S&P Capital IQ

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The Travelers Companies, Inc. NYSE:TRV

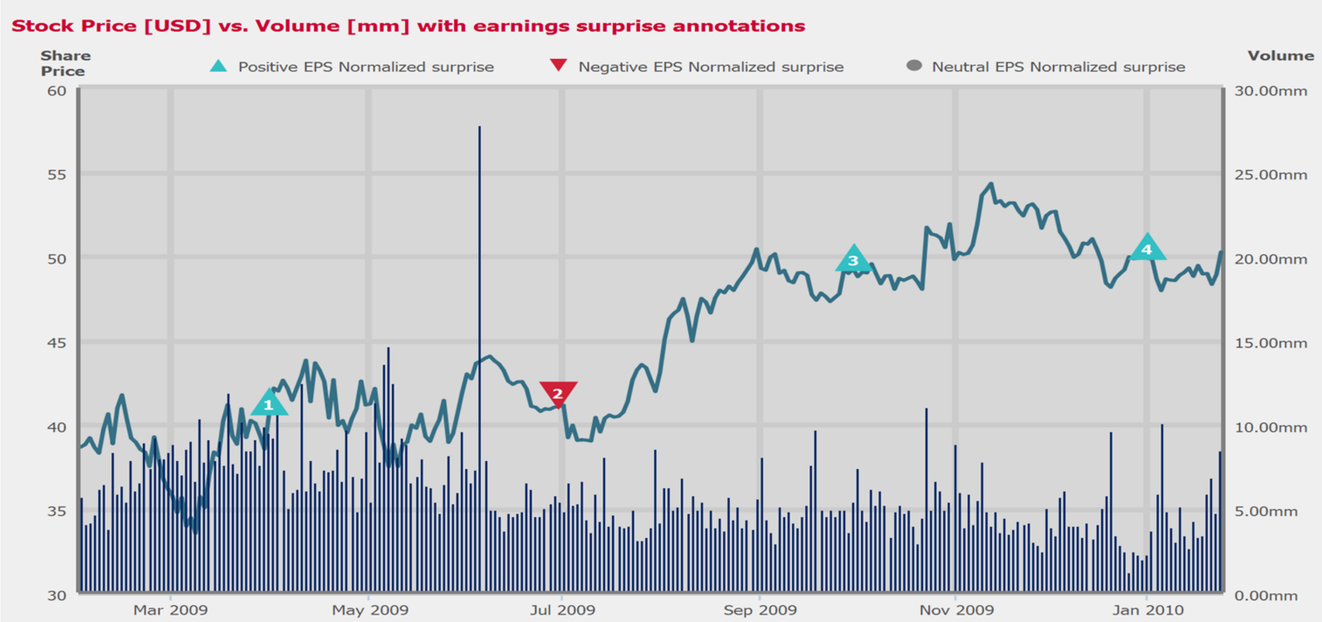
FQ1 2010 Earnings Call Transcripts

Friday, April 23, 2010 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2010-			-FQ2 2010-	-FY 2010-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.37	1.22	(10.95 %)	1.48	5.73	5.81
Revenue (mm)	5426.64	6119.00	12.76	5625.18	22216.96	23029.14

Currency: USD
Consensus as of Apr-23-2010 1:37 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ1 2009	1.30	1.34	3.08 %
FQ2 2009	1.27	1.25	(1.57 %)
FQ3 2009	1.32	1.61	21.97 %
FQ4 2009	1.49	2.12	42.28 %

Call Participants

EXECUTIVES

Alan David Schnitzer
Chairman of the Board & CEO

Brian W. MacLean
President and Chief Operating Officer

Gabriella Nawi
Senior Vice President of Investor Relations

Gregory Cheshire Toczydlowski
Executive Vice President and President of Business Insurance

Jay S. Fishman
Former Executive Chairman

Jay Steven Benet
Vice Chairman and Chief Financial Officer

William E. Cunningham
Former Executive Vice President of Business Insurance

William H. Heyman
Vice Chairman and Chief Investment Officer

ANALYSTS

Brian Robert Meredith
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Ian Gutterman
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Jay Adam Cohen
BofA Merrill Lynch, Research Division

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Barclays PLC, Research Division

Joshua David Shanker
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Keith F. Walsh
Citigroup Inc, Research Division

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Michael Steven Nannizzi
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Capital Returns

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Crédit Suisse AG, Research Division

Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the First Quarter Earnings Review for Travelers. [Operator Instructions] At this time, I would like to turn the call over to Ms. Gabriella Nawi, Senior Vice President of Investor Relations. Ms. Nawi, you may begin.

Gabriella Nawi
Senior Vice President of Investor Relations

Thank you, Frank. Good morning, and welcome to the Travelers discussion of our first quarter 2010 results. Hopefully, all of you have seen our press release, financial supplement and webcast presentation released earlier this morning. All of these materials can be found on our website at www.travelers.com under the Investor section.

Speaking today will be Jay Fishman, Chairman and CEO; Jay Benet, Chief Financial Officer; and Brian MacLean, President and Chief Operating Officer. Other members of senior management are also in the room available for the question-and-answer period. They will discuss the financial results of our business in the current market environment. They will refer to the webcast presentation as they go through prepared remarks and then we will open it up for questions.

Before I turn it over to Jay, I'd like to draw your attention to the following on Page 1 of the webcast. Our presentation today includes certain forward-looking information as defined in the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical fact, may be forward-looking statements. Specifically, our earnings guidance is forward-looking and we may make other forward-looking statements about the company's results of operations, financial condition and liquidity, the sufficiency of the company's reserves and other topic.

The company cautions investors that any forward-looking statement involved risks and uncertainties and is not a guarantee of future performance. Actual results may differ materially from our current expectations due to a variety of factors. These factors are described in our earnings press release and in our most recent 10-Q and 10-K filed with the SEC. We do not undertake any obligation to update forward-looking statements.

Also in our remarks or responses to questions, we may mention Travelers' operating income, which we use as a measure of profit and other measures that maybe non-GAAP financial measures. Reconciliations are included in our recent earnings press release, financial supplement and other materials that are available on the Investor section on our website.

With that out of the way, here is Jay Fishman.

Jay S. Fishman
Former Executive Chairman

Thank you, Gabby. Good morning, everyone, and thank you for joining us today. All in, given the magnitude of catastrophes we experienced this quarter, we were quite pleased with our performance, reporting net income of $1.25 per diluted share, an increase of 13% from last year's quarter and a return on equity of nearly 10%. Included in this number was $0.61 a share in catastrophes arising out of the multiple storms in the Eastern United States, as well as the earthquake in Chile.

