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Selective Insurance Group, Inc. (SIGI)

Q4 2013 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone. Welcome to the Selective Insurance Group's Fourth Quarter 2013 Earnings Release Conference Call. All lines have been placed on a listen-only mode until the question-and-answer portion of today's conference. [Operator Instructions]

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

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

Thank you. Good morning, and welcome to Selective Insurance Group's fourth quarter 2013 conference call. This call is being simulcast on our website and a replay will be available through March 3, 2014. A supplemental investor package, which includes GAAP reconciliations of non-GAAP financial measures referred to on this call, is available on the Investors page of our website www.selective.com.

I'd like to point out that this quarter based on analysts' feedback, we have added two exhibits to the investor package. One is a GAAP insurance operations results exhibit by major line of business on page nine and the second includes catastrophe loss and casualty reserve development by major line of business on page 13.

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 result 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, President and Chief Operating Officer; and Ron Zaleski, Chief Actuary.

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

Dale A. Thatcher

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

Thanks, Jen, and good morning. The fourth quarter marked the conclusion of a strong year for Selective as we delivered on our 2013 goals. For the year, our statutory ex-cat combined ratio of 94.8% was more than one point better than our original guidance of 96%, as the impacts of our granular pricing strategy and underwriting and claims initiatives worked through results.

Catastrophe losses added 2.7 points to the combined ratio compared to our original expectation of 3 points. After-tax net investment income was stronger than expected, finishing the year at $101 million compared to our original guidance range of $90 million to $95 million.

For the quarter, operating income of $0.45 per diluted share was up from an operating loss of $0.04 per share in the fourth quarter of 2012, which was adversely impacted by Hurricane Sandy. In addition to lower catastrophe losses, better underwriting results drove the improvement.

The fourth quarter statutory combined ratio was 99.6% compared to 110.4% from the prior-year period. Catastrophe losses in the quarter were $14 million pre-tax or 3.2 points compared to $52 million pre-tax or 12.8 points a year ago. Cat 29, a series of tornadoes, high wind and hail that impacted several Midwestern states in November, was the primary source of the cat losses.

Also in the quarter, we had favorable prior-year casualty reserve development of $8 million or 1.7 points compared to a favorable prior-year casualty development of $2 million or 0.5 points in the prior-year period.

Overall, statutory net premiums written were up 10% in the quarter driven by Standard Commercial Lines, which were up 10%, and Excess and Surplus Lines, which increased 20%. Standard Commercial Lines renewal pure price was up 7.5% in the quarter and 7.6% for the full year, right in line with our projection. Meanwhile, retention in Standard Commercial Lines remained strong at 82%, with a statutory combined ratio of 100.2%, including 3.2 points of catastrophes.

For the quarter, commercial property generated an 82.7% statutory combined ratio. Our largest line of business, general liability, produced a statutory combined ratio of 98.5%. Workers' compensation results continue to be challenged and produced a statutory combined ratio of 127.3% for the quarter, which included $9 million or 12.8 points of adverse reserve development. Workers' compensation results clearly remained disappointing. We continue to modify underwriting and claims processes to improve results and we stay ahead of reserve trends through a quarter ground-up reserve analysis.

Personal Lines statutory net premiums written grew 4% in the quarter to $71 million, with a statutory combined ratio of 94.9%, including 3.6 points in catastrophe losses and 2.7 points of favorable prior-year casualty development. Personal Lines renewal pure pricing for the quarter was 7.2%, while maintaining strong retention of 85%.

For the year, we are pleased with the 96.9% statutory combined ratio generated by Personal Lines, as rate increases of 7.8% and various underwriting initiatives benefited results. Net premiums written for our E&S operations grew to $35 million in the quarter, up 20% from a year ago. While results in E&S improved from the prior year, this newest segment produced a combined ratio of 105.6% in the quarter.

