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PRESENTATION

Operator

Good day, everyone, and welcome to Selective Insurance Group's Third Quarter 2022 Earnings Call. At this time, for opening remarks and introductions, I would like to turn the call over to Senior Vice President, Investor Relations and Treasurer, Rohan Pai.

Rohan Pai - *Selective Insurance Group, Inc. - Senior VP of IR & Treasurer*

Good morning, everyone. We're simulcasting this call on our website, selective.com. The replay is available until December 4. We use 3 measures to discuss our results and business operations. First, we use GAAP financial measures reported in our annual, quarterly and current reports filed with the SEC. Second, we use non-GAAP operating measures, which we believe make it easier for investors to evaluate our insurance business.

Non-GAAP operating income is net income available to common stockholders, excluding the after-tax impact of net realized gains or losses on investments and unrealized gains or losses on equity securities. Non-GAAP operating return on common equity is non-GAAP operating income divided by average common stockholders' equity. Adjusted book value per common share differs from book value per common share by the exclusion of total after-tax unrealized gains and losses on investments included in accumulation -- in accumulated other comprehensive income. And GAAP reconciliations to any referenced non-GAAP financial measures are in our supplemental investor package found on the Investors page of our website.

Third, we make statements and projections about our future performance. These are forward-looking statements under the Private Securities Litigation Reform Act of 1995. They're not guarantees of future performance and are subject to risks and uncertainties. We discuss these risks and uncertainties in detail in our annual, quarterly and current reports filed with the SEC, and we undertake no obligation to update or revise any forward-looking statement.

Now I'll turn the call over to John Marchioni, our Chairperson of the Board, President and Chief Executive Officer, who will be followed by Mark Wilcox, our EVP and Chief Financial Officer. John?

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

Thank you, Rohan. Good morning, and thank you for joining us today. Before getting into the details of our performance for the third quarter and year-to-date, I think it's important to put these results in the proper context. We are operating in a very challenging environment defined by historically high levels of economic inflation, elevated catastrophe losses and capital market volatility. Despite this challenging backdrop, Selective continues to deliver consistently strong top and bottom line results. Through the first 9 months, net premiums written were up 11% and our non-GAAP operating ROE was 11.6%. Based on our updated 2022 guidance, we expect to produce a full year operating ROE of 12%, marking our ninth consecutive year of double-digit ROEs for our shareholders.

While pleased with our overall results, our underlying combined ratio has been under pressure due to higher severities in the property and auto physical damage lines of business. We remain disciplined in addressing this through a combination of pure price and exposure increases. On the flip side, higher inflation is also the impetus for the higher interest rate environment. This has allowed us to pick up significant book yield in our investment portfolio and boost overall returns now and into the future.

Moving on to results in the quarter. Growth in net premiums written of 11% was driven by strong renewal pricing in Standard Commercial Lines and Excess and Surplus Lines, strong retention rates and new business growth in Standard Commercial and Personal Lines and positive exposure change. Our combined ratio was 96.8% in the third quarter and 95.2% for the first 9 months. Catastrophe losses accounted for 4 points during the quarter, which was in line with our expectations and included a $10 million estimate for the ultimate net loss related to Hurricane Ian.

However, non-catastrophe property losses were 3.3 points above our expectations. For the first 9 months of the year, non-cat property losses were 1.8 points above our initial expectations, with approximately 60% of the excess losses attributable to the auto physical damage lines. While we've been highlighting this the past few quarters, this increase primarily relates to economic inflationary pressures.

Across all property lines, current year severities were up approximately 12.5% year-to-date. While frequencies were up slightly in the third quarter, they are generally in line with our expectations for the year-to-date. We continue to be diligent about adjusting building and contents values to reflect these higher repair and replacement costs. Year-to-date renewal premium change was 12% for our commercial property book and 10% for our E&S property and homeowners portfolios.

For the commercial auto physical damage line, loss severities continue to reflect inflationary pressures for factors such as repair parts, used vehicles and labor. Our efforts to address the ongoing profitability challenge in the commercial auto line have centered on price increases, which averaged 8.7% in the third quarter and 8% for the first 9 months of the year.

On the casualty side, we remain confident in our current year loss ratio selections, which included a 5.5% assumed loss trend. In addition, we continue to see favorable casualty emergence from the prior accident years. In the current accident year, reported casualty claim frequencies continue to emerge better than expected and remain below pre-pandemic levels.

Renewal pure price increases for the Commercial Lines segment averaged 5.8% in the third quarter, which was 100 basis points higher than the first quarter and 50 basis points above the second quarter. Our retention rate of 86% remains strong. Exposure growth during the third quarter was 3.8%, and total premium change in our Commercial Lines renewal book was approximately 10%.

We intend to remain disciplined and consistent in seeking price increases that, over time, match our forward loss trend expectations. This long-term approach to obtaining the appropriate price across the market cycle has defined our strategy for the past decade. As we look towards 2023, we expect the commercial lines pricing environment to remain constructive as industry-wide loss trends remain elevated and the reinsurance market continues to firm.

I also want to share a few thoughts on catastrophe losses, which have been well above expectations for the industry over the past 5 years. While Hurricane Ian was not a significant loss event for Selective, this catastrophic loss of life and property reinforced the importance of understanding and managing exposure to large events. Over the past 20 years, our actual catastrophe losses have been below the industry average as measured by points on the combined ratio.

Our catastrophe risk management efforts are centered on being disciplined around modeling catastrophe losses on both expected and extreme event bases, establishing clear guidelines around underwriting coastal properties, aggressively managing our aggregate limits exposed in markets that present the highest exposure and prudently purchasing reinsurance to protect the balance sheet.