Just to put this number in context, the estimate for catastrophes for the first quarter included in our previously provided guidance was about $0.13 a share. Offsetting the cats, we benefited from favorable prior-year development and our underlying performance from both underwriting and net investment income was a bit better than our expectations. The net result was operating income, which was in line with our expectations going into the quarter, allowing us to reaffirm our previously issued full year 2010 operating earnings per share guidance. Also, it's reflective of our continuing strong earnings power.

In an environment which remained similar to last quarter in terms of both economic and insurance market conditions, our business dynamics remained solid and were generally consistent with recent operating experience. Renewal rate gains remained positive in each of our business segments, retention was strong and new business in total remained on par with last year's quarter. We repurchased $1.4 billion of our common stock in the quarter and announced an increase in our regularly quarterly dividend by 9% to $0.36 per share. As these actions demonstrate, we continue to execute successfully in the marketplace, generate solid earnings and return excess capital to our shareholders.

Given that our operating dynamics this quarter were generally consistent with recent quarters, our call this morning is going to be somewhat different than in the past. We're still providing all of the same information in our presentation as we have previously, but we will not be going page by page with you so as to allow more time for questions.

Before turning over to Jay, I want to take just a minute to acknowledge and thank our claim department for all of their exceptional work, not only this quarter, but over the last couple of years. In 2008, we had Ike, Gustav and Dolly and while there were no major storms in 2009, it was still a quite active cat year. And of course, in the first quarter of 2010, we were again faced with an exceptional number of claims due to the multiple storms on the East Coast. Doreen Spadorcia and her entire Claim team have been remarkably busy, providing industry-leading customer service to our insureds and again demonstrating our commitment to providing high-quality service to all of our insureds during their greatest time of need. And with that, let me turn it over to Jay.

Jay Steven Benet
Vice Chairman and Chief Financial Officer

Thanks, Jack. There are several points that I'd like to highlight relating to Pages 4 to 7, many of which you've heard me say repeatedly over many quarters.

First, our balance sheet remained extremely strong. All capital leverage and liquidity measures were at or better than target levels. Even after repurchasing $1.4 billion of our stock and paying dividends of $168 million in the quarter, holding company liquidity increased to over $3 billion, almost 3x our target level due to the timing of dividends from our operating companies to our parent company.

Holding company liquidity is expected to move towards its target levels during the remainder of the year as we continue our share repurchases. Book value per share increased once again. And on an as-reported basis, operating income for the quarter did meet our expectations. That is, operating performance x the cats and x the non-cat weather and also adjusting for the favorable reserve development but including net investment income, all of that was in line with our expectations going into the quarter.

Despite the high cat losses and the relatively low yield on short-term and non-fixed income investments, we recorded a double-digit operating ROE. And finally, our results included a one-time tax charge of just under $12 million or approximately $0.02 per share, related to the recently enacted federal healthcare legislation that eliminated the tax benefit associated with Medicare Part D subsidies. Brian is now going to provide some color about our operating performance.

Brian W. MacLean
President and Chief Operating Officer

Thanks, Jay. We have included on Pages 8 through 16, all of the segment performance statistics that we traditionally discuss with you. As Jay mentioned, we're not going to go through each slide, but instead, speak more broadly about the significant drivers for the quarter, leaving more time for questions.

Obviously, weather had a big impact on our results and will be the headline for the quarter. We had six domestic cat events, the two largest being the February snowstorm in the Mid-Atlantic that paralyzed Washington D.C. for several days and the Nor'easter in mid-March that impacted New York, New Jersey and Southern New England. In addition, there were several international events, the largest being the earthquake in Chile. So all in all, a very active catastrophe quarter.

But looking beyond the near-term impact of weather, our production and core underwriting results continued to perform very well. In Business Insurance, retentions remained strong and were up slightly across the business. Renewal pricing improved modestly, with pure rate continuing to be positive for the segment, exposure change on renewed accounts was still down. But the rate of decline moderated slightly from last quarter.

On the new business side, we feel good about the continued flow of new opportunities, particularly in middle market in the small end of Select. New business writings in the quarter were down from prior year, primarily due to the pricing discipline that we are maintaining in the larger end of the Select business. This segment of the market has been particularly competitive and reduced writings here reflect that position.

On a written basis, premiums are down. A direct result of the impact of the challenging economy on our customers. Some of that impact is seen in renewal premiums' statistics. But the majority comes from reduced audit premiums and increased cancellations and endorsements. These impacts either emerged over the life of the policy or in the case of audits, aren't reflected until the end of the policy period.

Since we are generally auditing accounts we wrote a full year ago, we expect this drag may continue to the next few quarters. As the economy stabilizes and eventually improves, we believe that based on our historical experience, the audit premium will rebound.

There are lot of weather and prior-year impacts in the combined ratio. Excluding these, we are experiencing the modest deterioration we had expected. Frequency remains low, claim severity is relatively benign and pure loss trend is marginally outpacing our modest rate gains. This deterioration is somewhat larger than the 30 basis point change in the adjusted combined ratio on the slide because the first quarter of 2009 does not include the positive impact of the adjustment we made to the full year '09 combined ratio in the second half of last year.

Moving to the financial Professional & International segment. Net written premium, after adjusting for the impact of changes in foreign exchange rates, were up significantly for the quarter. The primary driver of this increase was less seeded premium year-over-year, resulting mainly from changes in the structure of our reinsurance that directionally aligned retentions in our International business with the company's U.S. retention practices. And to a lesser extent, lower reinsurance costs.

For the second consecutive quarter, we did see quarter-over-quarter growth in our Construction Surety book of business due to activity in our large national accounts market. In our International business, new business is up compared to the prior-year quarter, primarily due to growth in marine and accidents and special risk products in Lloyds. Operating earnings in the quarter were down from the prior-year quarter, as a result of our exposure to multiple international named events, primarily the Chilean earthquake. The losses we experienced were consistent with the fact that Chilean earthquake was the seventh largest reported and was 500x stronger than the earthquake in Haiti.

Turning to Personal Auto, agency retention remained strong and the renewal premium change continue to be positive. New business improved significantly and it was at the highest level in the last five quarters. We believe that the new business declines that we saw in the previous quarters were due to the fact that we were ahead of the market and seeking increased rates.

