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Selective Insurance Group, Inc. *(SIGI)*

Q4 2011 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone. Welcome to the Selective Insurance Group's Fourth-Quarter 2011 Earnings Release Conference Call. At this time, all participants are in a listen-only mode. After the presentations, we will conduct the question-and-answer session. [Operator Instructions] .

At this time for opening remarks and introductions, I would like to turn the call over to Senior Vice President, Investor Relations and Treasurer, Jennifer DiBerardino. Ma'am, you may begin.

Jennifer W. DiBerardino
Treasurer & Senior VP-Investor Relations, Selective Insurance Group, Inc.

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

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

As a reminder, some of the statements and projections that will be made during this call are forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties.

We refer you to Selective's Annual Report on Form 10-K and any subsequent Form 10-Qs filed with the U.S. Securities and Exchange Commission for a detailed discussion of these risks and uncertainties. Please note that Selective undertakes no obligation to update or revise any forward-looking statements.

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

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

Dale Allen Thatcher

Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

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

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

Industry wide, 2011 was a record catastrophe year with a heavy East Coast impact from which we were not immune. This was the second consecutive record catastrophe year for us, but cat losses in the fourth quarter were in line with our expectations at approximately 2 points. For 2011 in total, cat losses were almost $119 million or 8.3 points on the combined ratio.

For the quarter, we reported operating income per diluted share of $0.33 compared to $0.48 a year ago. Favorable prior-year reserve development contributed to results, partially offset by lower net investment income and higher expenses due to the MUSIC acquisition.

The fourth-quarter statutory combined ratio was 98.7%, 4 points better than a year ago. Favorable prior-year casualty development of $10 million or 2.7 points and improvement in year-on-year non-catastrophe property results drove the results.

Total statutory premiums were up 17% in the quarter, driven by a 20% Commercial Lines net premium written increase, our third sequential quarter of growth. Commercial Lines growth included E&S business, which contributed $15.7 million in the quarter, along with audit and endorsement premium of $11 million in the quarter. Audit and endorsements have now been positive for three quarters.

2011 marked the first year of overall net premium written growth for Selective since 2007 with a 7% increase. For the full year 2011, audit and endorsement premium added $14.5 million to Commercial Lines growth versus return premium of $47.9 million in 2010.

The Commercial Lines statutory combined ratio was 98.2% in the quarter. Commercial property and commercial auto continued to perform well in the quarter reporting combined ratios of 75% and 96.3% respectively. Workers' compensation results showed further improvement in the quarter with a statutory combined ratio of 111.9 versus 123.8 a year ago. Again this quarter, workers' compensation results had no prior-year development.

We continued to address profitability in this line through a combination of rate increases, underwriting improvements and claims initiatives. The BOP line reported a fourth-quarter statutory combined ratio of 80.7%, including $4 million, or 22.5 points, of favorable prior-year casualty development. In our standard quarterly reserve review, we determined the BOP reserves to be developing a redundancy that required action.

Recent accident-year combined ratios have been running in the 110 to 115 range, which includes a more normalized catastrophe load and is more representative of current results in this line.

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

To improve Personal Lines profitability, we continue to focus on driving rate and mix of business changes across our Personal Lines book. We successfully renewed the Property Catastrophe Reinsurance program in January. The program structure remains $435 million in excess of $40 million retention.

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

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

For the year overall, our alternative investment portfolio generated a 17% return or $21 million, primarily from increased distributions. The after-tax yield on fixed maturity securities was 2.8%, flat with last quarter, but down from 2010 levels.

Lower reinvestment rates will place ongoing pressure on the total yield generated on our fixed income portfolio. We maintain a well-laddered investment portfolio, but as bonds mature and reinvest at current depressed market rates, we expect the yield on our portfolio to remain under pressure.

Invested assets increased 5% from a year ago to $4.1 billion. Our fixed income portfolio has an overall credit rating of AA minus and duration of 3.1 years, including short-term investments.