We successfully renewed our 2014 property catastrophe treaty, increasing the limit of our top layer from $150 million to $250 million. This expands the program to $685 million in excess of $40 million in retention and exhausts at approximately a 1-in-250-year event. As we increase our catastrophe reinsurance program, we look for ways to minimize the credit risk inherent in the reinsurance transaction by dealing with highly rated reinsurance partners and by purchasing collateralized reinsurance products, particularly for extreme tail events.

The current program provides $197 million in collateralized limit. The entire program was placed essentially in line with 2013 ceded premium in spite of the additional limit that was purchased. Pricing on the program decreased similarly to the pricing reported broadly in the market for January 1 renewals.

Turning to investments, fourth quarter after-tax investment income was $26 million, essentially flat with the year ago. However, investment income beat our expectations for the full year at $101 million, driven mainly by returns on the alternative investment portfolio.

Investment assets increased 6% from a year ago to $4.6 billion, primarily due to increased operating cash flows and $78 million of net proceeds from our junior subordinated note refinancing in February. In fact, operating cash flows as a percent of net premiums written improved to 19% for the year, which compared to 14% in 2012 and 8% in 2011. After-tax new money rates were 1.8% in the quarter and 1.4% for the year. As these rates are lower than our current portfolio yield, investment income continues to be negatively impacted.

As we look forward to 2014, we're using an estimated after-tax new money rate of 2.25% in our investment income projections. After-tax yields on the fixed income portfolio were down 22 basis points from a year ago to 2.3%, resulting in a 10 basis point decline in the overall portfolio yield.

The overall portfolio unrealized gain position declined from $188 million pre-tax a year ago to $79 million, largely due to rising interest rates. Also, the quarter-end unrecognized gain position in the fixed income held-to-maturity portfolio was $24 million pre-tax or $0.28 per share after-tax. Our fixed income portfolio maintains a high credit quality of AA- and a duration of 3.5 years, including short-term investments.

Surplus and stockholders' equity ended the year at $1.3 billion and $1.2 billion respectively. Book value per share at December 31, 2013 was $20.63, up 4% from 2012, as the impact of rising interest rates on our portfolio's unrealized gains has been more than offset by positive net income and the pension revaluation.

Our premium surplus ratio for 2013 decreased to 1.4-to-1 from 1.6-to-1 a year ago. We achieved operating return on equity or ROE of 9.2% in the quarter and 8.4% for the year. Total ROE for these periods was 8.9% and 9.5% respectively, comparing to our current weighted average cost of capital of 9.2%.

As a result of the extreme winter weather that has been headline news since the New Year began, we're providing a preliminary estimate for severe weather losses, including catastrophes, for January 2014 of between $28 million and $32 million or roughly 6 points on the first quarter combined ratio. The losses are due to the weather experienced throughout our 22-state footprint related to freezing temperatures and snowstorms. Early industry estimates on the broader impact of cat 31 and cat 32 are not yet clear.

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

John J. Marchioni

President & Chief Operating Officer, Selective Insurance Group, Inc.

Thanks, Dale, and good morning. 2013 was a strong year for Selective on many fronts as we met or exceeded our primary operational and financial targets. Standard Commercial Lines, which represents 76% of our premium, performed at a 97.1% statutory combined ratio for the year. Personal Lines, which is 17% of our premium written, performed at a 96.9% statutory combined ratio.

Representing 7% of our premium base as the newest line of business, the Excess and Surplus operation improved their statutory combined ratio to 102.9% in 2013. The positive results were driven by the improvement in rate and retention, augmented by our success last year in writing more quality new business.

We often speak of the competitive advantage provided by our strong agency relationships combined with a high degree of pricing and underwriting sophistication. This is evidenced not only by the 19 consecutive quarters of Standard Commercial Lines pure price increases that we have achieved, but also about the granularity of the pricing strategy that we continue to execute. Importantly, we have maintained high retention percentages as we continued to drive pricing. The tools utilized by underwriters allow them to efficiently evaluate the impacts of pricing and non-renewal actions on their book of business, along with the impact of policy-level decisions on an agent's portfolio.

This precision promotes better communication between our underwriters and agents and also allows specific targeting of the highest rate increases on our worst-performing accounts and protecting retention on our best accounts. We are confident in our ability to maintain discipline regardless of how the market cycle develops.