Turning to investments. The higher interest rates so far this year have negatively impacted the value of our investment portfolio and reported GAAP book value. However, we have managed the portfolio to take advantage of the higher rates and enhance investment portfolio yield. As of September 30, yield on the fixed income and short-term investment portfolio was approximately 80 basis points higher than at the start of the year. With a 3.4x investments to equity ratio, every 100 basis points of higher return on the investment portfolio translates to over 260 basis points of additional ROE.

We are an underwriting company, first and foremost. We view an increase in investment ROE contribution as an opportunity to exceed our ROE targets, not as an opportunity to forfeit underwriting margins.

I'll close with a few quick business updates. We continue to execute on our major strategic priorities. Our commercial lines geographic expansion plans discussed on recent calls remain well on track. Geographic expansion is a lower-risk way of leveraging our skills and infrastructure to grow the business in lines that we understand well. In October, we began writing new commercial lines business in Alabama and Idaho. We have previously opened Vermont in the second quarter. We will continue to open additional states over the next few years.

While our personal lines results were again marked by catastrophe losses, we continue to make solid progress in migrating our business towards the mass affluent market. Our new business growth in this segment largely reflects the ongoing migration. Heading into 2023, we expect to obtain additional rate and exposure changes to further offset higher loss severities. Filed rate increases in the third quarter averaged 6%.

Our E&S business remains a strong contributor to our financial results. It is a segment that continues to offer attractive business flow opportunities and margins. Although we are seeing heightened competition for casualty-driven classes such as construction, we are well positioned to deliver our continued growth in this segment. However, we will not do so at the expense of profitability.

As I look to the remainder of the year and into 2023, we are well positioned to navigate this challenging environment and continue to produce the strong and consistent results we have delivered over the past several years.

With that, I will turn the call over to Mark.

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Thank you, John, and good morning. I will review our consolidated results for the quarter and for the first 9 months of the year, and we'll discuss our operating performance and financial position. I will then finish with our updated guidance for 2022.

For the third quarter, we reported net income available to common stockholders per diluted share of $0.66, a non-GAAP operating EPS of $0.99. Despite a high level of attritional non-cat property losses and a small loss from our allocation to alternative investments this quarter, we reported an annualized non-GAAP operating ROE of 10.5%. Based on our full year guidance, we are positioned to deliver solid results for the year with a 12% operating ROE, which is above our 11% target. Given a higher expected cost of capital going into 2023, we expect to increase our operating ROE target for next year.

Turning to our consolidated underwriting results. We reported 11% growth in net premiums written for the quarter and year-to-date, driven by strong growth in each of our segments. We reported a consolidated combined ratio of 96.8% for the third quarter, down from 98.6% in the year ago period. The combined ratio included $34 million of catastrophe losses, or 4 points, and $16 million of net favorable prior year casualty reserve development, accounting for 1.9 points. We booked $10 million in ultimate net losses for Hurricane Ian related primarily to losses for the second landfall in South Carolina as we do not have a meaningful property exposure in the state of Florida.

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In addition, we reported $1.9 million in estimated claims handling fees from Hurricane Ian from our participation with FEMA's National Flood Insurance Program. On an underlying basis or excluding catastrophes and prior year casualty reserve development, the third quarter combined ratio was 94.7%. This was 4.3 percentage points higher than the year ago period, driven principally by higher non-cat property losses.

For the third quarter, non-cat property losses accounted for 19.6 points on the combined ratio, which was 3.5 points higher than in the year ago period. The higher losses were primarily due to elevated auto physical damage and commercial property severities and were driven by the economic inflationary factors that John mentioned. We also experienced a somewhat higher level of frequency to the third quarter compared to the first half of the year. As a reminder, attritional property losses do experience a level of volatility from period to period.

Also impacting the underlying combined ratio in the quarter was the recognition of $9.3 million of ceded earned casualty reinstatement premium related to development on 3 losses for the 2018 and 2020 treaty years. While these losses are fully reinsured under our casualty treaty, the reinstatement premium added approximately 0.8 points to the consolidated combined ratio this quarter. We've otherwise stayed on our casualty loss picks for the 2022 accident year.

For the first 9 months, we reported a 95.2% combined ratio or 93.1% on an underlying basis. Catastrophe losses accounted for 4 points on the 9-month combined ratio, which is better than expected for this year-to-date period. The non-cat property loss ratio of 18.3% is running about 1.8 points above expectations year-to-date. This is the principal reason why our underlying combined ratio is projected to be higher than expected in 2022.

Moving to expenses. Our expense ratio was 32.6% for the third quarter, which was in line with the prior year period. For the first 9 months, the expense ratio of 32.4% was also in line with our expectations for the year. While we are focused on further reducing our expense ratio, the impact of economic inflation and the potential for higher reinsurance costs may collectively put some upward pressure on our expense ratio in 2023. Corporate expenses, which are principally comprised of holding company costs and long-term stock compensation, totaled $5.5 million in the quarter compared to $4.3 million in the year ago period.

Turning to our segments. Standard Commercial Lines net premiums written increased 11% in the quarter, driven by renewal pure price increases averaging 5.8%, excellent retention of 86%, new business growth of 5% and exposure growth of approximately 3.8%. The Commercial Lines combined ratio was 96.8% for the quarter and included 2.6 points of catastrophe losses and $16 million or 2.3 points of net favorable prior year casualty reserve development. The favorable prior year casualty reserve development was driven by $20 million from workers compensation for accident year 2019 and prior; $8 million from the business owner's policy line also for accident years 2019 and prior; and $3 million from bonds for accident year 2020.

