S&P Global
Market Intelligence

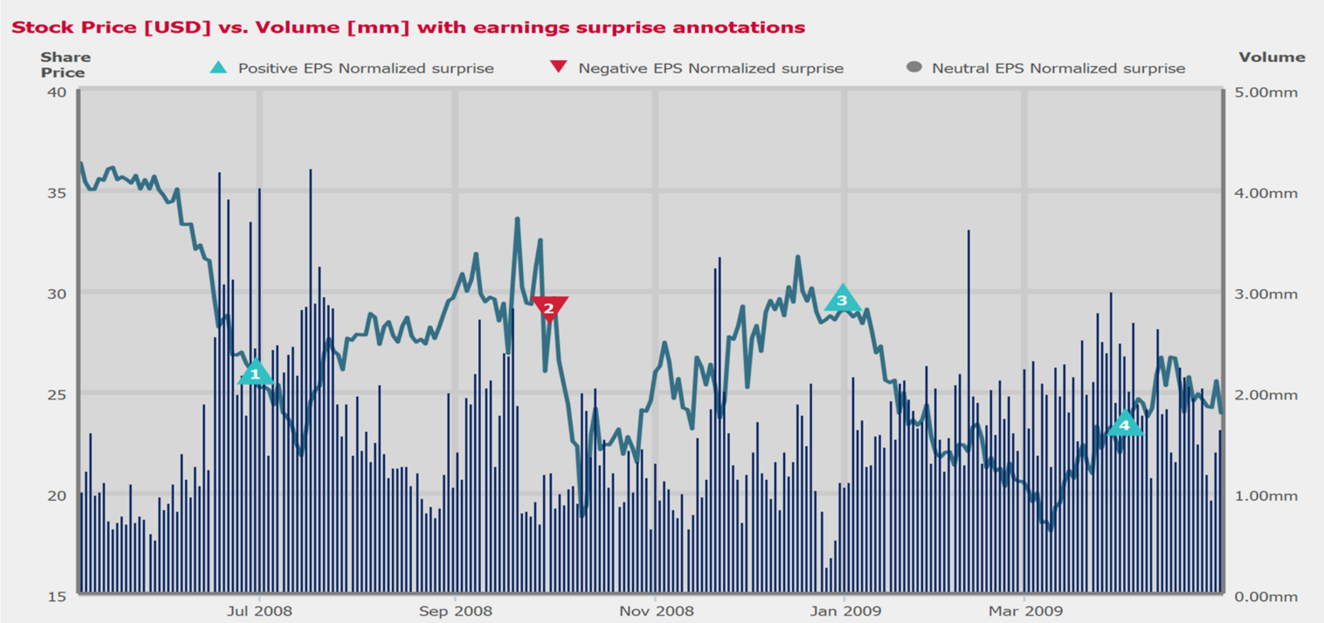
Cincinnati Financial Corporation NasdaqGS:CINF
FQ2 2009 Earnings Call Transcripts

Thursday, July 30, 2009 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2009-			-FQ3 2009-	-FY 2009-	-FY 2010-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.14	(0.03)	NM	0.48	1.37	2.01
Revenue	-	-	(4.19 %)	-	-	-
Revenue (mm)	912.20	874.00	-	915.83	3639.40	3729.10

Currency: USD
Consensus as of Jul-22-2009 9:30 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2008	0.28	0.42	50.00 %
FQ3 2008	0.50	0.45	(10.00 %)
FQ4 2008	0.52	0.57	9.62 %
FQ1 2009	0.20	0.23	15.00 %

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EXECUTIVES

Dennis E. McDaniel
VP & Investor Relations Officer

J.F. Scherer

Kenneth William Stecher
Non-Executive Chairman of the Board

Marty Mullen

Steven Justus Johnston
President, CEO & Director

ANALYSTS

Beth Malone
Wunderlich Securities

Dan Schlemmer
FPK

Fred Nelson
Crowell, Weedon & Company

Mark Dwelle
RBC Capital Markets

Michael Phillips
Stifel Nicolaus

Paul Newsome
Sandler O'Neill

Presentation

Operator

Good morning. My name is Amy and I will be your conference operator today. At this time, I would like to welcome everyone to the Cincinnati Financial second quarter conference call. All lines have been placed on mute to prevent any background noise.

After the speakers remarks there will be a question-and-answer session. (Operator instructions) Thank you. Mr. McDaniel, you may begin your conference.

Dennis E. McDaniel
VP & Investor Relations Officer

Hello. This is Dennis McDaniel, Cincinnati Financials Investor Relations Officer. Thank you for joining us for our second quarter 2009 conference call. This morning we issued a news release on our results along with our supplemental financial package.

We plan to file our quarterly report on Form 10-Q, early next week. If you need copies of the release or supplements, please visit our investor website, www.cinfin.com/investors. The shortest route to the information is in the far right column via the quarterly results quicklink.

On the call you will hear from Ken Stecher, President and Chief Executive Officer, and Chief Financial Officer, Steve Johnston. After their prepared remarks, we will open the call for questions. At that time, some responses may be made by others in the room with us, including Chairman, Jack Schiff Jr.; Executive Vice President, J.F. Scherer of Sales and Marketing; Principal Accounting Officer, Eric Mathews; and Senior Vice Presidents Marty Hollenbeck, Investments, and Marty Mullen, Claims.