In 2013, for Standard Commercial Lines, our lowest quality accounts, the low and very low buckets, which represent 9% of our Standard Commercial Lines premium, we achieved 15% pure rate and 74% retention at point of renewal. Our highest quality accounts, or above average, which are 53% of our Standard Commercial Lines premium, we obtained 6% pure rate with point of renewal retention at 90%.

Standard Commercial renewal pure price achieved for our full-year projection – sorry, achieved our full-year projection of 7.6%. Retention in 2013 also remained strong at 82%, which is in line with our retention in 2012. In addition to price increases, we separately measure the impact of underwriting improvements to our combined ratio. Currently, underwriting improvements are on track with our expectations.

The 9% growth in Standard Commercial Lines reflects the 7.6% rate increase, a 2% increase in policy counts. In 2013, we took advantage of improving market conditions and grew new business by 18% to $277 million. As we have grown, we have successfully diversified premium within our 22-state footprint by growing faster in our newer than in our historic core states.

In 2001, we set a goal to have no one state represent more than 30% of our premium. We've achieved this goal in 2008 when New Jersey premium represented only 29%. We've continued to further diversify with New Jersey currently representing only 23% of our total premium. We accomplished the concentration shift while actively managing our overall growth.

Selective doubled in size from 1998 to 2006 and pulled back on growth when it made sense during the soft market. The acquisition of MUSIC has further expanded our premium base across all 50 states and we'll continue to diversify Selective as this operation grows. We have ample opportunity to increase penetration in our current footprint, as we utilize sophisticated underwriting tools to write business with the best agents.

Our strategy to focus our field underwriters or AMSs on middle market accounts while pushing small accounts to a more efficient small business model resulted in an uptick in 2013 hit ratios for small, middle market and large accounts. Diversification across industry segments is improving as well.

Clearly, our workers' comp results are not where they need to be with a 114% accident year combined ratio. We continue to carefully manage growth in workers' comp with the full-year premiums up 5% compared to 9% at our Standard Commercial Lines book. Our approach to improve profitability of workers' comp is three-pronged. First, renewal pure price of 7.5% in 2013 compared to 4% loss cost trend for the line. Second, claims improvement initiatives, including a claim escalation model due to roll out in the first quarter of 2014 and creation of a strategic case unit; and third, underwriting initiatives, which include an analysis of the more challenged segments of business.

E&S profitability improved over 2012 levels while new business was up 19% as we continue to see business migrate back from the standard market. Momentum in driving business from our retail agency partners to our wholesale agency partners is increasing and we expect this to accelerate going forward.

E&S renewal pure price was up 7.5% in the fourth quarter and 6.5% for 2013, which when combined with our aggressive underwriting actions on targeted segments leaves us well positioned to produce consistent profitability, in line with standard commercial lines in the E&S operations going forward.

For Personal Lines, the statutory combined ratio for the year was a profitable 96.9% compared to 100.7% in 2012. We continue to drive profitability in the homeowners line, as we increased rate across the book and made underwriting changes, including raising deductibles to increase cost sharing.

Additionally, in 2013, we tightened our underwriting appetite for mono-line homeowners. For the year, our homeowners line achieved a statutory combined ratio of 95%, which includes 13.9 points of catastrophe losses and renewal pure price increases of 10.3%.

Personal auto results, while still below expectations, improved by nearly 3 points compared to 2012 as we have consistently achieved price increases that exceed loss trend. For the year, renewal pure price increased 5.6% in auto. We've improved the geographic distribution of our book with about 65% of in-force premium outside New Jersey in 2013 compared to 57% in 2010.

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

Gregory E. Murphy

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

Thank you, John. Our 2014 expected ex-catastrophe statutory combined ratio of 92% is built around a fundamental three-year plan laid out in early 2012 to achieve overall renewal – annual renewal pure price increases of 5% to 8%. The results speak for themselves, as we achieved overall renewal pure price increases of 6.3% in 2012, 7.6% in 2013, and we expect to achieve 6% to 7% in 2014.