These reserve releases were offset in part by $15 million of net prior year unfavorable reserve development in the commercial auto line driven by higher severities with $11 million attributable to the 2021 accident year. While frequencies continue to remain below expectations for the 2021 year, we now expect higher ultimate severities in this line and took action in the quarter.

Commercial Lines underlying combined ratio was elevated to 96.5% for the quarter. The 5.1 percentage point increase from the year ago period was principally driven by 4.2 percentage points of higher non-cat property losses. In addition, the ceded casualty earned reinstatement premium added 0.9 points to the combined ratio and elevated our current accident year loss ratios for the general liability and workers compensation lines, in particular. Commercial auto physical damage severities, which we highlighted last quarter, remained at elevated levels, and non-cat commercial property losses were also higher than expected for the quarter.

In our personal lines segment, net premiums written increased 11% relative to the prior year period. Renewal pure price increases averaged 0.5%, retention was up from a year ago at 85%, and new business growth was strong. These metrics reflect the successful execution of our mass affluent strategy as much of the growth was within our target market. The combined ratio, however, was elevated at 101.8% as a result of 14.9 points of catastrophe losses. The underlying combined ratio of 86.9% was 1.6 points lower than the prior year period.

In our E&S segment, net premiums written grew 9% relative to a year ago. Renewal pure price increases averaged 6.7%, retention remained strong and new business was up 8%. The combined ratio for the segment was a profitable 93% in the quarter and included 5.4 points of net catastrophe losses. The underlying combined ratio of 87.6% was 3.1 points higher than in the prior year period, driven mainly by higher non-cat property losses.

Moving to investments. Our portfolio remains well positioned. As of quarter end, 92% of our portfolio was invested in fixed income and short-term investments, with an average credit rating of AA-, and an effective duration of 4.2 years, offering us a high degree of liquidity. Risk assets represented 10.3% of our portfolio at quarter end, down 60 basis points in the quarter as we continue to derisk against a more uncertain macroeconomic backdrop.

For the quarter, after-tax net investment income of $51.5 million was down relative to $74.7 million in the year ago period, driven by alternatives. Alternative investments, which are reported on a 1-quarter lag, generated $4.4 million of after-tax losses compared to a $34 million after-tax gain a year ago. Year-to-date, we've generated $18 million of after-tax gains from our alternative investments. Our current best estimate is for approximately $7 million in after-tax income from alternatives for the full year, implying an $11 million after-tax loss from alts in the fourth quarter, principally reflecting the negative third quarter performance of public markets.

As a reminder, while we provide our best estimate of alternative investment income for the full year, there is a high degree of imprecision in estimating alternative investment income in any given period. The after-tax yield on the total portfolio was 2.7% for the quarter, which translated to 8.9 points of ROE contribution. While generating underwriting income remains our primary focus, we continue to manage the investment portfolio to optimize our risk-adjusted investment yields in what is an attractive fixed income market.

We invested approximately $2.3 billion of new money in fixed income securities during the first 9 months of the year. As we put this new money to work, we've taken the opportunity to move up in credit quality, improve liquidity and increase our book yield. The average pretax new money yield for the quarter was up meaningfully to 5.1% relative to 2.2% in the year ago period and came in well above the pretax yield of our portfolio.

In addition, approximately 14% of our fixed income portfolio remains invested in floating-rate securities. And these securities are resetting at higher benchmark rates, helping increase book yield and investment income. Since year-end, we've increased the pretax book yield of our fixed income and short-term investments portfolio by approximately 82 basis points, which includes approximately 36 basis points from the third quarter.

About half of this increase year-to-date has come from our floating rate exposure. We expect another uplift in book yield from fourth quarter floating rate resets. In addition, we expect to put an additional $300 million to work in the fixed income purchases in the fourth quarter from organic cash flows from maturities, coupons and operating cash flow.

After-tax net investment income, excluding alternatives, which principally reflects our allocation to fixed income securities, was up 37% in the quarter compared to the prior year period and is up 19% year-to-date as these higher reinvestment rates are starting to benefit our results. This will accelerate as we look ahead to next year. While the current investment market is helping drive significantly higher investment income from our fixed income investments, this environment has negatively impacted the total return of the portfolio. The investment portfolio and total return was negative 2.6% in the quarter and negative 8.8% for the first 9 months of the year.

Turning to capital. Our capital position remains strong with $2.4 billion of GAAP equity as of September 30. Despite statutory capital and surplus remaining at year-end levels, on a GAAP basis, book value per share was down 7% in the quarter and is down 20% for the first 9 months of the year, driven mainly by after-tax unrealized losses within fixed income. Adjusted book value per share increased 1% in the quarter and is up 10% for the trailing 12 months after adjusting for dividends.

Our holding company cash and liquidity position remains strong with $506 million of cash and investments, which is well in excess of our longer-term target. Our net premiums written to surplus ratio stands at 1.45x, which is in the middle of our target range of 1.35 to 1.55x. Our debt to capital ratio of 13 point -- excuse me, 17.2% is also conservative. Overall, despite the unrealized mark-to-market investment losses, we remain in a strong capital and liquidity position, which is available to support our growth.

For the first 9 months of the year, we repurchased 165,000 shares of our common stock at an average price of $75.20 per share for a total of $12.4 million. As of September 30, we had $84.2 million of remaining capacity under our share repurchase program, which we plan to continue using opportunistically. In addition, our Board of Directors approved a 7% increase in our quarterly cash dividend on common stock to $0.30 per common share.