First, please note that some of the matters to be discussed today are forward-looking. These forward-looking statements involve certain risks and uncertainties. With respect to these risks and uncertainties, we direct your attention to our news release and to our various filings with the SEC.

Also, reconciliation of non-GAAP information as required by Regulation G was provided with the release and also is available on our website. Statutory data is prepared in accordance with Statutory Accounting Rules and therefore is not reconciled to GAAP.

With that, let me turn the call over to Ken.

Kenneth William Stecher
Non-Executive Chairman of the Board

Welcome and thanks to all of you for joining us today. As you know we have reported disappointing second quarter financial results. Record catastrophe losses and ongoing cumulative pricing pressures have taken their toll on us this year. Further our pre-tax investment income has not yet resumed a growth trend compared to the year-ago periods.

The good news is that the same portfolio rebalancing that reduced our investment income also positioned us for the growth in book value per share that took place over the second quarter.

As a result of higher unrealized gains in our portfolio, policy order surplus in our main business, property casualty insurance rose about $135 million between the end of the first quarter and June 30.

It is good to see book value and surplus moving in a positive direct again and to see the progress we are making with our strategic initiatives to increase our long-term competitive advantages. Today, I'll focus on operations, markets, and status of those initiatives to improve future financial performance.

Steve will discuss our second quarter results and their main drivers, including catastrophes reserve development and accounting changes. In February, we said our year 2009 results will likely fall short of our longer-term targets. Despite our derivative results so far this year, we remain confident in our long-term outlook, believing that the strengths we bring to the market will position us for strong future performance.

Our independent agent relationships are strong and the many opportunities they give us to quote their best accounts are helping to offset some of the negative effects of the continuing soft markets. Agents count on us to provide a stable market for their client's insurance needs and to deliver best-in-class claims service, particularly when widespread storms occur. They highly value our local field team concept.

Our solid reputation among agents is one of the reasons that our new agencies are so quickly embracing Cincinnati style of service. Of the $3 million in premiums, our new taxes inches growth in the first half of this year. Six of these new agencies produced more than one quarter a million dollar each for premium.

One agency generated over $1.5 million. Technology clearly is central to maintaining those agent relationships in our high tier position within agencies. We are right on schedule to begin deploying our new commercial administration system for package and auto, and will give agents new processing efficiencies also allowing us to write more business with our proportionate increase in expenses.

Some of our underwriters already are using this system to produce policies for Ohio and Indiana agencies, when we deployed in October for using agent offices in the first five states. We will also introduce direct to all capability for package and auto. Our agents are really looking forward to having this capability.

The system will be up and running for agents in a total of 11 states before year-end 2009, preparing us for strong profitable growth when the economy and insurance market pricing begin to approve. And we will go into that market face with solid reserves, having made no compromises of our reserving practices along the way.

We have proven that we are willing to make difficult decisions to protect our track record of strong reserve adequacy. Steve will discuss this quarters' reserve development in detail. From a strategy level, our intention is to continue having a balance sheet that holds the potential of favorable reserve releases in the future earnings. That approach increases stability.

We also believe that our diversification efforts in several areas increase stability and will serve shareholders well in the future. Most of you listening today are aware that we maintain a well diversified and highly rated bond portfolio, exceeding our insurance reserve liabilities by more than 20%.

In recent quarters, we increased our bond holdings and reduced our common stock holdings to 25% of the total portfolio. We are very comfortable with our rebalance with asset classes. Most significantly, we diversified a way from equity concentrations in any single sector or issue.

Our portfolio diversification effort is a capital preservation strategy to manage volatility risk. Our new surplus lines operation brings the benefits of diversification to our insurance coverage product offerings. This operation is still very small, but as we said in our news release, is a significant contributor to new business growth in 2009.

The surplus lines products help our agents meet more of their clients needs. Also benefiting company performance by offsetting some of the soft pricing in our standard market commercialized. Our stable life insurance income likewise helps offset some of the market cycle impact of our property casualty business.

Finally, another very important diversification effort is our geographic expansion. The expansion's in new states is one of the several ways that we are addressing catastrophe risk and especially destructive effects of that risk on a homeowner results.

By entering or expanding our personal lines offerings in seven states in 2008 and 2009, we are setting the stage to gradually increase scale and overtime work to delude our concentration of insured exposures in the Midwest and South. We have confidence that those diversification strategies will produce long-term benefits.

Next, I will comment on a commercial lines premium growth, a near-term challenge for us and others in our industry. The commercial lines market remains highly competitive based on what we are seeing. Our second quarter net written premiums declined 12.2%. We have seen some moderation of average price decreases to low-single-digit territory, but those are still price declines and they represent averages.

We continue to hear stories about more aggressive competition, especially for larger risk. Whether they are larger or smaller risk, we walk away from the business we believe is underpriced. For example we recently lost an account we have had for 20 years to another carrier. It was a school system with annual premiums in the six-figure range that our competitor discounted by over 30%.

You have heard us say many times that nearly 90% of our commercial policy count represents policies with Annual Premiums of $10,000 or under and that is still the case. Well looking just at new business for larger policies with annual premiums of $100,000 and up, we see the effects of intense competition.

