risk of that block. And as Liam mentioned, we have made significant progress this year. In the IFS, we provided some additional disclosures about policy counts this quarter.

Slide 19 shows that since September 2012, Japan VA contract in-force are down about 18%, resulting in a permanent reduction in the size and risk of the block. Japan's surrenders have been driven by the sharp improvement in in-contract moneyness due to a combination of market factors, including higher equity market levels and a weaker yen. In addition, 73% of total contracts are beyond the surrender charge period.

This slide also shows GMDB and GMIB net amount at risk, or NAR, over the past several quarters. GMIB NAR is down 92% over the past year to only $0.5 billion at September 30. Moneyness is another way to measure the improvement in the book. At the end of the quarter, 53% of the GMIB contracts are out of the money, which means that the account value exceeds our GMIB guarantee. This compares favorably with 43% at June 30 and 2% at year end 2012.

In August, the first tranches of Japan VA contracts become eligible for annuitization. To date, many contract holders are surrendering rather than annuitizing or deferring their annuitization, which is a positive for us and that we come off risk faster than expected. While the eligible number of accounts is small in 2013, it ramps up substantially in 2014, which will allow us to develop a more informed view of this aspect of customer behavior next year. 2015 is the peak for potential annuitizations, with about $5 billion of account value eligible to annuitize.

Again, it's too soon to know if our current experience will continue, but initial signs have been favorable.

Moving to Slide 20. Favorable markets and in-force management initiatives are driving similar trends in our U.S. VA block. As Liam mentioned, the annualized full VA surrender rate increased to about 20%, including about 6 points from in-force management initiatives, including the ESV program.

During the quarter, we finished the ESV program launch, extending the offer in 4 more states. As of quarter end, 91% of GMWB contracts are out of the money and 84% of total contracts are beyond the surrender charge period.

GMWB NAR has declined 67% since September 30, 2012, while total U.S. VA contracts in-force have decreased by 14%.

Based on the policyholder behavior across the VA blocks, we are confident that Talcott will be positioned to return capital to the holding company in late 2014 or early 2015.

Our capital resources are summarized on Slide 21. At September 30, they totaled $17.7 billion, down $400 million from June. The decrease was in holding company resources, while total insurance company capital was up slightly after the impact of the quarterly P&C dividend to the holding company.

Life surplus was flat this quarter, as operating income from non-VA books, including the Group Benefits business, offset the modest negative impact of VAs. Life capital margin remains strong, with an estimated RBC ratio of 460% in The Hartford Life and Accident group, allowing us to complete the Group Benefits legal entity separation project without utilizing holding company resources. We remain on schedule to complete that project by the end of the first quarter 2014.

The decrease in holding company resources reflects the $320 million debt maturity and $241 million of share repurchases. Going forward, we expect holding company resources to decline due to the equity repurchase program and the March 2014 debt maturity but to remain in line with our liquidity target of approximately 2x annual interest expense and dividend payments.

Before turning to your questions, let me provide a brief summary of our fourth quarter outlook, which is on Slide 22.

Our current outlook for the fourth quarter core earnings is a range of $420 million to $445 million or $0.87 to $0.92 per diluted share.

This outlook assumes catastrophe losses of $42 million after tax and Talcott core earnings of $165 million to $175 million, including approximately $7 million in after-tax costs for the ESV program. This outlook also assumes limited partnership income of about $60 million before tax, which equates to a 9% yield.

We are estimating an average share count of about 485 million shares based on $200 million of share repurchases. Also expected is a realized gain of approximately $15 million after tax from the sale of the AARP member contract center for health insurance products to a division of UnitedHealthcare. This center, which generates about $15 million of core earnings per year, is included in the Consumer Markets segment. This deal is consistent with our strategy to sharpen our focus on P&C, Group Benefits and Mutual Funds. The transaction is expected to close before the end of the year.

If you add this fourth quarter outlook to our year-to-date results, which are summarized on the slide, 2013 core earnings would be about $1.7 billion. This is well ahead of our April outlook of $1.45 billion to $1.55 billion.

Our actual results will depend on a lot of factors, including no major CATs in the fourth quarter. However, we are very pleased with our 2013 results and appreciate the significant effort by all of our teammates to achieve these results.

We look forward to delivering both growth and progress on our strategic goals in 2014. We are in the midst of the planning process, and we'll share our 2014 outlook with you on our February call.