You can see from the change in Agency Autos' quarter-over-quarter combined ratio, that profitability has improved as rate gains are now outpacing lost costs. Approximately one point of this improvement was attributable to lower frequency, which we believe was a result of the winter storms impact on miles driven. After normalizing for the quarter's frequency, core Auto margins are improving and well within company targets.

Within Agency Property, the story this quarter was clearly the weather. Adjusting for the weather, the combined ratio for the quarter was modestly higher compared to the prior-year quarter, a portion of which is the expected slight margin compression. This compression continues to be driven by year-over-year increases in the cost of materials, primarily asphalt shingles.

Agency Property production results for the quarter continue to be strong, in spite of the difficult housing market. PIF continues to steadily grow with strong retention and continued positive renewal premium change. New business is up significantly compared to the same quarter last year. So even with an extraordinary number of catastrophic events in the quarter, we posted solid results.

Core combined ratios remained within company targets, new business remains robust despite the challenging macroeconomic conditions, rate overall remains positive and retentions continue to be strong. We believe that these results are a direct outcome of the long-term capability from competitive advantages we have built, as exemplified by our claim response this quarter. These capabilities are sustainable and we'll continue to differentiate Travelers within dependent agents, customers and brokers.

Now before I turn it back to Jay Benet, let me touch on an issue that has gotten a good bit of press. On Page 17, we've outlined why we believe our exposure to Chinese drywall will not be problematic. First, from a business-profile perspective, we have no direct liability exposure to Chinese drywall manufacturers and have virtually no general liability exposure to U.S. residential contractors. In fact, we have no general liability exposure to 37 of the 38 U.S. residential contractors identified in Bloomberg and the one we do right has an SIR [ph] And our limits above that are minimal.

On the Homeowner side, we are disproportionately underrepresented in the states with significant impacts. So we do not expect a significant number of claims but given our policy structure limits profile, we believe any losses should be contained. Additionally, the fact that there is very strong product ID here is helpful. That is, we know where it is, where it came from and when it got here. And all of this should help limit this various [ph] claim activity. To date, we've gotten 52 claims and we are comfortable -- our overall exposure is not problematic.

Now with that, let me turn it back to Jay Benet.

Jay Steven Benet
Vice Chairman and Chief Financial Officer

Page 18, sets forth our guidance for full year 2010's fully diluted operating income per share, which is a range from $5.20 to $5.55, unchanged from what we previously provided, which in round numbers should translate into an operating return on equity of approximately 11%.

We're now assuming cat losses of $640 million after tax or $1.30 per diluted share, which incorporates our actual cat losses for the first quarter and our original estimates to quarters two through four. No further estimates of prior-year reserve development either favorable or unfavorable, a low single-digit decrease and average invested assets, ex unrealized gains and losses, resulting from a reduction of holding company liquidity due to share repurchases.

Full year share repurchases, that are still in the range of 3.5 billion to 4.0 billion and the weighted average diluted share count after share repurchases and employee equity awards in the range of 490 million shares to 495 million shares, which is a bit higher than what we had previously assumed, due to the impact of the recent increase in the price of our shares.

Before I close, let me explain in response to several questions we've been asked, why we did not pre-release this quarter's cat losses. We write cat exposures as part of the ordinary course of our business and cat losses are just one of a number of item that could impact the quarter's results. We think it is more informative generally to release all of our results together so that information is presented in context. This is particularly true in a quarter like this when the cat losses came from a number of relatively smaller events. And we have losses from seven cats in the quarter, as Brian said. Some of which occurred very late in the quarter.

It's also our strong preference to take the time to acquire a regular quarterly closing process to our results before we announce. This approach makes more sense for a company of this size that we are now, especially in a quarter when we had a number of moving pieces on our performance on an overall basis was generally consistent with our expectations. Finally, this approach was also consistent with the over time nature of the company's stated financial objectives and are previously disclosed intention to stop giving guidance beyond this year. So with that, I believe Jay has a closing comments he'd like to make.

Jay S. Fishman

Former Executive Chairman

Thanks, Jay. Just one more comment before we open it up to questions. You may have noticed that a number of our senior executives have over the last year or so sold some of their shares and I wanted to take the opportunity to clarify our views.

Our senior executives received a meaningful portion of their compensation in the form of performance-based equity. As a result of that, as well as our recent performance, all of our named executive officers and substantially all of our senior executives have equity positions that are well in excess of the company's ownership requirements. This actually has been the case for quite some time.
The recent financial crisis underscored for all of us the importance of prudent, personal, financial planning and diversification. Given this and our significant executive ownership, we don't discourage executive sales driven by personal financial decisions as long as the minimum share ownership requirements continue to be met. And with that operator, we'll open it up for questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Jay Gelb from Barclays Capital.

Jay H. Gelb
Barclays PLC, Research Division

Jay, can you talk about the expectation for continued improvement in the accident year of combined ratios, ex-cats? We saw that in the first quarter and just given the kind of environment, I'm trying to get a sense of whether you anticipate that continuing through the year?

Jay Steven Benet
Vice Chairman and Chief Financial Officer

This is Jay Benet. I think when we look at each one of the segments, there's probably a bit of a different story. We had talked about some rate gains in the BI segment that had been in our written premium back in the second half of last year. And of course, that will get earned in, along with the rate gains that we've seen in the first quarter. Relative to loss trend, I think as Brian said earlier, what loss trend, well, it's running at a benign level. It's still probably running a little bit ahead of where the rate gain has been. So we would expect, in terms of just the underlying trends in our business to see some margin compression of a modest amount in the BI segment. If you flip to the other extreme and look at PI, PI is in a different position. PI has been experiencing rate gains for a period of time. And as those earned in and the lost cost remained pretty benign in that business, I think we'd see some margin expansion there. And again, all things being equal, all of this is going to be dependent upon the weather and loss activity that you've heard us talk about from quarter-to-quarter. But I think just overall, slight expansion overall. Brian do you want to add?

Brian W. MacLean
President and Chief Operating Officer

Yes, and Jay's comment there in PI is Auto. As I said in my comments on the Homeowner side, there's a little bit of a margin compression. On the Auto side, we definitely got extension.

Jay S. Fishman
Former Executive Chairman

Jay, and if you go back to what the guidance, the previously issued guidance that we issued and we were referring this morning, what we said at the time was that we expected for the organization overall, total consolidated, that we expect it modest, I think was the word we used, deterioration in the loss and LAE ratio for the organization overall. And that's still our underlying premise embedded in the guidance.