Our new business written in this size category during the second quarter was $7 million less from the second quarter last year, accounting for nearly the $8 million decline in commercial new business. Commercial premiums also have come under pressure, due to economic sensitivity. This year the rate of premium decline for contractor classes and our general liability at workers compensation business is roughly double that of our non-contractor classes.

Many businesses pay estimated premiums based on estimated exposures such as sales or payroll, then an audit at the end of the period true's up the premium. Our premiums generated through such premium audits declined $13 million during the first half of 2009 versus 2008. Before I close the prepared comments on our insurance operations, I will mention that our public parent company is highly liquid at June 30 with more than $1 billion in cash and marketable securities.

Strong capital provides the Corporation with financial flexibility for dividend and related decisions made by our Board of Directors. To maintain a desired parent company financial flexibility, we recognized that the performance of our commercial and personal insurance segments must improve.

For the reasons I have reviewed today, we believe it will improve. Although our expectations for the remainder of 2009 our modest, we expect to deliver strong financial performance for the longer-term.

Now Steve will discuss details of the quarter.

Steven Justus Johnston
President, CEO & Director

Thank you, Ken. As Ken mentioned, abnormally high catastrophe losses led to a combined ratio of 116.6 of the quarter. Catastrophe losses totaled $118 million or 16.1 loss ratio point. In total, 11 PCS named cats caused damage to our policyholders, most of it arising from three major wins and hail storms across the South and Midwest.

Our total catastrophe losses where higher than the $106 million estimated in our preliminary release, due to inclusion in our total estimate of several PCS defined cats that each cost us less than $3 million, but in total added up to approximately $12 million. Our homeowner line of business was most affected with 77.6 points of the 147.8 loss and loss expense ratio coming from these catastrophes.

On the more positive side, our total property casualty reserves on prior accident years developed favorably, giving us a benefit of approximately $29 million or 3.9 percentage points on the second quarter combined ratio. While overall reserve developed was favorable, there was some variation by line of business.

We have strengthened the reserves for prior years workers compensation claims by $29 million, while all other lines in total developed favorably by $58 million. The reserve development for workers compensation was primarily for accident years 2005 and prior. Nothing has changed in terms of our reserving philosophy and we continue to target total reserves in the upper half of the actual range.

For any insurance company strong reserves are essential to a strong balance sheet. Our track record of favorable reserve development goes back some 20 years and that trend appears to be continuing. Now, for some details on investments. Our more diversified investment portfolio contributed nicely to book value, which grew by 6.7% to $25.49 per share during the quarter.

Even after considering the turbulent markets and sales had harvested some capital gains, the equity portfolio once again ended the quarter with over $0.5 billion in net unrealized gains. As a result of the transformation of the portfolio over the past year, pretax investment income decreased by 8.4% quarter-over-quarter to $119 million.

We also adopted the carrier requirements under FSP 115-2, while there is no overall impact on equity or book value there will be an indirect impact on investment income for comparative purposes.

When the investment was written down as other than temporarily impaired, the cost of the bond was written down. Stand over the remaining life of the bond, the difference between that written down cost in par was amortized into the investment income over the remaining life of the bond.

During the fourth quarter of 2008, this amortization added $3.1 million to investment income and for the first quarter of 2009, it added $2.4 million. Most of the bonds that we previously wrote down as OTTI were written down for non- credit related issues. Under the new rules, there is not a material amount of this amortization included in second-quarter investment income and we anticipate that there will not be a material amount going forward.

This makes for a tough comparison for the second quarter sequentially to the first quarter of 2009 and will also make for a tough comparison in the upcoming fourth quarter. Adjusting for this accounting change, we do expect investment income to resume an increasing trend by the end of the second half of the year. Our liquidity, balance sheet, and financial condition and remained very strong putting us in a good position to grow profitably.

As a profit property casualty subsidiary group level, we are writing business at a premium to surplus ratio of 0.93 to 1.0 with statutory surplus of over $3.2 billion at June 30, 2009. Cash flow from operations for the first half of 2009 was $157 million, compared to $334 million in the first half of 2008.

As Ken mentioned, we have over $1 billion in cash and marketable securities at the holding company, as well and we also have short-term unused borrowing capacity on two lines of credit of approximately $175 million. Our debt-to-total capital ratio is relatively low 16.8% and our two non-convertible, non-callable debentures are not due until 2028 and 2024.

The value creation ratio we measure - we used to our long-term success increased nicely during the quarter. Describing our long-term goal more specifically for the five-year period from 2010 through 2014, we are targeting a 12% to 15% average for the total of our rate of growth and book value per share plus the ratio of dividends per share to beginning book value per share.

2009 remains challenging but our value creation ratio for the second quarter was plus 8.4%, bringing the year-to-date value to approximately 2.0%. This is up from minus 16.6% for the first half and minus 23.3% for the full-year of 2008. A key point is that our investment portfolio changes and other risk management actions have increased financial stability.

We believe our risk adjusted capital indicates exceptional financial strength. Ken?

Kenneth William Stecher
Non-Executive Chairman of the Board

Thanks, Steve. Steve gave you a good overview of the items that put us in an operating loss position for the quarter. It has been a strong second quarter with just a few rays of sunshine. We have the capital strength to grow profitably. We have the ability and intend to outperform. We are making good progress on initiatives that increase our long-term advantages, and bring them to the bottom line.
With that let me open up the call for questions. Just a reminder that Jack Schiff, J.F. Scherer, Eric Mathews, Marty Mullen, and Marty Hollenbeck are here with Steve and me and we are all available to respond. Amy we are ready for questions.