After suspending purchases of municipal securities in 2011, we're now selectively buying high quality municipal bonds for the portfolio, which will slightly extend duration. We continue to invest primarily in high quality corporate bonds while maintaining an overall duration of just over three years. The only Eurozone sovereign debt exposure in the portfolio is to Germany and Finland and it totals less than $13 million.

Our total exposure to the Eurozone is $63.9 million, which includes $30.9 million in bank fixed income, $19.4 million in corporate fixed income and $1.1 million in equity exposure to one Eurozone consulting firm.

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

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

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

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

On page eight of the investor packet, we have provided an exhibit detailing the impact of the DAC accounting change on our balance sheet and income statement, including retroactive application of the change for prior periods.

We completed our acquisition of MUSIC on December 31, which rounded out the earlier E&S renewal rights transaction with Alterra. The structure of these transactions allowed us to remove the uncertainty around prior reserves and development by not taking the liabilities of the business and allowing us to select business based on our underwriting guidelines on a go-forward basis.

As a result, no unearned premium was transferred, culminating in a significant difference between written and earned premium this year. This will put modest pressure on our overall GAAP expense ratio in the first year, especially under the new DAC rules.

Surplus remains strong at $1.1 billion at December 31, while stockholders' equity increased 3.6% from a year ago to $1.1 billion. Book value per share increased to $20.39 from $19.95 a year ago, partially offset by an $11 million pension plan charge as a result of lower discount rate assumptions.

Our premium surplus ratio was 1.4 to 1 at year-end. In lieu of share repurchase activity, we deployed excess capital in 2011 on the strategic acquisitions of our E&S platform to build long-term shareholder value.

Now, I'll turn the call over to John Marchioni to review insurance operations.

John J. Marchioni

Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

Thanks, Dale, and good morning. Pricing in the Commercial Lines marketplace continued to gain momentum in the fourth quarter as more competitors began driving higher renewal rates, while we achieved our 11th consecutive quarter of renewal price increases with a positive 3.4%. This is a market improvement from the prior quarters in 2011 in which rate increases averaged 2.7% and we believe reflects the improving market.

While we were the only company to consistently achieve positive Commercial Lines renewal rate over the past three years, in the fourth quarter, we began to hear more broadly that other carriers are starting to underwrite and search for higher rates. Our 3.4% increase in the fourth quarter, and even more importantly the 4.5% we achieved in January of 2012, reflects our pricing success in the hardening market.

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

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

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

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

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

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

Personal Lines net premiums grew 6% in the quarter, while new business was down 24%. A total of 46 rate increases added the potential for $18 million on our in-force book in 2011. Renewal pure rate increases were 6.1% in Personal Lines and retention increased almost two points to 86.9%.

We remain focused on improving the quality of our Personal Lines book through writing more low frequency, high retention business and continuing to push rate on both homeowners and personal auto. The flood book is performing very well with revenue up 16% and net income up 51% for the year.

In 2011, we experienced a record number of flood claims at almost 10,000. This claim volume put stress on our organization and the NFIP. The flood team rose to the occasion and provided the best customer service possible to address those losses.

We're pleased with the $15.7 million in E&S premium written in the fourth quarter from the Alterra renewal rights transaction, which we have re-branded as STONECREEK SPECIALTY underwriters, bringing total 2011 E&S premium to $24.1 million.

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

We are also looking to tap into the $300 million to $400 million in contract binding authority business being written through our retail agency base. This is lower hazard, low limits E&S business that is being underwritten by seasoned professionals in STONECREEK and MUSIC. We are fully committed to our strategy to introduce new and expanded products to our agents and customers. Initial feedback has been positive as this type of small contract binding authority business is a natural fit with our current book of business.

Now I'll turn the call over to Greg.

Gregory Edward Murphy

Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

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

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

If this new cycle would have last around three years and produce annual price increases between 5% and 8% and a consistent loss trend would facilitate reaching our overall targeted return on equity of about 12%.