To wrap up, let me summarize a few themes from the quarter and the year. Our go-forward businesses are producing strong results, with top line growth in P&C and improving margins in P&C and Group Benefits. Talcott has made significant progress in reducing the size and risk of the legacy annuity liabilities, with favorable contract holder behavior, resulting in higher surrender rates. And capital resources remain strong. And with favorable trends at Talcott, we are confident in our ability to return capital from Talcott in late 2014 or early 2015.

Now I'll turn the call over to Sabra, so we could begin the Q&A session. Sabra?

Sabra R. Purtill
Senior Vice President of Investor Relations
Thank you, Chris. We have a little less than 30 minutes for Q&A. [Operator Instructions] Melissa, could you please give the Q&A instructions?

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Tom Gallagher from Crédit Suisse.

Thomas George Gallagher
Crédit Suisse AG, Research Division

I just wanted to ask a few questions on Talcott. The first question is, does running off the VA block on your own still make the most economic sense here? But to another way of asking, is the bid-ask spread still too wide in your view to pursue risk transfer deals?

Liam E. McGee
Former Chairman

Well, Tom, this is Liam. Our strategy on Talcott remains unchanged. That's to reduce the size and risk of the VA book. And as you heard in both my remarks and Chris' remarks, Beth and her team have been proactive against that strategy as evidenced by the increased lapse rates, the significant reduction in the policy count in the last 12 months, whether that's through the Enhanced Surrender Value or policyholder education. We've also -- we're also consistent in saying that potential transactions that can permanently transfer these exposures and accelerate a release of capital are things that we'll continue to evaluate, and we would pursue those transactions that are attractive in terms of sales price and the capital that would be released compared to the underlying economic value of the business. I'm not going to speculate on any theoretical transactions, Tom, so I think that's going to be the extent of my remarks on that topic.

Thomas George Gallagher
Crédit Suisse AG, Research Division

Okay. And Liam, suffice to say, though, given how fast the lapse rates are moving and the -- also to Chris' comment about the now policyholders that could elect to defer or to annuitize who are actually surrendering, I'm assuming the view of fair market value continues to grow higher in your view based on those trends.

Liam E. McGee
Former Chairman

Again, I'm not going to speculate on how the market might value it. What I'd say is that obviously we have a lot of flexibility because of some of the things you noted and that Chris and I have mentioned as well, and we'll look at all options, including continue the great proactive work that Beth and her team have done this far and including evaluating potential transactions. But we would also pursue those that are attractive in terms of sales price and the capital that would be released as compared to the underlying economic value of the book.

Thomas George Gallagher
Crédit Suisse AG, Research Division

Understood, Liam. And then just a follow-up for Chris on -- what's the best way that we should be thinking about Talcott? You're looking -- between U.S. and Japan, lapse rates are running at 20% to 30%. And so if you look forward a year or -- more at a higher level, assuming 5% or 6% or so market appreciation, that would imply, all else equal, the year-over-year profit decline would be roughly 15% to 20%. And I know that's not the way you're thinking about it economically but that would be the way it's presented in your P&L unless I'm missing something else that might be major there. And so, a, is that the right way to think about it, or there are some other offsets? And b, would you all be better off giving net income guidance on this business, or guidance that somehow better expresses the way you're thinking about the economics?

Christopher John Swift
Chairman & CEO

Tom, it's Chris. A couple of points. I think you are seeing that the trends right and Beth might be able to comment upon what she sees for fourth quarter lapses but they are elevated, particularly in Japan and in the U.S. So we'll talk more about it in February when we give guidance, but I do think your point of view on a substantial decline in Talcott's core earnings is right on. So I think you're wise to look hard at those forward views, given the elevated lapses in Japan and that the recent elevation we've seen in the U.S. Beth, would you care to comment upon fourth quarter lapses and what you've seen?

Beth A. Bombara
Chief Financial Officer and Executive Vice President

Yes, sure. So as we look at the activity that we've seen in October, we continue to be very pleased with the level of surrenders that we're seeing. In the U.S. we're slightly under the 20% that we saw for all of Q3. And in Japan, we're running maybe around 25% or so. So, again, I think as markets stay where they are, continue to rise, we'd expect our surrender rates to continue to be very elevated. And as Chris pointed out, that does have the impact of reducing earnings going forward. But more importantly, it reduces the risk, which is what we're focused on.