As we look out into 2014, we are confident in our ability to achieve expected renewal pure price increases in Personal Lines of 6.25% and E&S of 8.5%. Commercial Lines could face more pressure due to the declaration in the industry that Commercial Lines pricing power is over. We don't agree for the following reasons. One, for 2013, the industry is close to an accident year combined ratio of 100%; two, expectations that the industry returns to a more normal level of catastrophe losses; and three, ongoing pressure on investment yields.

Conning & Company is estimating a 2014 commercial line industry ROE of 7%, which underperforms the industry cost of capital by about 120 basis points. To give some perspective, we calculate that in 2014, the commercial lines industry would need to increase pricing, assuming a 3% loss trend, about 20% in order to lower statutory combined ratio by 10 points and generate a 12% ROE.

Our 2014 Commercial Lines renewal pure price target is 6% to 7%. Based on recorded premium to date, the Commercial Lines renewal pure price increase for January 2014 is expected to be up 6.2%. Although January renewals can be competitive, as carriers gear up for the New Year, Selective's January renewals typically represent about 10% of our Commercial Lines annual premium volume.

We remain encouraged by our growth opportunities as market conditions continue to modestly improve. In addition to the benefit of pure price increases, we are gaining traction in our E&S business, expanding our agency force and implementing new products. Our success for profitable growth lies in our ability as a super-regional carrier to work side-by-side with the best agents in the business.

Why is this important? Because our agents have very effective sales management cultures and provide their customers with the highest level of services. They generate strong retention. Partnering with the best agents and providing Selective franchise value proposition helps us create mutual success.

We offer the following 2014 estimates as guidance. An ex-statutory combined ratio of 92% for ex-catastrophe losses, no prior-year casualty development, four points of catastrophe losses for the year, after-tax investment income of $100 million, and weighted average shares of 57.4 million.

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

Jennifer W. DiBerardino

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

Jane, are you there for questions?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Vincent DeAugustino, KBW. Your line is open.

Vincent M. DeAugustino
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Hi, and good morning, everyone.

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

A

Good morning, Vince.

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

A

Good morning, Vince.

Vincent M. DeAugustino
Analyst, Keefe, Bruyette & Woods, Inc.

Q

First question. You guys have kind of already hit on it, but with personal auto and workers' comps. So those remain kind of two of the last need-to-work states, and kind of just by my back-of-the-envelope math, if you hit a 100% combined ratio on both of those, that would imply something in the neighborhood of about a 3-point ROE improvement. And so you guys listed some of the workers' comp rate and non-rate actions that you have in plan. I'm just curious if those in combination over the next 24 months might get us closer to 100% combined ratio, and then just how significant are the non-rate versus rate actions for both of those? Thank you.

John J. Marchioni
President & Chief Operating Officer, Selective Insurance Group, Inc.

A

This is John. So I'll start and then certainly Greg or Dale could jump in. We don't put out guidance relative to the actual combined ratios by workers' comp, and certainly internally we have a very good sense in terms of what those three areas of improvement will generate for us, and we highlighted them in the prepared comments.

The rate over trend, and we know what it's been in the past and we have our forecast based on the final rate increases that we know up to this point. So, rate over trend is one part of that. The mix improvements, and we mentioned challenge segments, based on our analytics capabilities and our modeling capabilities, we understand which segment of a business and which hazard grades of business are really driving the negative performance. We have aggressive plans to address those and expect those to generate real improvement.

And then finally, on the claims side, as we mentioned, by having an escalation model, which essentially gives us a very early indication at which claims are likely to really cause us issues in the future and getting them into the hands of top-notch claims professionals, that's where the real dollars are in the claims and reports. So those are very meaningful in our eyes. We don't disclose the actual impact of those. But I would say internally, we're very comfortable in terms of what those would do for us over the next couple of years.

On the personal auto side, you cited that at the other line that we really need to address. We agree. We've talked about the rate over trend. We also had some underwriting mix improvements that we look at there as well that we continue to see an improvement in mix in a number of key variables that we use for rating purposes that we know lead us to lower frequency, higher retention business.