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

Our commercial lines pricing strategy is a significant part of our overall prop improvement plan, which also includes the following; one, commercial lines underwriting mix and business improvements; two, many claims initiatives that should produce a cumulative three-point run rate improvement in our loss and expense ratio over the next two-year period compared to the 2010 base year; and three, significant rate and underwriting improvement in personal lines.

For 2012, we expect to file and obtain overall personal lines rate increases of 8.3% with homeowners up about 11.5%, overall, net premiums written growth of 17% in the quarter. In order to fully analyze that growth rate, you need to look at the component parts.

The addition of our new E&S operations added 5.2 points of growth. Renewal premium price increases for both personal and commercial lines added about 3.4 points of growth and audit and endorsement premium added about 3.7 points of growth. Thus, the underlying growth rate of our core book was about 4.4% for the quarter, mostly driven by a three-point increase in our commercial lines retention ratio to 82%.

Our agents are very committed to Selective, mainly due to our significant focus on relationships, customer service, technology and consistency in the marketplace. We have responded to agent's and customer's needs by increasing our products and services allowing for deeper agency penetration and stronger agency relationships. To capture our new business, we have focused on expanding our appetite in commercial lines by adding almost 50 new and expanded products over the past two-year period.

Our field model remains the foundation of our success with agents. We have expanded our field model in 2011 by deploying field-marketing specialists. Field-marketing specialists are responsible for small commercial and personal lines business generation throughout our footprint.

In addition, our agents are excited about our new E&S platform that provides them the capability to consolidate more of their best business with Selective through our new wholesale agency partners as we continue to improve the contract binding authority service model.

As John said, our agents control approximately $300 million to $400 million of this type of business, which for the most part is placed in a highly fragmented manner. Our investment portfolio is very high quality and our investment strategy has not wavered. We addressed the low interest rate environment in 2011 by deploying a high dividend yield equity strategy without materially changing the portfolio risk profile.

In addition, we have strategically limited our concentration of risk over the years as demonstrated by our well diversified corporate and municipal bond portfolios and our minimal sovereign debt exposure.

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

Selective has stood strong for 85 years. We are a growth company and we will grow at the right time with the right discipline and at the right price. I'm proud of the hard work that our people have accomplished throughout the soft market to position this company for long-term success. My sincerest thanks to our employees, our loyal agency force and shareholders for your continued support.

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

QUESTION AND ANSWER SECTION

Jennifer W. DiBerardino
Treasurer & Senior VP-Investor Relations, Selective Insurance Group, Inc.

Marion (22:52), will you take questions now please?

Gregory Edward Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

Operator?

Jennifer W. DiBerardino
Treasurer & Senior VP-Investor Relations, Selective Insurance Group, Inc.

Hold on one minute while we find the operator.

[audio gap] (23:48)

Gregory Edward Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

I understand that there may be technical difficulties with Verizon, but I – what we can – from what we can determine, the call did go out.

Operator: Excuse me.

Gregory Edward Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

Oh, you're back, okay.

Jennifer W. DiBerardino
Treasurer & Senior VP-Investor Relations, Selective Insurance Group, Inc.

A

Marion (27:29)? Hello?

Operator: Ron Bobman, your line is open.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

Okay. I patiently waited, heard the whole prepared remarks, so it was fine from my end except for this little lapse.

Jennifer W. DiBerardino
Treasurer & Senior VP-Investor Relations, Selective Insurance Group, Inc.

A

Sorry. Thank you very much.

Gregory Edward Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

Sorry, apologies.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

No sweat. You're worth waiting for. I had a couple of questions. One of the gentlemen in the prepared remarks was talking about competitors raising rates in a – I think the words were used sort of in a socialized manner. I didn't understand what he meant by that.

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

This is John Marchioni. Those were in my prepared comments. And what we mean by that is socialized rate increasing is across the Board, so not differentiating between quality of account. And I think as the market started to firm, there is no question market-wide rates need to go higher, but it's still important that you recognize which accounts need the greatest level of rate increases and which require the least amount and really just keeping up with loss trends.