I'll conclude with an update on our guidance. We currently expect a GAAP combined ratio this year, excluding catastrophe losses, of 91.5%, inclusive of net favorable casualty reserve development in the first 9 months of the year. Our guidance assumes no additional prior accident year casualty reserve development. Our catastrophe loss assumption assumes 3.5 points on the combined ratio. That puts our full year expected combined ratio expectations at 95% for 2022, which is consistent with our guidance at the start of the year.

The component parts, however, have changed with the benefit of lower-than-expected catastrophe losses, a better-than-expected expense ratio and favorable casualty reserve development being offset by higher-than-expected non-cat property losses. Our after-tax net investment income assumption of $215 million remains unchanged from last quarter as lower after-tax investment income from alternative investments of $7 million is offset by higher investment income from fixed income. As a reminder, we started the year with an expectation of $200 million of after-tax net investment income, including $20 million from alternatives.

An overall effective tax rate of approximately 20.5%, which includes an effective tax rate of 19.5% for net investment income and 21% for all other items, and weighted average shares of 61 million on a diluted basis, which assumes no additional share repurchases we made -- we may make under our authorization.

Overall, a solid first 9 months of the year and our updated guidance implies a non-GAAP operating ROE of around 12% for the year. This would be a solid result against the macroeconomic backdrop this year -- that this year has presented and another year of elevated catastrophe loss activity for the industry. As we look ahead to 2023, we remain well positioned to continue delivering strong, disciplined, and profitable growth.

With that, I'll ask the operator to open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question is coming from the line of Michael Phillips of Morgan Stanley.

Michael Wayne Phillips - *Morgan Stanley, Research Division - Equity Analyst*

I guess I want to focus on your commercial pricing is up sequentially. I'm trying to get a sense of how much of that is, property versus casualty. As I compare, John, your comments on the casualty loss trend, you're still assuming 5.5%. So I kind of want to focus on the casualty side of that for a second. I'm assuming that the property rates are moving up pretty hard in reflection to the inflation. So I assume that's a pretty easy fix over next year. I want to see how much cushion there is in the current price on the casualty side as we think about your 91.5% this year and what that might look like next year.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

Yes. Sure, Mike. Thanks for the question. And I think there's a lot of pieces in answering that question so I'll try to work through them. Just at the highest level, that the 5.8% in the quarter for Commercial Lines pricing, the comp -- workers comp continues to be a negative impact on that. So workers comp pricing continues to be relatively flat. So excluding comp, the overall pricing is at 6.6% on a quarter - for the quarter, 6.1% year-to-date.

Commercial property is at 7.5%. Now I think that's an area that we expect to see go higher as we move into next year. And like you've heard from many of our competitors, when you think about the inflationary impacts on loss trends and the inflationary exposure adjustments for commercial property, in particular, the blending of rate and exposure were up about 12% this year. So again, we'll think about it in those terms.

But I think it's important to recognize that while the exposure increase provides a loss ratio offset, I won't call it a benefit but it sort of neutralizes the impact of some of this inflation, it shouldn't be mistaken for replacing the needed rate in that line of business for us and the industry. So yes, you want to look at them together in terms of the changes in severity but rate continues to be a need for that line of business. So that's kind of how we think about it overall.

And as I said earlier, we see, when you look at our retention and as strong as our retention continues to be, that the market remains constructive and will remain constructive. But I think the other part of your point, and I just want to clarify that the 5.5% loss trend that you cited, which we've also cited, is the casualty loss trend embedded in our '22 loss picks. We are always evaluating a view of forward loss trend and we'll continue to do that, and we'll provide you that along with our updated guidance as we get into the beginning of 2023.

But I would say if you look at this on a casualty versus property basis, and I think that's the best way to look at it for a company like Selective, about 2/3 of our premium are in casualty lines. And if you deconstruct that 5.5% loss trend we have assumed in our 2022 casualty loss picks and exclude comp because comp continues to exhibit very different loss trends and more favorable loss trends, that embedded loss trend in our casualty lines, ex comp, is a little over 6%. And our price for those casualty lines, excluding comp, is a little over 6%. So I think when you look at that, you view that as a relative offset for casualty.

The remaining 1/3 of our premium is in property lines, and that's a combination of true property and auto physical damage. That's where you look at the combination of rate and exposure in that 10% to 12% range, 12% for commercial and around 10% for E&S property and for home. And our actual severities, and I hesitate to call this a trend, actual severities on the property lines are up about 12.5% for the year-to-date period. Because economic inflation is the primary driver of that, I think that's what creates the forward uncertainty, but you would expect it to track relatively closely with forward economic inflation on the component parts of the CPI that hit the property lines. I'm not sure I hit all the pieces of the question.

Michael Wayne Phillips - *Morgan Stanley, Research Division - Equity Analyst*

Yes, I think you did. I appreciate it. And then I'll switch over to investments. You've done some work there to kind of reorganize the book and take advantage of the yields. It sounds like you're not done from what Mark was saying. I guess I'm going to kind of reconfirm that there's -- you're still putting new money into the higher rates and maybe it sounds like a positive for -- even more of a positive for where yields can be -- your earned yields could be for next year.

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Mike, this is Mark here. That's exactly right. I would say it's been a very constructive environment for fixed income investing this year. We've put new money to work in much higher reinvestment rates than we've seen in quite some time. And as I mentioned in my prepared comments, we've been able to increase the embedded book yield within our fixed income and short-term investment portfolio. We've taken it up from 2.97% to 3.79% in just the first 3 quarters and we expect to see that to continue.