Operator

Your next question comes from the line of Jay Cohen from Bank of America Merrill Lynch.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

A couple of questions, I guess, probably for Doug. Two lines of businesses I would like to ask about on the Commercial side. First is workers' compensation. I've seen some industry data that suggests that claims frequency, after spiking in 2010, came down in '11 and '12, and I want to get a sense of what you're seeing in that line. And then secondly, in the commercial auto business, in the Program business, where the biggest reserve addition was taken, can you talk about the tail on that business? How long it is?

Douglas G. Elliot
President

Sure, Jay. This is Doug. Let me talk about workers' comp to start with. We are seeing very positive signs in our comp book over the last couple of years, particularly around frequency. And obviously, we spend time looking at it across our markets but certainly, in our Small Commercial and Middle Market businesses, our frequencies in the last 4 to 6 quarters have been flat to down, so I think consistent with some of the signals you're seeing in the marketplace. But we think both our underwriting actions and some of things we've done in the last couple of years have clearly driven our change. So good news on the frequency front in workers' comp. In terms of the automobile, transportation programs, we do have our arms around it. This is more an exit strategy than it is a fixed strategy. At the moment, I'll share with you, by 1/1/14, we'll be out of the 5 programs that have caused really much of our financial adverse positioning here. There is clearly a BI severity dynamic in the marketplace, not just in the Programs area but across commercial auto in general, and we're underwriting and pricing our way through that. The tail, when I think about commercial auto, clearly, it's not a workers' comp tail but it's also not a property tail. So I think of it in that 3- to 4-year period of time, and we're aggressively looking at '09, '10, '11 and '12 as we speak. So I feel like we took actions to deal with the increased severity over that period of time, and this book will run out over the period of the next 12 months.

Operator

Your next question comes from the line of Brian Meredith from UBS.

Brian Robert Meredith
UBS Investment Bank, Research Division

Two questions. One, I guess, is for Doug. Doug, I'm just curious in the Commercial line's underlying loss ratios, obviously, very substantial improvement year-over-year. How much would you attribute that to just kind of lower than kind of trend loss costs?

Douglas G. Elliot
President

Brian, very difficult to articulate. I do believe that in our positive trends, more than rate is coming through. We have an have aggressive analytics program where we quintile our book of business and we look at retentions and price changes across classes, industries and geographies. And so probably, much of the change is rate driven. But I think an appreciable component of our 3-plus-points of improvement year-over-year is driven by, what I would say, underwriting quality of change in the book.

Brian Robert Meredith
UBS Investment Bank, Research Division

Okay. So more just is the changes in terms and conditions you're doing, not so much just it's been a lucky kind of weather situation, non-CAT weather?

Douglas G. Elliot
President

Yes, certainly, in the properties side. I mean, we've strengthened our ability to underwriting our product in the marketplace relative to Property over the last 3 years. And so deductible changes, policy form, et cetera, all contribute on the Property side. I was kind of giving you more of global across all lines of view of just increased attention to our risk product in the marketplace. And I think the analytics behind some of our choices have clearly driven some of that positive change in our loss ratio.

Brian Robert Meredith
UBS Investment Bank, Research Division

Great, and then for Chris. Because I'm wondering if you could give us a sense of what you think the market consistent value is for the Japanese and the U.S. runoff books right now. Is it appreciably higher than it was at Investor Day?

Christopher John Swift
Chairman & CEO

I think, directionally, I can comment upon that, Brian. We'll periodically update numbers when appropriate. But generally, I would say, for Japan, it's less negative. And for the U.S., it's greater, greater positive. So I mean, that's where we stand here right now at the third quarter, and we are contemplating updating that at least once a year. And give us a little time, and we'll put it out there at the appropriate time.

Brian Robert Meredith
UBS Investment Bank, Research Division

Is there any way we can kind of -- is it 20% higher in the U.S.? 10%?

Christopher John Swift
Chairman & CEO

It's meaningful. I'd say in that range, yes.

Operator

Your next question comes from the line of Erik Bass from Citigroup.

Erik James Bass
Citigroup Inc, Research Division

I was hoping you could talk a little bit more about just your expectations for capital return from Talcott. And I guess, specifically, the factors that affect the timing of paying dividends.