Jay Steven Benet
Vice Chairman and Chief Financial Officer

And the other segment that we should comment on is the FPII segment. Of course, there's a very diverse mix of business there. But let's say, like PI perhaps there, a slight level of margin compression as well.

Jay H. Gelb
Barclays PLC, Research Division

And then my follow-up is on the expense ratio. Now heading towards 33%, are you comfortable with that level of expense ratio? And if so, maybe you can talk about what investments are driving that?

Brian W. MacLean
President and Chief Operating Officer

Yes. Jay, this is Brian. The exact ratio is going to bounce around quarter-to-quarter as premium volumes move and there were other miscellaneous things going through on the expense side. But we'd have been making significant investments in our platforms across a lot of our businesses. Probably the most obvious are in small commercial and in the personal arena where the product and platform are significant part of our marketplace proposition. But even across the middle-market, we've been doing a lot of different things which connect the capabilities that we have in the marketplace. So that's been another area of investment.

Jay S. Fishman
Former Executive Chairman

We always get a little reluctant answering with respect to specific elements of the cost structure. Loss dollars are mitigated or generated by investments in the sort of expense and loss ratio, just can't be looked at. We don't think in separate pieces. So we get back to returns on equity. And are we satisfied with our overall returns in our business, current returns as well as long-term prospects. And the answer is, yes. We very much are.

Operator

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

Brian Robert Meredith
UBS Investment Bank, Research Division

First one, Brian, can you talk about PIF trends in Personal Auto Insurance? And given that your combined ratio is now are down to more than acceptable levels, should we expect to start seeing you guys -- that number stabilize and maybe given some of the dynamics right now in the personal auto insurance market where there are some competitors with fairly high combined ratios and perhaps maybe picking up some share here going forward?

Brian W. MacLean
President and Chief Operating Officer

Yes, Jay. I think we -- Brian, I'm sorry. We definitely do feel that way. Greg Toczydlowski is sitting here, why don't I throw it to him and have him talk about that a little bit.

Gregory Cheshire Toczydlowski
Executive Vice President and President of Business Insurance

Yes, Brian, as you indicated, we are feeling comfortable with the margins. And we watched two primary factors, that's the flow of our co-information. And we can clearly see their quote flow is up, and then we look at the competitiveness of our quote activities, specifically in comparative raters. And we can see that our close ratio was also up this quarter. If you look at the staff supplement, you could see the output of that, that we do have sequential gain in PIF from the fourth quarter to the first quarter. So as we've got those margins right in the middle of a target where we want them to be, we're going to continue driving that growth and you can see that in some of the data that we reported this quarter.

Brian Robert Meredith
UBS Investment Bank, Research Division

And then my second question, Jay is, I noticed that you said that you took an extraordinary dividend out of the operating companies this quarter. I'm curious, why do you take the extraordinary dividend? Does that also mean that you still have your regular dividend capacity available to you this year to the holding company?

Jay Steven Benet
Vice Chairman and Chief Financial Officer

This is Jay Benet. We ended up in a very, very strong position and our operating companies at the end of the year. Profitability in the fourth quarter was extremely strong and we do an analysis of what the capital levels are and decided that we were just overcapitalized based on our profitability. So rather than leaving it there to take out in the normal course, we went to the various fix [ph] That regulate us and show them what our capital levels were, what we wanted to do and then just ask if we could take it out sooner than later, and we did. So it's just the holding company, so we have the flexibility now going forward to just execute on our share repurchases. And we just think it's prudent management to do that when the operating companies have excess capital.

Brian Robert Meredith
UBS Investment Bank, Research Division

What is your kind of regular dividend capacity that you still hold available for this year?

Jay Steven Benet
Vice Chairman and Chief Financial Officer

We had about $3.5 billion that we could take out without regulatory approval. I should say, though, that if that becomes, without getting overly complex about it, this is a rolling calculation. To the extent you get regulatory approval and increase the amount that you take out in the quarter, it'll change for the remainder of the year, how much you could take out without regulatory approval. But we're confident that whatever we would like to take out of the operating companies, barring the unforeseen head catastrophe or whatever, we'll be able to do this year.

Operator

Our next question comes from the line of Keith Walsh from Citi.

Keith F. Walsh
Citigroup Inc, Research Division

First question, just with respect to the guidance. You've maintained your projection for the year despite the incremental $0.50 insurance cats, slightly higher share count and even if we net out the benefit of the reserve release, is this guidance or better guidance driven by business trends or is it the jump in non-investment income?

Jay S. Fishman
Former Executive Chairman

It's actually I think a kind of more simple than that, which is that when you look at the results for the first quarter, the $1.25, $1.22 was absolutely consistent with what we had incorporated in our original full year guidance of $5.20 to $5.55. So the all-in first quarter results were very much consistent with the embedded number for the first quarter in the annual guidance. So it's just the reaffirmation of the same underlying trends.

Jay Steven Benet
Vice Chairman and Chief Financial Officer

As you'd expect for a company of our size and sophistication, I mean we're constantly looking at what our plans are for the future. And in this particular case, as Jay said, we've incorporated the actuals for the first quarter into our revised low code investment income, looking at margins going forward. And based on hitting what we had expected to the operating income or thereabouts in the first quarter, we haven't seen anything that would change the overall look for the rest of the year.

Keith F. Walsh
Citigroup Inc, Research Division

And then just with regards to the non-fixed income part of the portfolio, if you can talk a little bit about the volatility? And I know it's hard to give maybe a normalized rate of return for that, but what is sort of a long term expected rate of return for that part of the portfolio?

William H. Heyman
Vice Chairman and Chief Investment Officer

This is Bill Heyman. I guess the basic question, what is long term? We make private equity fund investments with the expectation that our capital will be out for an average of seven or eight years. And I don't think we would make those investments. We didn't think there was a reasonable chance of low double-digit returns, although our estimates are more conservative than that, given the current climate. With respect to hedge funds, which are now only $500 million in a portfolio of $70 billion, the same hurdle is used. But for estimating purposes, we're in the mid- to high single digits. But over the long term, we would require 12% or so to stay in these asset classes in any size.

Operator

Our next question comes from the line of Larry Greenberg from Langen McAlenney.

Larry Greenberg
Langen McAlenney

The tax charge in the quarter, was that in the interest and other line?

Jay Steven Benet
Vice Chairman and Chief Financial Officer

Yes, it was, Larry.