We have cash flow we can put to work. We can opportunistically, with a few constraints, trade the portfolio. And we continue to have the allocation to the front end of the curve with our funding rate exposure. And we've seen LIBOR, SOFR, whichever benchmark you want to use, increase significantly, and that's increased significantly since quarter end as well. So we're going to continue to optimize our risk-adjusted returns in the investment portfolio. And I think that's going to continue to deliver a higher level of core fixed income, investment income over the next number of periods.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

And I guess just to reinforce the point Mark explained well how we think about investment -- investing and our philosophy around investing. That increase in investment ROE we view as positive. And in the near term, it does serve as a bit of an offset to the property commentary we just had around underwriting margin pressures. But our focus remains on improving that underlying combined ratio and addressing those inflationary pressures in the property line. So this is a great offset, and we'll continue to balance them to give us additional upside from an overall operating ROE perspective, but we expect to continue to boost underwriting margins going forward.

Operator

We have the next question from the line of Paul Newsome of Piper Sandler.

Paul Newsome - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

I want to return to kind of the thinking about how we should think about the prospective margin expansion prospectively. I was hoping you can sort of critique my basic thinking. About 10% of the business, I think, is in workers comp, and I may or may have a view on margin contraction or expansion there.

It sounds like if I take workers' comp out, about 2/3 of your business is in liability insurance, and it looks like rate is about matching the ratio, as we speak. And then the issue seems to be the other roughly 1/3 -- 1/4 of the business that's property where you may or may not be exceeding rate. But I guess, do I have the math there right? And is the issue really about, in a sense, whether or not I think that 12% inflation on property will continue and my own opinion about what happens with the margins in workers comp? Is that a fair way to look at it?

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

Paul, it is a fair way to look at it. I think the way you split the book up is right in terms of the property, the casualty split and with and without comp. And I think, to your point, you've got an assumption relative to comp margins going forward and that is what it is. But I think that's exactly right.

The pressure we've seen in our underlying combined ratio this year is entirely driven by non-cat property losses, and that those non-cat property losses, in our estimation, are not an underwriting concern. There's nothing in our portfolio that's dramatically shifted. It's purely a severity being pushed higher by the cost of repairing and replacing property, be it commercial property, personal property or auto physical damage. And the direction of that alongside of the direction of rate plus exposure on those property lines is where you ought to think about margin impact on a go-forward basis.

Paul Newsome - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

So is there anything, in your opinion, that might change what would happen with property inflation that -- other than just a macro view on what's going on with property inflation, with respect to book or with respect to industry?

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

I think for our book -- and I can't speak for others, for our book, this is not about replacing parts of the portfolio because there's some underwriting concern in the portfolio. This is about pricing and making sure our exposure is accurate. Now I will tell you, this exposure dynamic is not a new concept for us. We've always reviewed individually and the entire portfolio to make sure our insurance to value was strong, and it always has been strong. So that's got to be a focus.

But I do think the other important point here, and again, for us, this goes back to good risk selection, good pricing and good exposure management is, while there's a lot of focus on for the industry on catastrophe exposure from hurricane, we have seen as an industry and as a company an increased frequency of severity of severe convective storm activity across the country. And I think this is something we've always focused on.

We look at a line-by-line risk-adjusted combined ratio target. And when you think about it in those terms, your risk-adjusted target combined ratio for the property lines for everybody needs to be in the mid-80s. And the market is not currently pricing the property line to the mid-80s, and that has to happen. And I think that's -- this is not just about keeping up with inflation. This is -- these are lines of business that need additional underwriting margin improvement that may still largely be achieved through pricing.

Paul Newsome - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

That makes sense. So I guess the way to sort of boil this down to, if I think about your underwriting performance next year, it's going to be about what I think is happening with both inflation on property in general, plus this issue of convective storms and essentially risk rising to property, whether in the business itself. Is that a way to summarize it?

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

I think that's the right way to think about it. Again, I don't want to get too far out in front of our own guidance for next year, but the dynamic -- the marketplace dynamic and the Selective dynamics on casualty and property are different dynamics. And I think they're important to understand and think about separately.

Operator

We have the next question from the line of Meyer Shields of KBW.

Meyer Shields - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

So I want to follow up on the last question, if I can. When you talk about risk selection, are the ideal risks in an inflationary environment the same as the ideal risks in a less inflationary environment? Does that change the standards for risk selection?

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

I don't -- it shouldn't because again, I think you always want to pride yourself on getting your exposure correct. And as long as you're doing that, your inflationary environment should not be a factor in terms of risk selection. And that's an interesting question and I'm sort of thinking about how I answer it as I'm answering it. But I don't -- nothing jumps out at me as to why we think about that differently.

As long as you have a good organizational discipline about getting accurate exposures upfront -- and again, premium is rate times exposure, so you need both to be right on a consistent basis. And as long as you understand where your rate level needs to be based on underwriting characteristics, age of building, damageability, roof age, roof type, all of the occupancy protection, all of those things, they can be considered in your underlying rate. But if you have that right and you get your exposure right, it shouldn't be an inflation up or inflation down difference in risk selection.

Meyer Shields - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay. No, that's helpful. I was thinking more on the casualty question. Thinking is the wrong word, but I was curious as to whether in the area of -- in a time, I'm sorry, of elevated social inflation, whether targets look different than they might have in the past. But I completely understand what you're saying.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

Yes. Now social inflation, though, Meyer, just to follow up on it, social inflation is a little bit different, and I think that's where you do want to be very focused on your hazard mix across your casualty lines of business. And again, for us, our hazard mix remains fairly stable, and it allows our actuaries more stability when they look at frequency and severity trends, both of which could be influenced by social inflation.