Liam E. McGee
Former Chairman

Well, Chris will, I'm sure, want to give more detail. I'd reiterate what he and I have said is that we are confident that Talcott is positioned to return capital to the holding company in late 2014 or early 2015. I'd remind you, Erik, that there's a lot of work in process, whether it's closing the U.K. sale, or the completion of the Group Benefits realignment, et cetera. So there is still some work afoot. And with that, Chris, if you want to add any more perspectives to Erik's question.

Christopher John Swift
Chairman & CEO

I think you're right to mention the moving parts, Liam. So I always just start by saying what's different today, Erik? I mean, for '14, for both Group Benefits and Mutual Funds, I mean, we're going to have cash flows coming to the ultimate parent company, holding company, that we didn't have in prior years. So there's probably about $150 million in new cash flows that are coming out of those, I'll call it former Talcott entities. With relation then to Talcott, the remain Co., we always think about it in terms of the Japanese balance sheet and the U.S. balance sheet. I think, for Japan, one of the things just to keep in mind is there is a little bit of a constraint on dividends. Meaning, you have to have positive retained earnings. We just barely turned positive at the end of the third quarter 2013 here. So our current thinking is we will inform the regulators, we don't have to seek their approval when we're in positive retained earnings. But we will bring them a 2014, early '15 plan for capital extraction out of Japan, make sure they understand it and begin to execute it in the second half of 2014. And then with regard to the U.S., similar constraints. After we spin off Group Benefits into its own legal entity, I mean, we're in extraordinary dividend land because, again, we have negative retained deficits at HLIC and ILA. So we'll, at the appropriate time, work with the regulators to extract capital. But that would have to be in the form of extraordinary dividend. Does that help?

Erik James Bass
Citigroup Inc, Research Division

Yes, that's helpful. And then, I guess, just over time, how quickly should we think about capital and reserves being freed as policies lapse? So maybe not thinking specifically in 2014 but just on kind of an ongoing basis, what is the lag between kind of seeing lapses and then when those reserves could -- reserves or capital could potentially become available for dividends?

Christopher John Swift
Chairman & CEO

Yes, we'll cover a little bit more of our outlook of earnings and capital in February. But I would say that I think, generally, you have to keep in mind, I'll call it, we always talk about it, Beth and I, units of risks, right? We're still managing units of risk, and we run our stress scenarios that we are always going to manage to. So lapses, by definition, will always have a lag factor compared to units of risk in a stress scenario. And we'll describe that the best way we can in February.

Operator

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

John Matthew Nadel
Sterne Agee & Leach Inc., Research Division

A couple of questions. One, just on the -- I'm thinking about, especially in relation to Tom's question, about the pace of runoff, maybe pace of account value decline, in the runoff VA box and thinking about that sort of 15% to 20% type of pace of decline in Talcott earnings as a result. And I'm sort of connecting that to the fourth quarter outlook for Talcott, which suggests something, on an annualized basis anyway, that's a much faster pace of runoff when we adjust for some of the one-timers. Just wondering if there's anything you can help us understand there as it relates to the fourth quarter outlook versus the third quarter, which looks like it was more in the $200 million, $205 million range if we take out the ESV costs and maybe some strong results in the Other line.

Christopher John Swift

Chairman & CEO

Yes, John, it's Chris. I think you got to think in terms of just going to the fourth quarter that the third quarter had, I'll call it, a couple of one-timers in it, particularly for, I'll call it, investment income partnerships. But generally, as lapses occur, we're going to have less fee income. We are projecting just less net investment income in total in Talcott from regular spread products and then any other income. And we did have a couple of one-time benefits for taxes and other, I'll call it, miscellaneous income benefits that just aren't expected to recur. So I really do believe the one -- the range that we gave, which, at the midpoint, $170 million, $175 million is really what you need to think in terms of just a basic core run rate going forward and really adjust for lapses from that rate.

John Matthew Nadel
Sterne Agee & Leach Inc., Research Division

Okay. And maybe we'll follow up a little bit off-line. And then just one other question on the -- you've updated us in the past on your progress on expense initiatives relative to your targets. There's nothing here in the third quarter presentation. But can you just update us, at this point, how much of your expense saves is in your third quarter results? And how much more should we expect as we move through 2014?