Question and Answer

Operator

(Operator instructions) Your first question comes from the line of Michael Phillips from Stifel Nicolaus. Your line is open.

Michael Phillips
Stifel Nicolaus

Thank you. Good morning, everybody.

Kenneth William Stecher
Non-Executive Chairman of the Board

Good morning.

Michael Phillips
Stifel Nicolaus

Couple of questions, first some on top line, you know the drop in exposure is unexpected and the south market clearly isn't - hopefully it is getting little bit better, but it is pretty sharp drop here in the quarter and is there anything that would cause it to fall of so quickly besides the drop in exposure that would make this second-quarter kind of more of an anomaly or - I guess I would expect this to be more of a gradual thing than what I saw here in the second quarter?

J.F. Scherer

Mike, this is J.F. I think it appeared to us as well kind of an abrupt decrease confluence of both the absence of contribution of audit income, as well as the effect - the double effect of not only are we giving back particularly in the construction area, returned premiums to contractors because the premiums - payrolls and sales they estimate last year this time are obviously coming in lower, but then also their outlook to the future in terms of the renewal premiums are having a double effect.

As we take a look at our book of business, were we are seeing price pressure are on the larger accounts as has been described in our release, as well as Ken's remarks, but also on our construction book of business. So, it appears to us that the effects of the economy seem to manifest itself more significantly here in the second quarter.

Michael Phillips
Stifel Nicolaus

Thank you. So, as you think about your entry into the new states, new business that you're getting out, are you cautiously thinking about trying to diversify a little bit more away from the construction and contractor type business that you're kind of heavily focused on now?

J.F. Scherer

We have been trying to do that for some time or really across the Board for us. In Texas, for example the economy and actually what we found working with our agency's down there, the economy is not as bad, the construction accounts that we are writing down there are fairly the survivors of quarter out there, we are not targeting contraction, we are continuing to right the balance book of business, part of which would be construction. So there is no effort to steer away from that particular line of business in places like Texas or Colorado, but certainly we are anxious to right a balance for the business.

Michael Phillips
Stifel Nicolaus

Okay, thanks. I'll switch over to the reserve development on the workers compensation for Steve, you know now we have got the second quarter of that and I guess the same reason is a slight change in the inflation assumption had such a dramatic ripple effect, but I guess given that we see now two in a row, is there any reason for us not to think that maybe on the inside of the house there that you're sort of cautiously taking baby steps and that we could therefore expect more of the same going forward or do you think you have taken what you need to take on that line?

Steven Justus Johnston
President, CEO & Director

Mike asked a good and fair question. The short answer is, we do feel that we have taken what we need for workers compensation, but I think it is again a good and fair question, I think as we looked at the second quarter just more evidenced materialized on these prior years and our actuarial department - as most use multiple models to review the data and as they look at it over the second quarter more - all of the models start to converging to a higher result than they had at the first quarter, you know we had one, maybe one model than that they all start to converge to the same number, which gave us more confidence and the need to add reserves to workers comp, but again back to the answer of the question we do feel we have it at this point.

Michael Phillips
Stifel Nicolaus

I will hop off at just one quick numbers question, if you could give the operating cash flow for the quarter and I will hop off?

Steven Justus Johnston
President, CEO & Director

Yes, it was 100 - for the quarter, I have it for the half year that I gave in my prepared remarks. I think we can get to you for the quarter before the call ends Mike.

Michael Phillips
Stifel Nicolaus

Okay, thanks.

Operator

Your next question comes from the line of Beth Malone from Wunderlich. Your line is open.

Beth Malone
Wunderlich Securities

Just talking about the weather related losses, I mean I know that has always been a part of the business that you ride, do you think there is any, is it being impacted as well by your new agencies, or new markets that you're going into exposing you more to weather than in the past?

Kenneth William Stecher
Non-Executive Chairman of the Board

Beth, this is Ken Stecher, I don't think I'll let G.F. respond in addition if he would like, but I don't think it is that so much, it is just the weather patterns in the last two years have focused much on the Midwest and I think this year is an example and the Midwest to the Eastern part of the country, you know has been so much cooler and that just capped the thunderstorms and hailstorms going much longer than they normally would.

And it is focused on an area where we have the largest part of our home order line, you know in the Ohio, Indiana, and Illinois area. So, I think that has kept the size of the catastrophes at a higher-level than we have experienced in many years in the past. I don't think it is an effect of just the agencies that we're appointing or the business that they are giving us. I think it is just that - what I believe is a temporary weather pattern change, but I don’t know if J.F. would like to add anything to that or not.

J.F. Scherer

No, but I can't anything to that. The newer areas we are in, North Carolina, South Carolina, Maryland, very little business from those areas, we did in Arizona, Idaho, Montana, and Utah. Of course once again very little business so far in those areas and no losses from cats in those areas.

So, it is - we our already having the impact where the weather is having the impact, it is in our traditional areas.

Beth Malone
Wunderlich Securities

Do you feel, it seems somewhat random obviously active guide kind of thing, but is it possible that you're getting adequate rate or rate increases now on those books to make you feel more comfortable going into 2010?