But again, it's about getting those underlying fundamentals right and then it shouldn't make a difference. I think the bigger question is, if you see a shift in your casualty portfolio, that presents a different frequency and severity pattern because your hazard mix has shifted. That's a different answer, but our portfolio has been quite stable from a mix perspective.

Meyer Shields - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Right. No, perfect. And that would certainly help with the credibility, which is, I think, critical at this point. And then a more production question for Mark. Can I just get cat losses by product line for the quarter?

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Sure. So the cat losses for the quarter, if the focus is Standard Commercial Lines, let me start there in commercial auto, $1.4 million; in commercial property, $13.3 million; in BOP, $3.4 million. With a little rounding, that should add up to the $18.2 million that's in the financial supplement. Did you need the year-to-date or any of the other segments or does that...

Meyer Shields - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

No, I'll take -- if I can just -- I mean, I assume the assessment's all for property but can you do personal lines mix?

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Yes. So for Personal Lines, it's about $1 million in personal auto; $10.3 million in homeowners so that's $11.3 million; and then in E&S, $4.6 million in property; and the combination of all 3 should add up to the $34.1 million for the quarter.

Meyer Shields - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay. Perfect. And then looking forward, with regard to floating rate securities, I was hoping you could update us on the plans for either expanding or contracting that portion of the portfolio.

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Yes. So that's an excellent question, Meyer. From our perspective, we look at the overall portfolio and all the key risk metrics in terms of credit quality, liquidity, book yield, et cetera. And as I mentioned in my prepared comments, we have taken the opportunity to strengthen the overall investment portfolio. We did increase the average credit rating in the portfolio back to AA- on the back of the purchases, the $2.3 million in purchases we put to work here today.

We still have a pretty significant allocation to the front end of the curve. It allows us to barbell the entire curve and go a little bit longer. At the long end, we have that short-term allocations. And we see still a little bit more room to run in terms of LIBOR or SOFR with the set expectations in terms of hiking. Some of that's already built in, but I think there's a little bit more room to grow there.

But I think one of the things we're thinking about is not to get caught with that reversing on us. And so our expectation is -- and with all investment decisions, the markets change daily so things can change as you move from period to period. But at this point, I think our plan would be to take that floating rate exposure down at some point over the next quarter or 2, being mindful of duration. The yield curve is pretty flat. We don't want to extend duration too much.

Some of that floating rate exposure is to AAA and AA rated securities. With a potential recession next year, we'd like to be up in quality. So we need to be mindful of credit quality as well and making sure there's liquidity in the market to execute the sale of some of that floating rate exposure. But if you put it all together, I think expectations are to ride it for a little bit longer and then perhaps take that floating rate exposure down over the next quarter or 2.

Operator

We have the next question from the line of Grace Carter of Bank of America.

Grace Helen Carter - *BofA Securities, Research Division - Research Analyst*

Looking at the attritional loss ratio in Personal Lines, it doesn't seem to have moved around quite a bit over the past few quarters, which we've seen, at a lot of peers, some pretty substantial, sequential deterioration. I was just wondering if you could help us think through what might be shielding your book from some of the volatility that we've seen. Appears so far that has to do with the transition towards mass affluent and just kind of how we should think about that trending from here in light of inflationary pressures.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

Yes. Grace, thank you for the question. I don't know that I could point to anything specific other than what you've already pointed to, which is our book has been transitioning meaningfully from the mass market to the affluent market. And that does present a different pattern from a loss trend perspective that we anticipate and plan for. But I don't want to suggest that there is an absolute change in frequency and severity that's already evident in our portfolio.

We like the business we're writing. We constructed a rate plan specifically targeted for that segment of the marketplace. And again, I think the other important point is we didn't cut prices in the middle of the pandemic like many of our peers did. So our starting point was a little bit different. We opted to do premium credits that we thought were appropriate but didn't change our underlying base rate structure.

This is not to suggest we don't think rate needs to go higher. And as I mentioned in my prepared remarks, our filed impact of the rate changes we're taking in both auto and home are going higher. But I do think it's a little harder to compare our results because we're in the middle of this meaningful transition of the book of business.

Grace Helen Carter - *BofA Securities, Research Division - Research Analyst*

And I guess, in light of widespread expectations for substantial increases in property reinsurance pricing, and I would think, given lower exposure to cat-prone regions in your books, that you would probably compare pretty favorably versus peers when trying to renew things at a reasonable price. But if you could just kind of help us think through how you're thinking about upcoming reinsurance renewals.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

So we've agreed, and we appreciate your comment that reinsurers should view our program as very attractive on a relative basis. But I'll hand it over to Mark to let him talk a little bit about what they're seeing in the market.

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Yes. Good question, Grace. So I won't repeat all of the industry information that's out there on the state of the reinsurance market. But at the highest level, there's clearly a need for primaries in the U.S. to buy more on the back of exposure growth that we've seen this year. We expect to see next year and clearly, a little bit of a lack of perhaps capacity, given results, lack of retro and then other factors and alternative investment markets.

But I think you summed it up nicely for us. Reinsurance is a core part of our capital management program. It's important we have a well-placed, well-structured reinsurance program across our property pro-risk, casualty XOL and then property cat to manage volatility and solvency.

And we trade with highly-rated reinsurance partners. We have a -- really an extensive panel of reinsurers, whether that's in London with THE Lloyd's syndicates, whether that's in Europe, whether that's in Bermuda or the U.S. And we take a really long-term view and a partnership approach to managing our reinsurance relationships.