Larry Greenberg
Langen McAlenney

And then on reserve development, in the FPI (sic) [FPII] line, it appears in the last two quarters. Favorable reserve development has jumped up a bit from where it had been running. And I'm wondering if there's anything that you might be able to isolate to explain that? And then more generally, on reserve development, can you talk at all about the complexion in the favorable development and whether the balance between reserve releases associated with case or IBNR reserves has changed over the last, let's call it, six quarters or so?

Jay Steven Benet
Vice Chairman and Chief Financial Officer

I'll take a shot at it. As it relates to the first part of the question, and looking at FPII, FPII goes to the same processes as the rest of our businesses. Each quarter, we're looking at changes in actuarial views associated with very granular levels of our reserves. And whether it's in the International businesses or whether it's in the Bond and Financial Products businesses, we'll take positive reserve development or negative reserve development when we see a need to do that. And I don't think there's anything in particular that's been driving the reserve development in FPII, but it has been a part of, depending upon the quarter, partly Bond and Financial products, and partly International. The longer the tail associated with the business, the more we wait. So I think in the Bond and Financial Products business, it's probably been more of the early 2000-type events that have been reserved for. And we've seen claim activity just settling out a little lower than what our expectations were. As it relates to just the rest of the businesses, I'm not sure I can really answer your question as to whether it's development on case reserves versus rethinking of the IBNR because as you know, as time goes on, less and less IBNR and more cases. And we tend to look at it in its totality, but it's the same phenomenon whether it's looked at by an individual business line or particular accident year. What we're seeing is that as time has developed, on some of the longer tail lines, we're seeing favorable reserve development that's dealing with less payments of claims than we anticipated. Some of the developments is the roll forward from older accident years to more current accident years if in fact the reserve analysis is indicating that the original loss picks were higher than what they would seem to be. But that's not the major driver of it. The major driver is just looking at the claim activity. I hope that's responsive to your question.

Larry Greenberg
Langen McAlenney

Yes, that's helpful.

Jay S. Fishman
Former Executive Chairman

Can I interrupt for a second? I want to go back and just actually clarify an answer that we gave previously in response to the question about the expense ratio. Just as I've been reflecting on it, and I said were the returns in our business, generally consistent with our expectations to produce long-term, mid-teens return on equity. That was the sort of shorthand that I was giving you. And I said, yes, they were. We always have lines of business, always have lines of business where the returns are not at levels that we want them to be. And we have been consistently public about seeking rate gains where we need them. So I didn't mean to imply by that answer that every product that we have net hurdles in every specific way. In a very general sense, in responding to the question about the expense ratio overall, we feel pretty good about the overall returns that our portfolio of products generate. But it certainly doesn't mean that we don't have products where the competitive environment is such that strategically, we're seeking rate so that we can bring those products either into the range of acceptability. And there's a number of those that are not or further up into the range of acceptability to meet our long term hurdles. I hope that's clarifying, but it is really a complex question asked in a very simple way.

Operator

Our next question comes from the line of Michael Nannizzi from Oppenheimer.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

Just a question on the Management Liability business, if I could. For recent books, has there been any loss emergence outside your expectation, either in '09 or so far in 2010? And could you talk specifically about the community bank portfolio?

Alan David Schnitzer
Chairman of the Board & CEO

Sure, it's Alan Schnitzer. In the more recent years, I think the less experience in -- generally is portfolio across all the Management Liability business has been within expectations. There's nothing there I would say that's a trend that surprised us.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

And then just a question on the Commercial business, so if we do the math on renewal plus new business on the Commercial segment, it doesn't quite match up. Is that because that renewal rate is calculated based on policy count? And I guess to follow that, do that mean that you're getting more growth at the small end of Commercial rather than the large end?

Brian W. MacLean
President and Chief Operating Officer

I'm trying to make sure I've got the question straight. So when we ...

Jay Steven Benet
Vice Chairman and Chief Financial Officer

This is Jay Benet. The statistics that you're referencing aren't based on policy count; they are based on dollars. I'm thinking [ph] (40:33) of premium dollars. And If I understand the question, if what's you're trying to do is look at the sum of business retained plus new business in rate, what you're missing is what we had disclosed in the fourth quarter in a bar graph that we presented. What's the impact of exposure changes, cancellations, endorsements and audit premium, and that's what gets you to the dollar amount of the premiums in the first quarter. So if you were to do that with Business Insurance, what you'd see is about 82% net retained business, another 19% new business, approximately 1% of rate, all of which would have been a 2% increase in net written premium. And what's taking place is about a negative 6%

relating to exposure, cancellations, endorsements and audit premium that translates into the negative 4% overall.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

And just one last question, if I could, on leverage. How important is operating near that 1:1 premium [indiscernible] (41:40), is that a target or is that more just a result of other things that you're doing?

Jay Steven Benet
Vice Chairman and Chief Financial Officer

It's absolutely the result. What I've indicated before is that we have the various rating agency models that we apply along with risk-based capital. And whether it's, say, invest to core ratio or the S&P or Moody's models or Fitch models, we evaluate what the operating company capital requirements should be for a strong AA company as we are. And from that, we then look at the leverage of the holding company, the holding company cash, come up with the actual capital position. And the fact that premiums to surplus is approximately 1:1 is not something we look at. It is absolutely the result of that process.

Jay S. Fishman
Former Executive Chairman

Let me add a comment, and Brian make sure I'm right on this, about the -- we tend to lump them together, this exposure, audit premium, and it's a function of the way that our arithmetic is done. There are two -- several different dynamics operating there, but the two principal ones are audit premiums, which one should think of as retrospective in nature. Clients make estimates of what their ratable factors are at the inception of a policy. At the end of a policy, we come in and we do an audit. It turns out the ratable factors that might be payroll, it might sales, it might be trucks on the road. It turned out to be less than they had originally anticipated because of the speed and depth of the decline in the economy. And so we have an audit premium. They return a previously written premium to us. We think of that as almost a retrospective adjustment. Then there's embedded in our renewal business, change in exposure on a renewal basis, which is not always entirely factual because once again, clients make estimates of what their ratable factors will be. And it wouldn't surprise any of us if in fact, given the economy, that there's a tendency at the moment to continue to overestimate, if you like, the impact of the economy. And so it becomes difficult -- and understate the exposure, which is something we believe is happening today, but we can't prove it. We can't obviously find it in the numbers. And it'll be interesting as the economy levels out and ultimately returns to watch our senses that the retrospective audit premium dynamic will be the first to change because in fact, the catch-up will occur and then we'll begin to see the renewal dynamic of exposure a little slower and a little bit longer. But those are two very different dynamics of the economy that just tend, given our arithmetic, to be lumped together. And maybe that's helpful in thinking about it.