And as we've also said in the past, because of our expansion outside of our – the State of New Jersey where our book is less mature in terms of age, average age of years in-force in the industry and as that book continues to age, which it has and will, we expect to see that improvement come down as well.

And then finally, I would say, a number of the claims initiatives that we talk about, generally speaking, on the liability side as well as the property side, as we've implemented, will impact personal auto as well as homeowners.

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

A

Vince, yeah, this is Greg. Yeah. And I would say that – what John just went through, to me in the Personal Lines area, it fits with the long-term story we've communicated consistently. One is that we're going to have a very aggressive home strategy to bring the home combined ratio down on a normal cat year into that upper 80's band. And then the other that we mentioned too, auto was going to be a longer developing story as we continue to factor in the underwriting improvements and laid that down. So, in terms of the expectation, I think that story has always been, as I'd like to refer to, the tale of two cities relative to Personal Lines improvement.

And on the comp side, I would say that John articulated the three legs of the stool. We're very aggressively managing each one of those because bringing that comp number down is very important to us. You see those improvements embedded in the different parts of the waterfall chart that we produced relative to rate and trend and then also relative to the underwriting and claim improvements. The bigger claim improvements obviously impact the comp numbers overall. But that's something that actuaries have to respond to in a diligent manner. So that's the only commentary I would make on that.

Vincent M. DeAugustino
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. All of that is extremely helpful. And Greg, going to some of your rate commentary, I know rate is not the only lever and it's probably too much focused on right now. So just a preface that I completely agree with your assessment that rate increases should continue. But we've seldom seen industry earn its cost of capital and we're kind of nearing a cat-normalized ROE. We've historically started to see competition start to ramp up a little bit. So I'm just kind of curious if you think maybe things are a little bit different this time around and whether or not we're seeing enhanced discipline because of some of the factors that you've kind of run through.

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

A

It's interesting. I mean, to me, the biggest thing that's out there that I think that changed the dynamics and I think that's true for several years now is the fact that most companies, if not all, more publicly report their renewal price increases, and I think that gives you a lens into what's happening in their premium base relative to rate and then you're comparing that with loss trend. So I think to the extent that when you look at the numbers and you look at our prepared comments, we're looking at an industry, commercial lines, that is close to 100% combined ratio on an accident year basis, and Dale went through the catastrophe activity that we saw – we experienced in January. My guess is we're not immune from that, so as an industry-wide event, that's going to be fairly significant.

Investment yields that we talked about on the call, our new money rates of 2.25% still put pressure on trying to consistently raise rate and prove your underwriting in the sector, and I think the ongoing public exposure of rate is very helpful and maybe we'll keep a little bit more discipline in the marketplace.

John J. Marchioni
President & Chief Operating Officer, Selective Insurance Group, Inc.

A

And if I could just add to that as well, that's more of the external aspect and what we're talking about here in terms of market pricing. At the same time, as we also reiterated in the prepared comments, we've learned a lot over the last 19 quarters in terms of how to really manage price and retention throughout a market cycle. And when you look back at the beginning of this pricing cycle where the market forecasts were still negative and we were starting to get positive rate, I think our underwriters, our agents have really learned how to work together to manage pricing on a very responsible basis regardless of where the market is. I bet it wouldn't get harder if the market started to move, but we feel like we've got the tools and the relationships in place to manage throughout the cycle.

Vincent M. DeAugustino
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. Perfect. And then one more if I could just sneak it in for Dale. Dale, you had mentioned that the new reinsurance program basically covers up to 1-in-250-year event. I think if memory serves me correctly, you guys were probably at a 1-in-228 year before. So, is the increase just purely on just the enhanced reinsurance cover, or are there any underlying modeling changes that actually increased kind of the expected gross loss at a 250-event type thing?

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

A

Sure. It's actually a combination of those two things. Obviously, adding the additional cover at the top moves it out, but also with RMS coming out with their latest model this past year. Remember, in 2012, the RMS model increased everything by – in excess of 80% for everybody while their 2013 version actually decreased the curve for everybody by a little bit. So they gave a little bit of that back. So, a combination of those two things and pushing the cover out to a 1-in-250-year event.