J.F. Scherer

I think that if they continue at this level that, you know I think the obvious answer is no. These are abnormally at least we feel we had normally high levels and the pricing is more aligned for a longer-term approach. You know having said that particularly in the homeowner's line there's a lot of work being done on the pricing side, in terms of pricing segmentation and more pricing points, they are working to get geographic diversification by going into other states and then also working on things that they can do to reduce the cat exposure.

Beth Malone
Wunderlich Securities

Okay. And then on the workers comp, how much of that - the experience you are having do you think is reflective of changes in the regulatory environment in those markets or legislative issues or is it just market conditions among competitors?

J.F. Scherer

That is a good question I guess I will take the first half of it and Marty Mullen probably has some comments as well. You know, the way I look at it, it is a tough line in terms of it being cyclical in nature that makes it difficult over time and we have seen big swings in results and workers compensation, I think also the long tail nature of it, you know makes it difficult to always get an accurate handle on right away, but we are doing what we can in terms of pricing. The product is appropriate as we can, our underwriters are using predictive modeling now as a tool in their decisions on pricing and you know working hard on what we can in terms of the underwriting. Marty?

Marty Mullen

Thank you, Beth. This is Marty Mullen and I would just mention a regulatory environment and certainly our specific venues that make a successful writing of work comp profitable or challenge based on some regulatory issues favorable or unfavorable work comp boards or decisions and make it difficult to proceed to anticipate successful resolution of those work complements for the employee and the company. We also deal with future issues concerning Medicare, secondary care fund, which is an issue that we are all dealing with it in the future and as it pertains to future work, claims and payouts, which is also a factor to be considered moving forward.

Beth Malone
Wunderlich Securities

Okay. All right thank you.

Steven Justus Johnston
President, CEO & Director

Thank you, Beth. Amy before we take the next question, I would just like to get back with an answer that our operating cash flow for the second quarter was $118 million and that compares to $156 million in operating cash flow for the second-quarter of 2008. Thank you and on to the next question please.

Operator

Your next question comes from the line of Paul Newsome from Sandler O'Neill, your line is open.

Paul Newsome
Sandler O'Neill

Good morning folks.

Steven Justus Johnston
President, CEO & Director

Good morning.

Paul Newsome
Sandler O'Neill

I guess, big picture we have had a pretty long of cat losses every quarter or close to every quarter for almost two years now. At what point do you think, you can go back to the regulators and just say, you know the world has changed and this is the way that cat losses are going to be, and we got to put rating for this?

Kenneth William Stecher
Non-Executive Chairman of the Board

Well, this is Ken Stecher. I will start it off. You know I think in some cases you know - the big thing I think is really the competition, I mean we can't go do that probably with some of the data we have currently. But if the other companies don't do that it could put us in a price this disadvantage. So we have to weigh that factor.

Secondly, maybe Steve would be better to comment on this, I mean as he mentioned in his previous comments when we factor in the rates we look at longer cat exposure trends and not short-term trends. And I'm not sure how regulators would feel about as you said, the last year and a half definitely cats have been much heavier than normal for us and you weigh against the 2007 year where they almost didn't exist in the states we were in.

Regulators are going to look at - trying to give us adequate rates to protect our solvency, but they're also going to want keep rates down to protect the consumer. So, we have that balance along with the balance of what we want to stay competitive. But we do have to money in the long run and that is the point that you are trying to make and that is one of the things that we have to try to balance.

Steven Justus Johnston
President, CEO & Director

And I would just add to that, Paul, this is Steve. You know clearly rate is an issue. You just can't look at the results that we have had and not come to the conclusion in rates to mention. So, we are filing for rate increases that will be effective in October that will be in the 5% to 7% range.

They won't be across the Board they will be addressing various pricing points, increasing our pricing points and we have seen a shift through this pricing effort that we have been making towards what we feel to be higher quality business. The geographic diversification is moving into full swing as well.

We have opened up four new states, for first in lines at the Arizona, Idaho, non-coastal South Carolina, and Utah. We are introducing personal auditors, speaks more to the account and the homeowners of property in particular that we are introducing personal auto in Maryland in North Carolina and so the efforts to gain more premium over a wider geography would make the impact of the various cat loses smaller to the total and then we are working also in taking underwriting actions in reducing our hurricane exposure. So, you know your point is a good one and I mean getting write-down to it price is an issue and we do need to get more rates.

Paul Newsome

Sandler O'Neill

I guess - given - I guess I also like to push back with you on the amounts of rate you are trying to get a hold of, you know 5% doesn't seem like it is quite enough to get you to an underwriting profit, I mean may get some benefit from geographic distribution, I apologize (inaudible) but the numbers don't seem to quite work up for me unless you achieve the second or third or fourth round worth of price increases to get you back to an underwriting profit?

Steven Justus Johnston
President, CEO & Director

Yes, it is a good point and it is hard to argue with Paul. The point that I wouldn't want to make though is that 5% to 7% is an average and there is a distribution in terms of the rate increase with much higher percentages of rate increase being planned for what we consider to be the pricing points that are causing the majority of the losses or where we need to get more rate. But it is, I think as Ken pointed out, you know a process that we have, an ongoing process.

Kenneth William Stecher
Non-Executive Chairman of the Board

Yes, have mentioned in prior calls, Paul. I think, we many more pricing tiers than we had previously and we are still trying to adjust those rates on the lower insurance scores. You know the ones with more and more rate, sort of working on that also, so it a combination of both of those things. But as Steve said we agree, we have to continue to work very aggressively on this issue.