And one of the things that I think is a little bit differentiated about Selective is the exposure management around property cat, and John mentioned that in the prepared comments. We have been running a property cat or a cat loss ratio on the overall combined almost 2 points below the industry as a whole. And when you think about the last 6 years, going back to 2017, all the loss activity that's happened, whether that's in Florida, whether that's in Texas, whether that's in California, having a book of business that's well managed from an aggregation perspective but outside of those peak perils, I think, differentiates us against our peer group from a reinsurance marketing perspective.

But as we look ahead to 1/1, our cat treaty does renew on 1/1, we look to place that. It has been very clean. It generated very strong profits for the reinsurers. But it's also well priced from a buyer's perspective, and we'll continue to look to get the reinsurance purchases that we need to protect the balance sheet, to reduce the earnings volatility and get that at a reasonable price. But we do recognize that there is a market dynamic that's happening. And suffice to say, I think as a whole, but as we all know, reinsurance prices are likely to rise at 1/1 through property cat.

Operator

We have the next question from the line of Matt Carletti of JMP.

Matthew John Carletti - *JMP Securities LLC, Research Division - MD & Equity Research Analyst*

I just had a follow-up on Grace's question related to Personal Lines. Can you help us a little bit with -- I know you've said kind of pure pricing is, I think in the quarter, you have kind of 0.5% increase, and you spoke a little bit about kind of pushing for more. Could you talk a bit about inflation guard features or other exposure type features that might be particularly in some of the home policies? And if you're getting kind of exposure increases there that act like rate and to what magnitude that might be helping things?

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

Yes, Matt, sure. And I want to just make sure we're clear on this. This -- we need to increase rate in our home book, and we're filing to start to increase rates in our home book. But to your question, as an offset to the inflationary impacts we're seeing, an exposure increase does serve to mitigate that. And I know oftentimes, people use the term acting like rate, I think you want to be clear on what that means. We view it as a loss ratio neutralizer, not a loss ratio benefit. So it addresses the trend that you're seeing.

Our actual exposure change year-to-date on the home book is 10%, roughly 10%. And we've got a very disciplined process. We rely on a third party that updates replacement costs and repair costs on a regular basis. Those feed right into our automated renewal process. And while there's a month or so lag in any updates to that, that automatically flows through the renewal portfolio. So yes, pricing needs to move and will move in our home book, but we're still getting the exposure -- the automated exposure increase, and it's running around 10%.

Operator

We have the next question from the line of Mike Zaremski of BMA (sic) [BMO].

Michael Zaremski

On the FEMA flood fees, Mark, I think you said it was $2 million. Is that -- do you expect more to come in the coming quarters? And should we still think that the majority of that hits the bottom line?

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Yes. Good question, Mike. It was, yes, $1.9 million that we booked in the quarter. The event did happen right before quarter end. Our objective in booking that fee estimate is to think about the ultimate fees that we expect to collect based on an expectation of frequency and severity for the floods that happened, principally in southwest Florida but other parts of Florida and the Carolinas as well. So that $1.9 million reflects our ultimate estimate, so we would not expect that to have more fee income on a go-forward basis. But I will highlight that the event did happen right at quarter end. There was quite a few estimates to come up with ultimate claim frequency and severity and coming up at $1.9 million. But I wouldn't expect that to move materially on a go-forward basis.

Michael Zaremski

Okay. Got it. And so did most of that kind of make it to the bottom line into core income, like how it used to in terms of the margin on that?

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Yes. Yes, that's exactly right. So that is fully owned as we reported. It effectively shows up in the Personal Lines segment in other, and it's a reduction of the loss and loss adjustment expenses. So it's a little bit of a benefit on the loss ratio within Personal Lines in the quarter. But that's how that shows up, when it's fully earned.

Michael Zaremski

Okay, great. And switching to the expense ratio. I believe -- I will read the transcript. You talked about inflation and higher reinsurance costs kind of changing your outlook on the expense ratio. Maybe you can unpack those, especially the economic inflation element. Is that wages or just a mix of a lot of things?

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Yes. Thanks, Mike. You did pick up on that correctly. If I take a step back for a second, I think we've been on a journey to improve the overall operational efficiency of Selective over the last 5 years. And we've taken just over 3 points off the expense ratio, which is has been meaningful, and we continue to expect to drive operational efficiency and expense ratio down over time.

This year, as you might recall, embedded in our guidance was an expectation of a 32.5% expense ratio, and we expect to come in a little bit better than expected for the full year, which is embedded in our updated full year guidance. We had expected to take somewhere close to the 32%, which is our longer-term target for 2022. And we hope and expect to keep that going into next year.

What we're highlighting is when you think about the potential for higher reinsurance costs, it will come out with the guidance as we deliver the fourth quarter results next year. But when you think about the potential for higher reinsurance costs, we don't know exactly what that is today. But also some pressures from economic inflation coming through on wages and other line items.

And then also, we've enjoyed -- I shouldn't say enjoy, we've had a little bit of a benefit in 2022 on the expense ratio in terms of having a slightly higher level of attrition than we've seen in the past. But we do expect labor markets to cool off a little bit and that to come back to us and therefore, have the right headcount within the organization.

And you put all those factors together, we just wanted to highlight that compared to our prior expectations, we are expecting perhaps a little bit of drift up in the expense ratio going into next year than we thought perhaps a quarter or 2 ago. So a little bit disappointed on that. We continue to look for expense ratio improvement over time, but I think we're going to face some headwinds going into 2023.