Brian W. MacLean
President and Chief Operating Officer

Yes, I mean, one of the other interesting thoughts here as you look at our data and broadly across much of our business that certainly in the Business Insurance side, we're growing our customer base. It's hard to see in the premium because ...

Jay S. Fishman
Former Executive Chairman

It's just number of customers.

Brian W. MacLean
President and Chief Operating Officer

Right, because our's typical and I'm not just talking about we're writing a whole bunch of small ones, so the numbers are larger. We're, in the aggregate, growing our customer base. The premium is struggling because our typical customer might need a little less insurance than they do in normally robust times. And that typically comes through on the AP side, audit premium side. So it's an important note though that we feel good about the business growth.

Jay S. Fishman
Former Executive Chairman

It's a bit forward-looking and obviously may not happen. But if in fact we come out of this with more customers than we had coming into it, when the economy does recover, we think we'll be reasonably well positioned to anticipate a growth in premium. But a lot of factors got to happen obviously for the economy to get recover has to continue to stabilize first. But at the very basic core of it, we think we're going to be coming out of this with more Business Insurance customers then we went coming into it.

Operator

[Operator Instructions] Our next question comes from the line of Vinay Misquith from Crédit Suisse.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

On the Personal Auto front, you had a sequential PIF growth quarter-over-quarter. Could you give us a sense for what the competitive dynamic it would in the industry and how you're managing to grow the business now versus the last few quarters?

Gregory Cheshire Toczydlowski
Executive Vice President and President of Business Insurance

Vinay, this is Greg Toczydlowski. I think at Brian's comments, he talked about us being in front of some of the late cycle in late 2008 into 2009, and you can see that on our RPC statistics. We spent quite a bit of time really looking at filing activity across the country in understanding what the competitors are doing in terms of simple metrics like the ratio of increases, of filings to decreases, and we see an environment where increases are still outpacing decreases and by quite a bit closer to 4:1 right now. So as we moderate some of our rate as the market moves with some of theirs, probably to the levels that we were at in 2009, again, as I talked about our quote and close ratios, we can see we are becoming more competitive in the marketplace and feeling very good about our margins underneath that. And that's driving some of the sequential PIF growth.

Jay S. Fishman
Former Executive Chairman

So we just said becoming more competitive. It seems you did come to the conclusion from that statement that we're lowering price. What you really mean is that the pricing that we've established is that the market seems to be catching up to it. That's an important clarification.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

And your margins have also improved this year versus last year. Could you give us a sense of whether this is purely because of rate or do you think that there's an elements in the loss cost trends? I'd be speaking to your severity that's also helping you.

Gregory Cheshire Toczydlowski
Executive Vice President and President of Business Insurance

It's a combination of both. We've been very disciplined in our pricing in a very segmented level, and you can see that in the RPC trends. And that the loss trend, we're watching very closely, and some of the mileage-driven data and information that's out there is showing that there's been a slight improvement in frequency in the first quarter. And the loss trend is right where our expectations are. We're going to continue with our very focused and disciplined pricing.

Vinay Gerard Misquith
Crédit Suisse AG, Research Division

Some of the excess and surplus lines superiors have said that the competition among the standard out there is growing. Could you give us a sense how Travelers is ensuring that you're not driving business that is normally being written by the excess and surplus lines?

Brian W. MacLean
President and Chief Operating Officer

Yes, we watch very closely who we're taking business from, where it's coming from and are very confident that we are not out there writing any significant number of accounts that belong in the E&S market. The one place that I'll comment that sometimes some competitors who are in that space will talk about people taking account. Sometimes there are accounts that are in that marketplace because the agent, that is the only way in the small commercial side that they can assess markets. And so one of the other reasons why business moves out of excess and surplus lines, wholesale businesses into traditional distribution is the agents, hopefully, for all appropriate reasons, got appointed and come directly to us. But that's not I think the issue you're talking about, which is there are accounts that belong in that marketplace because they're complex risks and shouldn't be written in standard markets. And we're very comfortable that we're not taking that business.

Jay S. Fishman
Former Executive Chairman

And from time to time, we will have a program, because we've talked about this before, where it's written both in excess and surplus markets as well as in admitted markets, in standard markets. And so we do have an amount of business that we have had for a long time that's been around here, programs, in particular, that are also written in the E&S market. But again to Brian's answer, there's been no effort on our part to aggressively move business that has historically been in the E&S markets and move it over to us, quite -- just no.

Operator

Our next question comes from the line of Matthew Heimermann from JPMorgan.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

I was curious if you'd just comment on the reinsurance changes you made internationally. And I guess specifically, just clarify whether when you say you're changing the retention, the retention is at a similar level to like the U.S. excess of loss treaty, which I think is 500, or that housing plan is there or relative to capital, you've scaled the attachment points similar to where it is in the U.S.?

Alan David Schnitzer
Chairman of the Board & CEO

It's Alan Schnitzer. Neither, actually. This is on a pro-risk basis. We had been keeping lower net retentions internationally than we had in the U.S., so really just conforming that up a little bit. And then we've got some individual CAT treaties related to our Lloyd's businesses. That captured at much lower levels, and we move those up a little bit that from 35 to 70, nowhere near the numbers that you're relating from the U.S. So really, it's actually just aligning the factors, which is what we've got in the U.S.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

And on the per risk, I mean, I guess in order of magnitude, I mean and I guess, anecdotally, I mean, is that you're moving from a 40% to 50% on your pro-risk or I guess could you give some color there?

Alan David Schnitzer
Chairman of the Board & CEO

This is taking net per risk from $10 million to $15 million in one case and $10 million to $12 million in another.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

So nothing huge?

Jay S. Fishman
Former Executive Chairman

That's dollars. That's $10 million to $15 million per risk or $10 million to $12 million.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

I guess if you translated in that relative to the gross line that was put out on the contract, how does that percentage change? How does that translate into percentage, I guess?

Alan David Schnitzer
Chairman of the Board & CEO

We got to do the math quickly, but ...

Jay S. Fishman
Former Executive Chairman

I mean, It varies literally transaction by transaction. If we have a $20 million exposure instead of having a net pretax $10 million, we'll now have a net pretax $12 million. If we have a $2 million exposure instead of having a net pretax $10 million, we'll have a net pretax $12 million. So it's specific to the individual loss.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

I just wanted to make sure that you weren't expanding your gross appetite in concert with this or whether it was truly just a net without the gross line changing? That was the only reason I was asking the question.