Paul Newsome
Sandler O'Neill

Great thank you very much.

Operator

Your next question comes from the line of Dan Schlemmer from FPK. Your line is open

Dan Schlemmer
FPK

Hi, good morning. Another question I guess on the cats and it was around - it was basically $100 million in cats this quarter, which is pretty comparable to what you had in Q2 ‘08, you know they are fairly close and sort of what we are seeing, you know overall market I think is Q2 was bad for everybody, but I think this quarter, you know Cincinnati is more of the anomaly worse than maybe what we had expected based on just market share or whatever? Is there, do you have anything that can maybe - do you have any sense that you were hit particularly hard due to a lot of it being in Ohio or some other issue that caused your cats to be worst in industry this quarter or was there anything any specific drivers that you saw?

Marty Mullen

Thank you Dan this is Marty Mullen. I will just give you some more color on the three major claims or storms over your head which we have already centralized in our Midwest and some Southern states. The main driver is that Ohio and extensive wind claim, and I think what you're driving at is why is it greater for Cincinnati and some others that we are reporting in and I think it touches on a comment that has mainly hit us in the areas where we have our consistently historical business.

For instance the April 9, 11 storm South Midwest is mainly driven by a tornado in Nashville and subsequent hail in Alabama and Georgia, while states that we do a fair amount of commercial and personal lines business. And subsequent to storms of that filed a same pattern of Midwestern states involving hail and significant wind claims. Our past experience with these types of exposures in our areas leads us to develop - that can develop adversely and they have to be handled cautiously because of that long tail. Consequently, we think it is best to proceed with a cautious approach to these is the best practice.

Dan Schlemmer
FPK

Great, thank you. Separate question on - just on the surplus lines and you have sort of been little more than a year going on this now in this business, do you have a long-term target at this point? Do you this 3-5 years out is it sort of $10 million business or is it $100 million business or what are you guys thinking of in terms of a longer-term target for the surplus lines specifically?

Kenneth William Stecher
Non-Executive Chairman of the Board

Dan, this is Ken Stecher, I will start. You know J.F. has given numbers before in the past about the amount of business written by our agencies, in the sections and surplus line. So, I think it is a great opportunity for our company. We believe, it can be a fairly meaningful line, a business for us in the long-term.

We have a plan - business plan but we haven't disclosed any of those production numbers. So, I'm not going to give those at this point in time, but I think it really what it does is it matches up well with our strategy of trying to provide the products for our aging customers that they need for their success.

And I think when you look at where we started, a year and half ago and the written premium for the first six months is about $17 million, we are making some strides in that area. But I think J.F. can explain a little bit more about the real benefits that it provides between us and our agency customer.

J.F. Scherer

Dan, we wrote $15 million in new business in the first six months, just to give you a little color on it, as has been mentioned in the past, our agency is right about $2.7 billion in excess and surplus lines business.

We are on a market for all of it. We like to feel that our appetite range has been relatively modest just to put in the context, as far as new issues so far this year, the average premium has been $5,300, the medium-size premium is 2,000. So I would like to say that we are trying to grow this company hitting singles, may be doubles. Not trying to hit a home run though from time to time.

We do have agencies that are allowing us to write a very important account but we would have some size to it. So far this year, we have had 10,000 quotes just to give you an idea and converted about 3,700 of those. Retention so far on those accounts that weren't short-term is 87%. So, we are measuring a lot of things, as Ken said this is an important segment for our independent agencies due. There are a lot of standard accounts that have ENS exposure to them and that has allowed us to write some of those. So, in terms of long-term, given the potential we have within our own agencies, we think there is a lot of opportunity for us.

Dan Schlemmer
FPK

Sort of follow-up on that, you said I think 3,700 conversions, is that - do you find a particular, is there a particular niche that you are finding particular success in or is it more across the board, is there anything identifiable that is, you know whatever, where you are hitting the most?

J.F. Scherer

Special events obviously are a big deal with July 4 coming and gone for example, we had a lot of that type of thing, summer festivals would be a good example, church festivals, vacant property, now that we are writing the property, we are writing a lot of vacant buildings, vacant houses.

I think, probably a line of business would a prior suppression installation that seems to be a fairly large segment of this particular class of business. We are getting our opportunities in that area, but some products liability on the light manufacturers and I think as a general statement though given our agencies, the time they operate in and an awful lot of special event types of things would be reflected in our books.

Dan Schlemmer

FPK

Great, thanks. Last question, just on the dividend, you made a decision earlier this year to - not to increase the dividend, is that something you intend to revisit during the year, have you given any further consideration to that or is that something you really only will consider again sort of on an annual basis?

Kenneth William Stecher
Non-Executive Chairman of the Board

Dan, this is Ken Stecher. We discussed the dividend in every board meeting that we had. So, this is something that will be discussed in our next Board Meeting as like it always is. You know it is a board decision as you know, but you have the capital right now to support the dividend policy that we have, but as I said in my prepared comments when you look at a long-term view the operating results have to come into play and we must improve on the first six-month earnings per share numbers. We have to do that to just provide the capital to grow the company and give us the ability to pay the dividends going forward.

<TAG>Dan Schlemmer - FPK Great. Thank you.