Christopher John Swift
Chairman & CEO

Thanks for asking the question. I think we feel very good about all our expense initiatives here related to stranded costs related to our sales that we completed earlier this year. So we're right on track. They are beginning to earn in. And I think in February, when we get together and talk more about our run rate for '14 and even a little bit '15, I think will give you a better sense of the additional expense initiatives that we're planning above and beyond just getting the stranded corporate costs out from a deal perspective. But there is new rounds of initiatives that we're planning that, really, will take us forward for the next 3 years, with goals to become a more efficient organization.

John Matthew Nadel
Sterne Agee & Leach Inc., Research Division

Okay. And if I can sneak one more in just thinking about the Japanese VA business. I think, if I recall correctly, you guys hold contingency reserves in the Japanese sub. I think that number was somewhere around $700 million. Has that changed? Well, first of all, is that right? And secondly, has that changed meaningfully as a result of this faster pace of surrender activity? Have you started to build in to the actuarial assumptions this higher pace of surrenders?

Christopher John Swift
Chairman & CEO

I'll give you 2 data points just for clarity. You are right. It's a little light of $700 million on a U.S. dollar basis. It has been trending down just a little bit as the book runs off. So you're right. And then, the way we think about capital that supports the Japan, I'll call it block of business, 2 pieces, right? The $1.2 billion of capital in the legal entity that we disclosed. And then there's still, going back to what we disclosed in our Investor Day for Talcott, about $600 million of U.S. statutory capital that's backing -- that reinsurance business into the U.S. So those are the couple key metrics that I'll just share with you, John.

Operator

Your next question comes from the line of Jay Gelb from Barclays.

Jay H. Gelb
Barclays PLC, Research Division

For the Japan business, how would that $1.8 billion of total stack capital compare to a U.S. GAAP capital?

Christopher John Swift
Chairman & CEO

Jay, it's Chris. I would say it would be -- the U.S. capital would be slightly higher in the range of $2.4 billion. Again, in total, in aggregate, supporting all the, call it Japanese risks, no matter if they're in the island of Japan or if they're in the U.S. But in aggregate, I would say approximately $2.4 billion of GAAP capital.

Jay H. Gelb
Barclays PLC, Research Division

Okay. And on that same metric, what would you allocate the U.S. variable annuity business capital position?

Christopher John Swift
Chairman & CEO

I don't have that right in front of me, Jay. So I guess I'd want to be more thoughtful. But, again, I think if you go back to Investor Day, I think if you look at some of our disclosures, adjust for Group Benefits, now adjust for Japan, you're really left then with, I'll call it, runoff Talcott. But I'd rather be more thoughtful and just give you that number when we talk about our earnings and guidance for 2014.

Jay H. Gelb
Barclays PLC, Research Division

Okay. On a statutory basis of the $6.9 billion U.S. Life capital position, can you give a rough breakdown of what that consists of currently?

Christopher John Swift
Chairman & CEO

Yes. And I think I know where you're going, so of the U.S. statutory capital, how we think about it is x Japan, x, I'll call it, U.K. operation, HLL, and x recapitalization of Group Benefits, what Talcott will be left with is about $4.5 billion of statutory surplus. So when we get through the Group Benefits separation, when we sell and close on HLL in the fourth quarter, which is still on track, and you exclude sort of the Japan statutory capital that's allocated in the U.S. to it, you're left with $4.5 billion backing, I'll call it, the U.S. runoff liabilities, which are, again, are variable annuities and fixed payout annuities.

Operator

Your next question comes from the line of Christopher Giovanni from Goldman Sachs.

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

Liam, a follow-up for you in terms of you mentioned kind of a growing interest in the market for runoff annuity blocks. I'm curious if you could dissect a bit in terms of those that are showing interest. So maybe the mix of kind of PE-backed players, reinsurers or traditional insurers. And then how many of these guys are really just looking for kind of a lopsided deal versus maybe a more credible bidder and counterparty?

Liam E. McGee
Former Chairman

Chris, I think you can understand, for a variety of reasons, it's not appropriate for me to talk about it. Such transactions or conversations involve The Hartford characterizing counterparties, describing motivations, I just don't think would be appropriate.

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

Okay. And then, I guess, for Chris. Just an update in terms of the legal entity separation. You had mentioned to kind of strip out the Group Benefits piece. Any timeline for when you expect to have that done?

Christopher John Swift

Chairman & CEO

Yes, Chris. We feel very good about it. We've gotten, I'll call it, the legal entity approved in New York. And we got to get some product filings approved. We got to finish couple a little operational activities with admin systems. But I would say mid- to late-first quarter, we'll have that all done.