Jay S. Fishman
Former Executive Chairman

It's worth to putting just given how accounting works that this change is disproportionate between gross and net in this quarter.

Alan David Schnitzer
Chairman of the Board & CEO

Yes, we've got some -- in the segment, we've got a significant portion of the reinsurance that renewed, and all the CD premium gets booked in the quarter that it renewed. So it's got a significant impact in this quarter and over the year.

Jay S. Fishman
Former Executive Chairman

There's a tends to be a presumption that these things happen ratably. And actually, it's not how it works. The requirement is to actually see the entire amount from the gross add inception, not over the policy period, so this impact for written. So that it looks like a bigger impact on an annual -- what you're looking at is the annual effect, all being evidenced in one quarter.

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

And then I guess with respect to the industry-focused underwriting segment, are there any particular segments that you would highlight as being disproportionate drivers of the pressure in that segment?

Jay S. Fishman
Former Executive Chairman

When you say pressure ...

Matthew G. Heimermann
JP Morgan Chase & Co, Research Division

I guess you've seen, it looks like the economy is having a bit bigger impact given the rate trends there don't look dramatically different from the rest of the BI segment, that it just looks like it's suffering a little bit more. So I was just curious if there's any industry classes or segments that you would highlight as disproportionately driving or if it's just kind of consistent across everything in that segment?

William E. Cunningham
Former Executive Vice President of Business Insurance

This is Bill Cunningham. The two that could come to mind are construction and oil and gas. The amount of construction activity on the commercial side is down fairly dramatically, so we're seeing that impact for payroll and revenues for our contractors. And there's obviously less drilling on the oil and gas side. So those two classes are certainly disproportionate.

Operator

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

Jay Adam Cohen
BofA Merrill Lynch, Research Division

If you could talk more about the new business environment, new business was up year-over-year and Commercial Accounts down. You made some comments, I'm wondering if you could flush that out a little bit as far as competitive environment from new business? And then secondly, one type that we haven't talked about in a long time is asbestos. I hate to just cross it off my list, assuming no worry about them. Wondered if you can give us an update on what's happening there?

Brian W. MacLean
President and Chief Operating Officer

Hey, Jay, this is Brian. I'll tag team a little bit with Bill Cunningham on the new business side. And I assume you're talking specifically the Business Insurance there. A couple of different stories. I think the broad one is we've been doing a ton of things in the marketplace over the last three-plus years to drive more flow and more opportunities and a bunch of different funds. We've talked about them in the past. That has continued. We feel great about the amount of business that we're seeing in the marketplace and our ability to go through that in a pretty sophisticated way and find opportunities. So broadly, middle market, we feel great about. On the small commercial side, on the small end, the platform that we've rolled out in Select and our Travelers -- I mean, our express platform there has driven a lot of volume as we would have hoped, and we're seeing a lot of opportunity there. The challenges that got between those, and by that, I mean what we typically call the higher end of small commercial where the market place is more competitive, and that's the area where we're taking some pricing actions and seeing lower volumes.

Jay S. Fishman
Former Executive Chairman

The pricing action is upward.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

On the Commercial Insurance business, what's happening to your hit ratios, just to follow-up on that.

William E. Cunningham
Former Executive Vice President of Business Insurance

The hit ratios are down. I mean that the overall comment would be the new business environment remains competitive. As Brian mentioned, our flow of opportunities is up, continues to be up year-over-year, month this year compared to month last year. There's been a consistent increase each month, each quarter. We've worked through more opportunities. Our quote ratio's about consistence.

Jay S. Fishman
Former Executive Chairman

We got an increase in quotes. So go through the pieces.

William E. Cunningham
Former Executive Vice President of Business Insurance

So flow today, just to give you some perspective is up two folds compared to what it was three years ago. So we're seeing, up businesses volume [ph] (58:14) in terms of number of account opportunities than we did three years ago. And we're maintaining about the same quote ratio. So the number of accounts that we're quoting is about double compared to what it was three years ago. The percentage that we're actually getting an order on is down.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And then any comment on asbestos?

Jay Steven Benet
Vice Chairman and Chief Financial Officer

This is Jay Benet, Jay. The environment that we've seen in the first quarter has been very much the same environment that we've seen in recent quarter. There's literally been no change. I mean, we always welcome the day when we could watch a sporting event and not see an advertisement from a pointless [ph] (58:58) attorney talking about asbestos. So that continues in the marketplace. But there really haven't been any major new developments.

Operator

Our next question comes from the line of Josh Shanker from Deutsche Bank.

Joshua David Shanker
Deutsche Bank AG, Research Division

The advertising spend, how do you guys think about the payback in advertising spend and is it meeting your objectives?

Jay S. Fishman
Former Executive Chairman

The advertising spend is really, you can look at it in two separate pieces. There's an element of it that's pure brand. And the spending that we've done over the last several years has been long term, investment oriented, not action driven. The ramp up that we had in advertising has been very specifically behind our Direct-to-Consumer business where we're doing a lot more. The short story on our direct-to-consumer personal lines initiative is that it's a long-term program. We said that we would lose money along the way. We continue to lose money on it. In terms of driving customers from media to a quoting process, that's been actually pretty encouraging. So in the context of the effectiveness of the advertising, if the measure of it is the response that people have to it, that's actually been pretty good. Then the next learnings that we've had and we've spoken about it, next, really, is we have to take on in learning how to convert that response into higher numbers of quotes and then ultimately into higher number of sales. And in that arena, we still have -- about consistent with our expectations, we have a long way to go before this becomes a successful business venture.

Joshua David Shanker
Deutsche Bank AG, Research Division

Some of your competitors, very few of them say that they have a brand advantage in the commercial lines. Do you think that the advertising had helped with that for Travelers? Do you see any indication from your customers that they're identifying with the brand on the commercial side?

Jay S. Fishman
Former Executive Chairman

I think the best way that we can answer that, and of course this is all anecdotal and could be wrong, but if you sit with a group of agents, particularly those in our Business Insurance arena, they all are aware of the advertising effort that we've undertaken. They all comment on it and they all say that it makes their job easier. Now they could be just talking that. They could just be telling us that and not have it be substantive. But it is pretty clear to us that the agents do indeed see it. They appreciate it, and at least, as they described to us, it's helpful to them. I don't know is the specific answer with respect to customers. If you do watch brand tracker data, and we do, but again, this is a very long-term venture for us and I don't want to overreact to either good news or bad news in that regard, but brand tracker data would suggest that our advertising is being effective in terms of customer recognition. Now that's predominantly in the personal side. But again, these are all long-term efforts to accomplish something over time.