So, we've been very targeted over the last three years in terms of how we've done that, making sure that we've targeted the right accounts for rate and making sure we focus on retention, so that the greatest quality accounts – and that comment is that you don't necessarily see that with others.

And I think the other part of that too when we – it ties into the new business commentary is, as that happens, you're starting to see business that, despite a multiyear soft market, is coming out into the markets that is overpriced. So, there's an opportunity to write that because of that socialized approach to raising prices.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

Understood, loud and clear. And then I think maybe it was you, John, as well, I'm not positive, at one point you mentioned that new business suffered. There was an adverse impact as far as new business, but then I thought later in your comments that there was a positive comment regarding, I think, either January or most recently new business. If I heard that right, could you – is there now sort of a transition or an inflection or something like that?

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.

A

Yes, you did hear that correctly. So, the pressure that we had on new business was earlier in our strategy to raise rates. So, back in 2009-2010, when we started to be able to obtain a little bit of rate, two to three points, when the rest of the market wasn't moving, it did put pressure on our producers and therefore really did hurt in terms of new business submission activity as the rest of the market was still very aggressive relative to new business pricing in particular.

What we've now seen is, as the rest of the market has started to move towards firming price that the quality opportunities have started to flow again and that drag on new business has started to turn a corner.

I think the other important point to remember, and you heard this in the prepared comments as well, is from a year-to-year perspective, it does look like a big increase, but from historical new business levels, these are about where we would expect them to be and they were prior to 2009.

Gregory Edward Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

And if I could say, this is Greg Murphy, just to kind of give you an idea, a little background because I will tell you that sophisticated underwriting and granular pricing in Commercial Lines has really only been around for – or more significantly around for the past several years. And I would say that the difficulty in executing that strategy in a market that continued was – where rate was under pressure is very, very difficult to do, because you need some momentum in the market to be able to raise and lower prices and you can't lower prices unless you can raise prices.

So you are starting to see a transition now where we will better be able to execute our granular pricing capability in the marketplace. And you need a more firming market to be able to do that. So I hope that's an important concept to garner because rate in Commercial Lines, there's a whole lot of mispriced business out of there. And what sophisticated underwriting and granular pricing gives you is the capability to better identify that. But it's going to take a while to work through that, but this is the first part of the cycle that you're starting to see that execution happen in.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

Okay. You have – the deck is great, the PowerPoint. You had one slide in here, no numbers, 27 or 39, that – retaining our best commercial business, if it's retention rates and you've got it surrounded by diamonds. But I don't think there's a slide in here as far as retention Q4 2011 versus Q3, sort of the linked-quarter change in retention. Do you have any figures you could share with us about what retention has done the last couple of quarters either for all diamonds or like stratification?

Gregory Edward Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc. A

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

Ron D. Bobman
Analyst, Capital Returns Management LLC Q

And it was 79 in Q3.

Gregory Edward Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc. A

Yeah, we do track retention by diamond in that. I don't know if you have that, anybody has...

Dale Allen Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc. A

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

Gregory Edward Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc. A

Yeah.

Ron D. Bobman
Analyst, Capital Returns Management LLC Q

Oh, that's year-over-year.

Dale Allen Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc. A

That's not sequential quarter. It's been drifting upward over the course of the year.

Ron D. Bobman
Analyst, Capital Returns Management LLC Q

Okay, Q4 2011.

Jennifer W. DiBerardino
Treasurer & Senior VP-Investor Relations, Selective Insurance Group, Inc. A

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

Ron D. Bobman
Analyst, Capital Returns Management LLC Q

Okay, okay. And if we switch to Personal Lines, it seems generally, at least from the homeowners side, that the order of magnitude of rate increases is even deeper than Commercial Lines, but your retention's even improved more dramatically, I think, in the Personal Lines. Can you does talk about what's going on there? It seems that it's even a firmer market there and thus – and more uniformly so. So I guess retentions are not being impacted by these rate increases. Could you, I don't know , talk about Personal Lines? That's it for me. Thanks.