Vincent M. DeAugustino
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. Great. Look forward to talking to you guys soon. Thank you.

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

A

Thanks, Vince.

Operator: Our next question comes from Mark Dwelle with RBC Capital Markets. Your line is open.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Hey, good morning.

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

A

Good morning.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC
Q

Let's start first with the – thank you – the guidance on the catastrophes. You're probably just beginning to get claims, so I'm sure there's not a lot of rich data, but is it going to be biased more towards the Personal Lines or is it a reasonable mix of commercial and personal exposures that you're seeing?

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

So far, Mark, it's tending to match our mix of business, which runs around that 75 to 25 Commercial Lines predominant.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC
Q

Okay. That's helpful. And I assume it's – all geographies are reasonably impacted, and I think Chubb commented last night it's mostly burst pipes and cold weather-related more so than snow and accident-related.

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

Right. Cat 31 and cat 32, the combination of those two hit in 16 of our 22 states, and you also have on cat 32 actually the storm itself hit all [ph] third (31:19) of our 22 states. It seems that some of the states didn't get designated as cat zones by PCS. So, yes, it's very widespread.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC
Q

Okay.

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

The benefit of the cold weather in a sense did create more burst pipes, but the snow loads were lighter, so you had a tendency to have less roof collapses, but it's been mostly a very, very prolonged, severe temperatures coupled with very high wind. So, any weak spots in any structure really were exposed as a result of this event.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC
Q

Okay. That's helpful additional information. Second question I wanted to go into a little bit was the guidance and more particularly the combined ratio guidance. I'm really just trying to probe there a little bit more about how you're thinking about that. You generally had a pretty good track record on delivering your guidance targets, the combined ratio improvement represents 3 points to 4 points of accident year improvement. So you are thinking about that improvement kind of evenly across all the three major – the three segments of your business or do you see more potential in one segment versus another? Maybe we can start there.

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

Yeah. I would say that it's improvement to the largest degree in, I would say, Commercial Lines and E&S and followed by Personal Lines after that, for the comments that I made earlier relative to the home versus auto situation. But when you look at it and just kind of thinking about it, when you look at earned rate, our earned rate next year just based on the fact that we will rate this year at 7.60%, we're going to be earning rate right around at 7% next year. So that – when you look at earned rate versus trend, that's a big part of the laydown of the improvement year-on-year. It's coming from rate over trend in totality. When you look at the earned rate, it's fairly balanced among all three segments relative to how we got the 7.6% overall rate.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Okay. And then I guess parallel with that, is much of the improvement or is any of the improvement going to come from additional leveraging of the expense ratios? Certainly, it's been the case in the E&S segment. Can you tell how much of that might have been factored in as well?

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

A

Our expense ratio, as we've showed you in the multi-year waterfall model, actually starts to elevate as improvements in our core operations are more than offset by profit-based elements of our compensation. So, that's something you always have to be mindful of. As we continue to drop and improve our combined ratio, a profit-based element, which from the largest element of us would be the incentives to agents through the supplemental commission program that we institute, is why you see expense ratios actually go higher because of that profit base.

So I don't want you to read in there as that we're becoming less efficient. Dale and his folks are always showing you the premium volume that we generate per employee. So that's an efficiency measure that we look at. But you could actually – and as we've shown you, our expense ratios are trending to go higher out next year and even into 2014 – into 2015 and 2016 mainly as a result of a much higher supplemental commission agent payout.

Mark A. Dwelle
Analyst, RBC Capital Markets LLC

Q

Okay. That's helpful. I'll stop there. Thanks.