Operator

Your last question comes from the line of Mark Finkelstein from Evercore.

A. Mark Finkelstein
Evercore ISI, Research Division

Maybe the first question for Doug. Doug, in the specialty programs that you've set for termination, already terminated, what is the total value of the premium, looking a year from now, that won't be on the books anymore?

Douglas G. Elliot
President

The total value of all 5 of those transportation programs that we're exiting is approximately $50 million annually, so think of that out -- and several of those decisions have been made over the prior quarter. So the last program to cease writing, new and renewal, 1/1/14.

A. Mark Finkelstein
Evercore ISI, Research Division

Okay. And that -- the $50 million is still essentially in there? So that full value will go away over the next kind of 4 to 6 quarters or whatever?

Douglas G. Elliot
President

Correct.

A. Mark Finkelstein
Evercore ISI, Research Division

Okay, perfect. And then, I guess, a final question for Chris. Chris, could you just talk about J GAAP earnings a little bit? I feel like maybe we've actually kind of crossed over into positive surplus in Japan. Maybe a little quicker. I don't know if that's right or wrong, if you can comment on that. And then, secondly, kind of what are J GAAP -- or what have J GAAP earnings been kind of over the last 2 quarters?

Christopher John Swift
Chairman & CEO

I think between Beth and I, we -- I'll try to give you a frame. But we are, as I said, at September 30, about $10 million of positive retained earnings. Some of that is, again, just more fee income, more spread income off the general account products. Some of it is the, I'll call it, contingency reserves that are, I'll call it, running off. So as we look forward, that's why we want to finish 2014, get through March, which is their fiscal year, that those accounts all closed up, see exactly where we are, we will have a better, then, forward view of the next 12 months, with just the next fiscal year for earnings. And then take a comprehensive 12-month capital extraction plan in to the regulator and inform them what we're going to. And then begin to execute it in the latter half of '14. But, Beth, from a run rate side on GAAP -- J GAAP earnings, any color you could provide?

Beth A. Bombara
Chief Financial Officer and Executive Vice President

Yes, just -- if you go back to June, just as a starting point, we had negative retained earnings of about $60 million. So that's kind of the quarterly earnings that we see, if we got the positive $10 million, so you're looking at $60 million to $70 million a quarter.

A. Mark Finkelstein
Evercore ISI, Research Division

Okay. And have you turned positive a little quicker than your original plan was?

Christopher John Swift
Chairman & CEO

I would say, generally, right on schedule. Maybe a smidge sooner, Mark. But generally right on plan. I mean, if you think about it, I really consider it breakeven right now. So we broke even. We'll then have 2 additional quarters of, I'll call it, activity to take to the FSA. We'll look then at the next forward activity. So you really could see and get a sense that we're already looking 6 quarters ahead for what that balance sheet looks like and then how much capital we could take out.

A. Mark Finkelstein
Evercore ISI, Research Division

Okay. And then, actually, one last question, if I could sneak it in. Can you just talk about incidence trends in Group? And how they compared sequentially with the second quarter, which was obviously very strong?

Douglas G. Elliot
President

Mark, this is Doug. I would say that sequentially, the incidence trends in the third quarter compare very consistent with second quarter, right? So we're finally seeing some improvement relative to those patterns. And third quarter sat right on top of second quarter.

Christopher John Swift
Chairman & CEO

Hey, Mark, just to tell you another point. Just -- as Doug and I look at that business, I mean, just to remind you, I mean, fourth quarter is our seasonally highest and best quarter in Group Benefits. So again, there'll be, I'll call it, seasonality and incident in termination improvements that will ultimately come through when we report fourth quarter earnings.

Liam E. McGee
Former Chairman

And Mark, the other point I'd make is that, as you know, because of the waiting periods, the retention components of these programs, the back half of the year is important for us to stay on top. We're just beginning to take a peek at the '13 year, given how these contracts are set up.

Sabra R. Purtill
Senior Vice President of Investor Relations

Thank you. Thank you, all, for joining us today. We appreciate your interest in The Hartford. Sean and I are available after the call for any follow-up questions you might have. And I would also note that Liam McGee is scheduled to present to the Goldman Sachs Conference on December 10. So we look forward to seeing you there as well. Thank you, and have a great day.

Operator
Ladies and gentlemen, this concludes today's conference call. You may now disconnect.