Michael Zaremski

Okay, that's helpful. And maybe lastly, in terms of the great color you guys provide on loss cost trends, you talk about casualty claim frequencies have been emerging better than you all expected but -- and also below pre-pandemic levels. Are you willing to or able to kind of unpack by broader casualty lines? Is that coming more so workers comp or is it also commercial auto and general liability? Any color there would be great.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

Yes. I think it's been -- I would say it's fairly consistent across the casualty lines. It's -- we're seeing a fairly similar dynamic. There's noise when you break it down that far so I won't go into individual lines. But as a general rule, if you look at on levels frequencies adjusting for the impact of rate change, they're all behaving relative to expectations, and they're all down a little bit relative to what we saw pre-pandemic.

Michael Zaremski

Got it. And maybe lastly, sticking to loss costs. And just because I feel like you guys have done a much better job in commercial auto than the industry. But not to be negative, but most of the context you provided is that the higher than expected has come from the physical damage side.

And just want to make sure you're not seeing a creep up in the nonphysical damage severity because I feel like that's -- that was one of the issues the industry was having during kind of the last hiccups for the industry and you guys, to a lesser extent, in commercial auto. Or maybe I'm wrong, and it was also an issue back then, too.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

Yes. No, I think your question is a good one and an important one that I'm actually glad you're asking and hope you're asking of others. Severities in auto liability have been going higher the last few years for us and for the industry. You've seen some fair amount of commentary around that. And we embedded that assumed higher severity in our '22 loss picks for the auto liability line. But again, you've got to think of everything on an on-level basis. And for us, generating north of 8 points, actually 8.7 points in the quarter on commercial auto liability or commercial auto total, excuse me, is part of a response to that continued severity pressure on the auto liability line.

So I don't want you to think that the liability that severity hasn't been moving higher. It has, but we reflect that in our loss picks, and it was reflected in our '22 loss pick, that higher severity persisting, and that's in our casualty reported numbers that you're seeing come through. I can't speak to whether others are assuming that severity to continue or not. But I can tell you that's our philosophy. It's part of our prudent and consistent planning process. And that's why we continue to achieve higher rate level in commercial auto and expect to continue to do that going forward.

Michael Zaremski

And do you feel the industry is pricing commercial auto at adequate levels? Or is competition, especially given the lull in frequency, has that kind of heightened competitiveness there? I swear -- promise, that's my final question.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

Yes. So I think the industry is pricing conservatively. It's not an aggressive market, let me put it that way, for commercial auto. But I think we're talking about keeping up with higher severity trends with the current rate levels. The bottom line is there's more work to be done because the starting point for commercial auto industry-wide was still a reasonable amount above a risk-adjusted combined ratio target. So it's not irrational. It's certainly favorable, and I think in line with the severity trends that we're seeing, as it for the industry, but it still needs more improvement, which would suggest higher rate is needed.

Operator

We have the last question from the line of Jamie Inglis of Philo Smith.

James Inglis - *Philo Smith & Co. - MD and Partner*

Could you give me a sense of where the -- your Personal Lines growth is coming from? Are you just gaining market share or is it a particular geography that you're getting business? Or is it a type of competitor that you're getting business from?

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

Yes. The growth, and we pointed to this the last couple of quarters, is driven by the strategic shift we made to compete in the mass affluent market. That's driving it. It's in our existing footprint that we've had for Personal Lines, and that's really where the growth is coming from. It's really sort of deemphasizing the mass market personal auto and pursuing a segment of the market that we think places higher value on coverage and service and is a much better alignment with our business philosophy and our operating model.

James Inglis - *Philo Smith & Co. - MD and Partner*

Right. I understand that. But there are others that are in that business. Who -- where are you getting that business from? Who's giving that business up, I guess?

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

So I guess there are others in every business segment that we compete in and we compete successfully against. And we've got an organizational reputation for offering really good products, really good underwriting and pricing discipline and really good service. And we've got very deep agency relationships as a result of that foundational organizational strategy. And that benefits us in the personal lines affluent market, no different than it benefits us in the commercial construction market and the commercial manufacturing market and the E&S market.

James Inglis - *Philo Smith & Co. - MD and Partner*

Okay. And I wanted to swing to something. I think, John, you mentioned that your invested assets per dollar of equity is 3.40, which is up sort of, I would say, noticeably from the end of last year. I assume that's not a measure you manage to. It's just a result of how you run your business. Is that true?

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Yes. This is Mark. That's exactly right. The leverage ratio for invested assets to common equities is outcome, not a metric that you really have a lot of control over. It is obviously a function of growth in invested assets, which is a function of cash flow and valuation changes and then also earnings in the denominator and how much you retain versus how much stock you buy back and other capital management activities like dividends, et cetera.

So I think what you've seen with that ratio increasing over the last couple of quarters to the 3.38 at 9/30 is the fact that investment valuations are down, that's impacted GAAP equity and with the leverage of 3:1, it has more of an impact on the ratio because the denominator is going down pretty significantly and increases the overall invested asset leverage. But not -- unless you have significant capital management transactions, including issuing debt, et cetera, it's difficult to move that ratio around and manage to it. In the short run, it really is an outcome.

Operator

At this time, speakers, there are no questions on queue. You may proceed.

John Joseph Marchioni - *Selective Insurance Group, Inc. - CEO, President & Chairman*

Great. Well, thank you all for joining us. And as always, feel free to reach out to Rohan with any follow-ups. And we look forward to speaking with you again.

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Thank you.

Operator

And that concludes today's conference. Thank you so much, everyone, for joining. You may now disconnect, and have a great day.