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.
A

Yes, this is John. So you picked those pieces or put those pieces together appropriately. The market in homeowners in particular has been firming for a lot longer than we've seen in commercial property or Commercial Lines generally and we've certainly experienced that. When you look at a lot of the catastrophe activity over the last couple of years and the smaller events, but the higher frequency of smaller events, the market has certainly moved in that direction.

If you look at our retention, our new business has been under pressure the last year or so and with less new business – less first-year renewals flowing into your renewal book, that will help your retention improve as you go forward. So as you saw in the prepared comments, we anticipate a little over 11% of rate in 2012 on that line and would anticipate retentions continuing to be strong. And then the final point of note there is that 11.5% or even if you look at our rate for 2011, those are not across the board. We've targeted them based on risk characteristics and I think that's also kept our retention solid overall while making sure that retention on those targeted segments would be a little bit lower than the average.

Ron D. Bobman
Analyst, Capital Returns Management LLC
Q

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

Dale Allen Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.
A

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

Ron D. Bobman
Analyst, Capital Returns Management LLC
Q

But still not an insignificant – bit still clearly a significant increase in rate, so I guess sort of telling about the reinsurance market.

Dale Allen Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.
A

Yes, it is.

Ron D. Bobman
Analyst, Capital Returns Management LLC
Q

Thanks, everybody and look forward to seeing you. Bye, bye.

Gregory Edward Murphy A
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

Thanks for waiting.

Ron D. Bobman Q
Analyst, Capital Returns Management LLC

No problem.

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

Dale Allen Thatcher A
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

Good morning, Doug.

Doug R. Mewhirter Q
Analyst, RBC Capital Markets Equity Research

Good morning. First, just a very quick question to Dale. I drifted a bit and I missed one figure in the preamble. Could you just give me again the dollar amount of audit premiums in the fourth quarter versus fourth quarter 2010?

Dale Allen Thatcher A
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

Okay, let me get to that quickly. Did you have another one while I'm looking that up?

Doug R. Mewhirter Q
Analyst, RBC Capital Markets Equity Research

The rest is more – dealing with more for Greg and John about the guidance, which is a little more complicated.

Dale Allen Thatcher A
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

It was $11 million for the fourth quarter. I'm just trying to find it in the – versus $5.5 million in the previous year.

Doug R. Mewhirter Q
Analyst, RBC Capital Markets Equity Research

Okay...

Dale Allen Thatcher A
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

Of return – $5.5 million of return the previous year.

Doug R. Mewhirter Q
Analyst, RBC Capital Markets Equity Research

I thought it was negative. Okay, great. And Greg or John or both, I'm just looking at the 2012 guidance, and I appreciate you giving those numbers considering how uncertain they are. I just wanted to maybe walk through some of the math and see if that makes – if any of what I'm saying, if it makes sense. So if you take the 102.5 and you back out the catastrophe losses, which you know are going to be there, but it's a hard figure to estimate, you get to about breakeven on an accident year basis.

And if you look at the equivalent of that equivalent figure in 2011, it was about 101 if you back out the cat losses in your reserve development. So that implies, everything else being equal, a roughly – rates about 1% over loss cost trend. And considering the rate increases you've been getting and the improvements we've been seeing, I don't know, that feels a little light to me. That feels like you would might expect a little bit better than that. I know you try to be conservative, tough to pin that. I just wanted to see what your thoughts were on that.

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.
A

Yeah, I think there's a number of factors that come into that and I think Dale just articulated the first one. So you have to look at that higher rate needs to subsidize the higher reinsurance costs. We just talked about the $3.5 million of higher catastrophe reinsurance. Well, that needs to get in your number because that's coming 100% out of your rate. So – and then there are other planned changes in some of the other reinsurance programs that get renewed throughout the course of the year that you have to compensate on a year-on-year basis for where – some of that.