Operator

Your next question comes from the line of Mark Dwelle from RBC Capital Markets. Your line is open.

Mark Dwelle
RBC Capital Markets

Yes, good morning. One area we haven't touched on much is, a huge rate of growth in the life insurance operations, could we talk a about that in a little bit more detail?

Kenneth William Stecher
Non-Executive Chairman of the Board

Sure, Mark, this is Ken Stecher. I think what we are doing is, we have always stayed out of the variable markets for insurance. We have always sold our mortality products and we worked very hard to make sure that we have a competitive-term insurance products, we are building our book of Woodside marketing, we have a universal live product, and then in this past quarter, I mean, what we are starting to see is some of the benefits of the renewal rates of those types of policies.

It is not showing in the earned premium as much, but in the written premium there is a little bit of availability to - we have increased our annuities writings, but it is fixed annuities not variable, and we believe that with the products that we have we are well protected in that area.

So again, mostly standard, the all type life insurance price was really focused on.

Mark Dwelle
RBC Capital Markets

Okay.

J.F. Scherer

And I would add, this is J.F, I would add that our strategy has continued to be, - we did about 70% of our life premiums from a property and casualty distribution and we continue to exploit that.

Our property and casualty agencies continue to make it more part of their operations to sell life insurance. They have a very good relationship with their property and casualty account, we do our best to cross-sell, we have a field force that calls on those property and casualty agencies and so I think Dave Popplewell, President of our Life Company would tell you that having been involved in other distribution systems, the stability of using property and cash distribution systems really paid off for us when right now in the life insurance industry it has not been so good.

Mark Dwelle
RBC Capital Markets

Okay that is helpful. And moving back over to the commercial lines business, somebody early kind of generally asked this question, I would like to ask it a little more specific, in terms of the 12% decline in net written premium in the quarter, how would you, what portion of that is would simply have been price - what portion of that would have been volume declines whether that be existing business on reduced policy count of anything else and then what portion would be the things you describe such as payroll audits and kind of things that are summing - something in the nature of one-time or at least hard to predict to track?

J.F. Scherer

Well I guess, this is J.F. Mark, our persistency - our retention rate in commercial lines remains pretty strong at 91% in the second, third year of a three year policy, continues to be in the mid-90s. So, we are retaining the policies. So, we are comfortable that we are not losing in an order number of policies.

Pricing changes as we have mentioned, although pricing changes that occurred up until this quarter where we have seen an improvement to the low single digit declines on average at renewable. Obviously, we have some policies that were on the - that are earning their way through right now that are affecting things.

I would say that the largest effect that we are seeing though is the affect of the economy. Payrolls and the sales - for example, in 2009 just on a quarterly basis, a year-over-year decline for our contractor book of business on premium is 17.4%. For our general liability book of business in total, it was 8.4.

So, you can see the effect that the construction book has had and the effect that the economy in general is having on things. I think that is really the best description I could give.

Mark Dwelle
RBC Capital Markets

Will it be fair of saying this a different way - would it be fair to say had there not been any rate decreases across the policy book had rate been flat right of the equation, you would have still had a net premium decline in the neighborhood of 10%?

J.F. Scherer

Yes, I would say that as fair. We're getting some nods in the room here just some quick math, but yes. That is what we are seeing.

Mark Dwelle
RBC Capital Markets

Okay, thank you, that's all my questions.

Operator

Your next question comes from the line of Michael Phillips from Stifel Nicolaus, your line is open.

Michael Phillips
Stifel Nicolaus

Hi thanks. You guys in personal lines you mentioned the large losses in personal lines, not the first time and certainly not alone in mentioning that, you know you are also not alone in a lot of what other companies do in raising your retentions. How much comfort do you have in your pricing, I guess adequacy or the conference you have in any upper layers that are kind of new for you. And that might be part of the large losses there, or maybe they are not. Just comment on that.

Kenneth William Stecher
Non-Executive Chairman of the Board

Mike, are you talking about on the personal - which upper layers?

Michael Phillips
Stifel Nicolaus

I guess across the board, I mean you specifically mentioned on first alliance, but really anywhere across the board.

Kenneth William Stecher
Non-Executive Chairman of the Board

I think Mike - This Ken Stecher. Maybe when - what you are referring to is when I was mentioning pricing tiers, in fact it was instituted more pricing different rates, for different insurance scores and for the people that have the lesser or the higher insurance scores, (inaudible) look at it, you look at it from 1 to 12, you know 7 or 8 would a higher score and for the rate would be greater for those types of risk. Is that what you are referring to?

Michael Phillips
Stifel Nicolaus

Actually, what I referred to is as you have taken on higher retentions and so it is kind of a reinsurance question, therefore you're exposed to the higher losses and are you pricing the upper limits adequately?

Kenneth William Stecher
Non-Executive Chairman of the Board

We feel we are, I mean that is a tough question and you just have to - because it is harder to get the law of large numbers to work for you because you have fewer that go into those upper layers, but for our in-righting guidelines and so forth, but they are reviewed carefully and reinsurance is utilized and so we feel that we are.

Michael Phillips
Stifel Nicolaus

Okay, thank you.

Kenneth William Stecher
Non-Executive Chairman of the Board

Thank you, Mike.

Operator

Your next question comes from the line of Beth Malone from Wunderlich. Your line is open.