Operator: [Operator Instructions] Our next question comes from Ron Bobman with Capital Insurance. Your line is open.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

Hi. Sorry for the pause. I have a question about workers' comp and not so much on the claims side and the loss side but on the premium rates. I assume you've got sort of different cohorts in workers' comp, some that you regret the first day you look that you count the others that are just underpriced, some that are satisfactory and some that you're making margin on. And I'm just wondering if you could sort of comment about the rate action I assume across these sort of different cohorts and what the competitive environment is as far as – is it easily – are you easily able to renew all at whatever rate you're sort of asking for or feel you need or are there certain pockets that have a degree of competition? I'd appreciate some color on that. Thanks a lot, and congrats again on the results by the way.

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

Thanks. Thanks, Ron.

John J. Marchioni
President & Chief Operating Officer, Selective Insurance Group, Inc.
A

This is John. I'll start, I'll take a crack at this and then others can certainly jump in. The one thing I would say is based on our – the tools that we have and the quality of our underwriters and our agents, we don't believe we acquire a lot of new business that we regret on day-one. It could occasionally happen, but I would say generally speaking, we feel good about the controls we have and the mix of [inaudible] (36:37 – 36:39).

In terms of how we manage the renewal inventory, we talked to you in the prepared comments generally about our – the way we look at our renewal inventory by bucket, above average, all the way down to low and very low retention buckets. The same would apply. We give you overall numbers in terms of rate retention for those. The same certainly applies when we look at our worker's comp inventory, and because of the relative performance of comp to other lines, our targets are generally a little bit more aggressive on the lower end of our distribution of the policy inventory. So we feel like we're hitting the right areas by segment [indiscernible] (37:15) rate. And I think that's an important consideration.

With regard to the competitive environment, I would say that the comps remain surprisingly competitive. And I think, in particular, in the smaller lower hazard segments of business, we continue to see a fair amount of competitive pressures there. On some of the higher hazard and some of the more challenged segments, maybe a little bit less so. But we are focused on really hitting our rate targets across all of those segments. And on the low and very low buckets, our underwriters hate to position that if they can't get their rate level target on those accounts, they're going to opt for letting it walk. And in many cases, there are homes that are willing to take those accounts. So I hope I answered all the pieces of your question there.

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

Yeah. This is Greg, and [indiscernible] (38:01) I mean, we know we need to get as aggressive as we can on the comp line and that's the area where a lot of our underwriting focus and claim focus is earmarked to [ph] when I get it (38:14). Just – it's a constant refinement of what we do, how we do it. We probably lay out the most complete and comprehensive plan in terms of what we're doing to improve the operations, and we're just aggressively trying to deliver on all fronts of that.

Ron D. Bobman
Analyst, Capital Returns Management LLC
Q

Would you – just to give a little bit of sort of reference, would you – the most attractive cohort, I forgot whether you call it Tier 1 or not, or Tier 5. I think it's the Tier 1, if I remember correctly. Would you give us a little bit of ballpark or figure for the average rate you're getting for that most attractive cohort and the retention and then how, I assume, sort of diametrically oppose the Tier 5 most needy of improvement cohort, you're pushing for a rate or you're getting rate there and what the retention thought – sort of the book ends of your results on rate and retention?

John J. Marchioni
President & Chief Operating Officer, Selective Insurance Group, Inc.
A

Yeah. So just to give you a sense, you got the overall rate level and retention by bucket, at least for the above average and the low and very low in the prepared comments. For comparison purposes, on the comp side, in particular, the above-average buckets – above-average bucket is about 5.5 in terms of rate and retention of about 87%. And on the very low and low buckets, we don't have them together, but let's say, the rate is in between 15% and 19%, and the retentions are in the mid-to-high 60% range. So you'll actually see the balance there a little bit more aggressive on the low and very low buckets, and the retention is lower than we see overall.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

That's exactly what I was sort of looking for. I appreciate it. And again, continued good luck.

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

A

Thank you.

Ron D. Bobman
Analyst, Capital Returns Management LLC

Q

Thanks a lot.

Operator: [Operator Instructions] I'm showing no further questions from the phone lines at this time.

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

All right. Well, thank you for participating in the call this morning. If you have any follow-up items, please contact Jennifer. Thank you.

Operator: That does conclude today's conference. Thank you for participating. You may disconnect at this time.