And then I think when you get down to it, there's just a number of moving parts in the loss trend. I know that you started out – if you looked at the statutory combined – or go to the GAAP combined ratio as you did, the 102.5 minus the 2.5 points of cat is 100 and that 100 then does not include any development, either favorably or unfavorably, and then you're comparing that into the 2011 number.

There are other issues with property losses that can affect that. Volatility in property losses year-on-year can impact that number. And I think that we have a fairly comprehensive robust planning model that looks at multiyear in terms of loss trend and that's how we go through that process and that's how we end up at the end of the day.

I don't know what more I can add to that other than that in terms of where we are.

Doug R. Mewhirter
Analyst, RBC Capital Markets Equity Research
Q

Okay. Well, I appreciate that. And that's all my questions.

Operator: Our next question comes from Bob Farnam of KBW.

Robert Farnam
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Hi, there. Good morning.

John J. Marchioni
Executive Vice President-Insurance Operations, Selective Insurance Group, Inc.
A

Good morning, Bob.

Gregory Edward Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.
A

Good morning, Bob.

Robert Farnam
Analyst, Keefe, Bruyette & Woods, Inc.
Q

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

Gregory Edward Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.
A

Yeah, that's fine. That's good. Let me start with January because I think January is a better – I'm sorry – with January of 2012. It was a better indication and the rate level in January for comp was 6%. So, yes, we need to exceed rate level, I would say, loss trend. We comment on loss trend overall if we're talking about loss trend in the entire book being somewhere around 2.5, 2.6 range. Obviously, in comp, the trend is going to be much higher than that because you've got physician services, hospitals and Rx in there and all of those are much higher than that. So when you look at trend, you've got to look at trend relative to that line, not relative to trends in its totality.

So we have a strategy. Obviously here, it's multifaceted that includes a combination of rate level. It includes a combination of mix of business that we write in terms of the hazard structure, and then it has a number of claim initiatives that are specifically targeted to that line. But I would say that our strategy is to try to bring all of our lines into a more profitable arena.

As we look down the road and look at possible changes in accounting coming under IFRS accounting rules, they are going to be very different rules in terms of how lines of business are going to be calculated in terms of risk margins and which lines are profitable or unprofitable that you have to really start thinking about every line of business and how you get each line of business into a more targeted profitability range.

I would say one of the more restrictive elements in that has been getting rate level in some of the administrative states that we have, that's not a huge amount, but it's a fair amount of our business overall.

Robert Farnam
Analyst, Keefe, Bruyette & Woods, Inc.
Q

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

Gregory Edward Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.
A

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

Robert Farnam
Analyst, Keefe, Bruyette & Woods, Inc.
Q

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

Dale Allen Thatcher
Chief Financial Officer & Executive Vice President, Selective Insurance Group, Inc.

A

Well, I'd say that it's a fluid kind of discussion that you have with the rating agencies. A lot of it depends on the level of profitability, what are we achieving, what kind of – what's really generating the growth. The extent to which you have growth from price increases looks a lot different than growth from exposure increases in the discussions with the rating agencies.

I mean generally speaking, our sustainable growth rate to maintain the exact same level of premiums of surplus is approximately two points less than whatever ROE we're generating. So, that's the one factor to put in there.

Right now, we're at 1.4 to 1. We wrote as high as 1.8 to 1 pretty consistently during the last hard market and I think that that would be tolerated once we get to a level of profitability that supports that.

So, it remains to be an ongoing dialogue with the rating agencies, but there's certainly not a position of excess capital because we want to keep our capital and be able to participate fully as the market hardens.

Robert Farnam
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks, Dale.

Gregory Edward Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

A

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

Robert Farnam
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks.

Operator: [Operator Instructions]

At this time, there are no other questions.

Gregory Edward Murphy
Chairman, President & Chief Executive Officer, Selective Insurance Group, Inc.

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