Operator

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

Ian Gutterman
Adage Capital

Can you talk a little bit about the decline in non-CAT weather? I guess that surprised me. I thought, I guess, snow in all 50 states at the same time and now 50 of those states were CAT events. I would have thought non-cat and cat weather would be up this quarter. But you and Shepherd [ph] (1:03:12) both were saying that non-cat was down. So is there a categorization thing or last year, things were just below the cat threshold and this year, there are a lot of events just above or ...

Brian W. MacLean
President and Chief Operating Officer

Ian, this is Brian. I think the fundamental dynamic is the last point you're making, which is this quarter, the little tiny silver lining around the big dark clouds was the events were so bad that they all flipped into the getting categorized as a CAT event. So our normal first quarter flow of weather events is always there because there's always snow storms and there's always a little bit of wind and there's always some of that. Most of that got lumped into a CAT, and therefore, we've got offsetting benefit.

Jay Steven Benet
Vice Chairman and Chief Financial Officer

And that was the primary reason why we try to be very transparent on the fact that there was favorable non-CAT weather. We think it's important so you [ph] (1:04:13) and understand what the underlying dynamics are in the business and be able to look at combined ratios with that in mind.

Ian Gutterman
Adage Capital

My other question is on Auto. I guess, can you help me get more comfortable that the 95 this quarter is sort of that you're sustained by back below 96. And the reason I ask it that way is each of the last couple of years, you've been at 98, 99 and there's been a quarter in there that's below 96, then you go right back up. And to be honest, when I look at your reserve triangles for Auto, you've had a first availment the last couple of years. You're paid-on IBNR trends, frankly, look a little weaker than your peers. But on the other hand, obviously, you've got pricing coming through. I mean, sort of where are we, are we comfortable that we're below 96 or is it we're hopeful and we need a couple more quarters to see?

Brian W. MacLean
President and Chief Operating Officer

So a couple of pieces in and then, Greg, you can chime in. As I said in my comments, we've got about a point of good news running through there because of the weather impact on frequency. So the 95 in change is we think, from a run rate perspective, a little bit understated. We are seeing, we have been taking some rate actions as we've talked about and we are seeing now that, that rate is exceeding loss costs. So we are expanding our margins there, and we feel good about it. There also is seasonality in how the ratios come through, and that's one of the reasons why they do bounce around a bit. But, Greg, if you want to ...

Gregory Cheshire Toczydlowski
Executive Vice President and President of Business Insurance

No, just to comment on that seasonality. We typically see in the first quarter a little lower relativity. And we certainly talked to you about the fourth quarter, about a much higher relativity. And so when you consider all that, and in Brian's comment on the rate offsetting some of the loss trend and Jay's comments about we have target ranges of a return on capital for this line. Based on all that, we feel like the product is right in the middle of where we want of those targets. We feel comfortable with it.

Ian Gutterman
Adage Capital

Maybe a fair way to say it that it may not be below 96 every quarter, but hopefully it's a 96 for the year as the earn price keeps coming through?

Gregory Cheshire Toczydlowski
Executive Vice President and President of Business Insurance

We certainly price the product on a longer imputed basis. Yes, it's very difficult to do it at a quarterly level. But the ranges that we look at overall in terms of profit targets, the product line, it's closer to the 96 to 99 range. So when we consider all of that, we feel like we're right inside those targets.

Ian Gutterman
Adage Capital

I guess the one thing that surprised me is even if I take Brian's comment on it, it's just a 95 back to a 96, I guess, and some seasonality. It just seemed that they dropped from where the full '09 year was, and I would have thought the earn pricing would have come in a little bit more gradually unless there are some other benefits you're seeing possibly? You see what I'm getting at?

Jay Steven Benet
Vice Chairman and Chief Financial Officer

I think what might distort it though is if you're looking at it on a quarter-to-quarter basis, particularly sequentially, you have the fourth quarter, which has the higher loss content associated with it. And then you flip into the first quarter which has, by its nature and the seasonality factors, the lower loss content. So I think you have to see it develop over a few more quarters, I think.

Gregory Cheshire Toczydlowski
Executive Vice President and President of Business Insurance

It's a little bit [indiscernible] (1:08:01) when you're looking at quarter-over-quarter of this year for the 2009 period. We did have some adverse activity in the first quarter of 2009 for the fourth quarter of 2008. So when you adjust some of that, which we really look at more on an accident year, the health of the business, the trend certainly come through.

Brian W. MacLean
President and Chief Operating Officer

I think the bottom line here, Ian, without giving you a precise number for what we think the full year Auto is going to be, we feel better about the Auto line. There were some unusual seasonal things going through, but we feel good about the rate we're getting and the loss costs are controlled. And relative to where we've been, we see some real improvement here.

Operator

Our last question comes from the line of Ron Bobman from Capital Returns.

Ron Bobman
Capital Returns

I heard a question about your Lloyd's businesses and I was wondering how much hard and soft capital supports your Lloyd's businesses and exclusively how much in the way of LOCs do you use to make up those amounts?

Jay Steven Benet
Vice Chairman and Chief Financial Officer

This is Jay Benet. There's a fair amount of LOCs supporting the Lloyd's business. I think proportionally, it's probably about 80% LOCs relative to hard capital.

Ron Bobman
Capital Returns

And where are the actual dollar numbers?

Brian W. MacLean
President and Chief Operating Officer

I'm struggling with the number. I think it's in our K. $500 million is what I would remember.

Jay Steven Benet
Vice Chairman and Chief Financial Officer

Probably a little less than that, but it's about $500 million. It will go up and down based upon the expected writing that would ...

Ron Bobman
Capital Returns

What's the total capital number approximately for the LOC number?

Jay Steven Benet
Vice Chairman and Chief Financial Officer

It's $474 million. It's on Page 117 of the K.

Operator

Ms. Nawi, there are no further questions at this time. Please continue with your presentation or closing remarks.

Jay S. Fishman
Former Executive Chairman

We're all finished. We thank you, all, for your attention. We hope that this format was more responsive to your needs. Let us know if it's not, if there's anything we can do differently to be helpful to you. And thank you, all, for your time and attention.

Operator
Ladies and gentlemen, that does include the conference call for today. We thank you for your participation and ask that you please disconnect your lines. Have a great day, everybody.