Beth Malone
Wunderlich Securities

Okay, thank you. Two follow-up questions, one is on the reserving development in the workers comp that was based on a new assumption on inflation, inflation trends would that assumption have impact on reserves on your other lines of business or because of the nature the length of the workers comp you wouldn't see it elsewhere in your book?

Steven Justus Johnston
President, CEO & Director

This is Steve and we think it was most pronounced in the workers comp. We have actually seen pretty nice favorable development in the other commercial casualty lines and we think that you know the ability to get their, get our remediation process in place and get those claims closed more quickly and more favorably is helpful. So, I guess the answer to the question is, if you do see it impacting the workers comp more.

Beth Malone
Wunderlich Securities

So, it is really not an assumption about where you think inflation is going to go on these claims; it is more that your actual experience on the claims has been greater because of the inflated cost is settling them.

Steven Justus Johnston
President, CEO & Director

I guess for workers compensation as we - as the actuarial models regress really in three dimensions, we are seeing the paid losses over the calendar years increasing which would indicate calendar year inflation. So, we are saying that on the workers compensation line, but we just aren't seeing as much on the other casualty lines.

Beth Malone
Wunderlich Securities

Okay, and then question on the dividend, I mean you're not going to - it doesn't look like you're going to earn your dividend this year, I mean, I don't know about second-half, I am not going to make an assumption at this point, but what - when you talk about the need for improving your operating results in order to - is that to support your existing dividend or is that to justify increasing your existing dividends?

Kenneth William Stecher
Non-Executive Chairman of the Board

Beth, this is Ken Stecher. I think it is basically to continue the policy that we have. And I think that is the fact that we really do like the policy, in fact we pay a fairly sizable dividend. The fact we have been able to grow it. And we definitely want to maintain it.

When you look at, you know, when I said that we do need to improve results, yes the economy is very trying, the commercial lines pricing is still very soft, but if we and I know there is always an if to the questions, so here it comes, if catastrophes for the next quarter will be on the lines say the 5% or four of the five points of guidance that we normally give for the year, I mean that could deliver like, cats I believe to see this quarter about $0.48 impact.

I believe and that was about 15 to 16 points. The cats - that number would be decreased to five points, you know you can pick up about $0.30 of our earnings. As the question was asked previously on the workers comp reserve increase that we took, we believe we are where we need to be.

You know if that does not occur again, you get another X number of cents. So, your point is well taken while we are sitting here right now. The operating earnings did not cover the (inaudible) the board has declared in the first of the year. Is it possible that we could earn over $0.78 in the last half of the year?

I think if the weather improves, I think the possibility is there. The capital position for the quarter increased on a consolidated basis from about $3.9 billion to $4.1 billion. So, the potential would be there for the board to consider following the dividend policy that we have had in the past.

So those are the kind of factors I was trying to refer to as to what we are looking at. The other thing that I wanted to just clarify is that on a year-over-year basis in our past history there have been occasions where the board has declared a dividend in excess of the current earnings.

But they were looking at long-term, there were unusual circumstances from their view that caused the operating earnings for the year to be less and so they felt comfortable taking the dividend policy forward. That’s what I kind of referring to before is that potentially this year it could be done, but if next year would be below $1.56 current level, you know you just can't do it indefinitely.

Beth Malone
Wunderlich Securities

Okay. Thank you.

Kenneth William Stecher
Non-Executive Chairman of the Board

You're welcome.

Operator

Your next question comes from the line of Paul Newsome from Sandler O'Neill. Your line is open.

Paul Newsome
Sandler O'Neill

No, you actually - you covered the question, thank you.

Operator

(Operator instructions) Your next question comes from the line of Fred Nelson [ph] from Crowell, Weedon & Company. Your line is open.

Fred Nelson
Crowell, Weedon & Company

Thank you. A lot of congratulations goes to your investment department and for loss of a - that you allowed Marty and his staff to do to turn the book value up and to build the income and a lot of our shareholders are of course concerned about the fact that if you reduced the dividend that money can be put back in the portfolio to build a long-term wealth with the company. So, I haven't heard much talk about that, but I do want to say congratulations it was a tough period for all of us. And thank you guys and gals.

Kenneth William Stecher
Non-Executive Chairman of the Board

Thanks, Fred. This is Ken. I will let Marty talk a little bit about some of the portfolio reallocations we have done. I think he and his team has done an excellent job going through this economic environment that we have and positioning us which I believe in good position for the future.

Marty Mullen

Yes, Fred. There has been a lot of changes certainly our core philosophy of focusing on common stocks to the degree by a little higher than most P&C companies is still intact of being the smaller fashion. We finished the quarter at about 25% of the overall portfolio in common stocks. Virtually unchanged from the first quarter, we still like companies that pay and grow dividend, with a little more challenging in this environment certainly and we had a couple three in the first quarter that cut through dividend. So it is still a tough landscape out there, but we have taken a long-term putting a little more money into the bond portfolio increasing yields there will give us some additional flexibility in the common portfolio. So as Ken said I think we are well positioned going forward.

Fred Nelson
Crowell, Weedon & Company

Thank you.

Operator

(Operator instructions) There are no further questions at this time. Mr. McDaniel, you may continue.

Dennis E. McDaniel
VP & Investor Relations Officer

Thank you all for joining us today. We look forward to speaking with you again on our third quarter call. Have a great afternoon. Thank you.

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