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Conference Call Transcript

SAFC - Q1 2006 Safeco Corp. Earnings Conference Call

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CORPORATE PARTICIPANTS

Neal Fuller
Safeco - Vice President - Finance and Treasurer

Paula Reynolds
Safeco - President and CEO

Mike LaRocco
Safeco – President and COO

Chuck Horne
Safeco - Controller and Principal Accounting Officer

Mike Hughes
Safeco - SVP, Business Insurance

CONFERENCE CALL PARTICIPANTS

Matthew Heimermann
JPMorgan - Analyst

Gary Ransom
Fox-Pitt Kelton - Analyst

Josh Smith
TIAA-CREF - Analyst

Charlie Gates
Credit Suisse - Analyst

Ron Frank
Citigroup - Analyst

Tom Purcell
Viking Global - Analyst

Jay Gelb
Lehman Brothers - Analyst

J.F. Tremblay
HSBC - Analyst

PRESENTATION

Neal Fuller - *Safeco - Vice President - Finance and Treasurer*

Good morning, everyone and welcome to our conference call on our first-quarter earnings. Copies of our financial supplement, news release and access to our 10-Q filing, which we filed today, and we may refer to on the call, are available on our website at www.safeco.com/ir. We are broadcasting this call live on the same website and we will have a transcript posted later this week.

With us on the call this morning are Paula Reynolds, President and CEO, Mike LaRocco, President and Chief Operating Officer, and Chuck Horne, Controller and Principal Accounting Officer. We also have several members of our leadership team here for our question and answer session. We will start the call with a discussion of our results and our goals for 2006. And then we'll open it up for your questions. We expect the call to last approximately one hour.

During the call today, forward-looking information, including our plans, projections, objectives and future operations may be discussed. Actual results may differ materially from the forward-looking statements made during the call today. For a discussion of risk factors that may cause our results to vary, please refer to our most recent annual report on Form 10-K. We may also discuss various non- GAAP measures during our call today. Please refer to our press release, our 8-K filing or our website for the most directly comparable GAAP measure, together with a reconciliation between the two.

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It was another great quarter at Safeco, with record operating earnings and record earnings per share. Now to discuss our results more fully, I will turn the call over to Paula Reynolds.

Paula?

Paula Reynolds - ***Safeco - President and CEO***

Thank you, Neal. Good morning, everybody. I will quickly go through the consolidated results, then Chuck Horne will review the investments and capital with you. Then, Mike LaRocco will take you deeper into our business segment results for the quarter. I will then come back, discuss our plans for 2006, progress we're making and we will take your questions and then you can be on to the next call.

So here's a brief review of the consolidated results. First, net income in the quarter was $208 million, which I think we can conclude is a very solid result. Operating earnings, which exclude realized gains on investments were $198 million for the quarter, or $1.61 per share, compared with $190 million, or $1.48 per share in the year ago quarter.

Our operating ROE was 20% for the first quarter annualized, which is consistent with the returns earned in the first quarter of last year, and up from the 17% ROE we earned for all of 2005. Our P&C combined ratio was 86.9% in the quarter, compared to 88.5% a year ago. We reported very solid underwriting results in each of our major lines, Auto, Property, and Small Commercial. You'll hear more from Mike on each business segment. Overall, top line growth continued to be under pressure in the first quarter, with net written premium down 1.2% from the first quarter of 2005. I don't think this comes as an any surprise. It is consistent with the trend of declining growth over the past several quarters. Notwithstanding our discipline, it's not really where we want to be. So, we'll have more to say about what we're doing to combat this trend when we talk about the goals.

So, Chuck, I'm going to turn it over to you.

Chuck Horne - ***Safeco - Controller and Principal Accounting Officer***

Thank you, Paula. During the first quarter, we repurchased $5.2 million, or 4.2%, of our outstanding shares at an average price of $51.97 per share and a total cost of $270 million. This included 4.7 million shares repurchased for $244.5 million under the Rule 10b5-1 trading plan we announced back in February, 2006, and another 478,000 shares repurchased outside that plan.

On April 3rd, we completed the 10b5-1 program, leaving us 4.7 million shares authorized for repurchase under board-approved programs. We also repurchased $15 million of debt in February, buying some of 8.072%, 2037 debentures for $16.4 million.

Our actions in the first quarter are consistent with an aggressive, but disciplined program of capital management here at Safeco. You'll recall that we repurchased 4.5 million shares in the second half of last year.

Turning to investment income, our property and casualty pretax investment income was $117 million, up 3.5% from the same period in 2005. On an after-tax basis, P&C investment income for the quarter was $88 million, or 6.1% higher than for the same quarter last year. Over the course of the past 12 months, we've shifted the mix of our investment portfolio to include more tax-exempt municipal bonds, which represented 31.7% of the portfolio at March 31, 2006, up from 21.6% a year ago.

Cash flows from P&C operations in the first quarter $3 million, down from $147 million in the first quarter of last year. This is the result of higher payments for losses, including losses from the 2005 hurricanes, underwriting expenses and income taxes, and lower premiums received. You'll recall that for Safeco, the first quarter is typically the lowest cash flow quarter of the year. Net realized investment gains, after-tax were $10 million for the quarter, compared with $22 million in the year-ago quarter. Our book value per share was $33.57 at the end of the quarter, compared with $33.38 on December 31st. Our pre-FAS 115 book value, which excludes unrealized gains on bonds was $33.22, compared with $32.52 at year end. This is an increase of 2.2% from year end, and a 10% increase from the same time a year ago-even with our share buybacks, both in the quarter and during last year.

And with that, I'll pass it to Mike LaRocco to discuss our operating results.

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Mike LaRocco - *Safeco – President and COO*

Thanks, Chuck, and good morning, everybody. Let me begin with the overall combined ratio. Paula noted we had a very strong result of 86.9% for the first quarter, versus 88.5% in the first quarter of 2005.

The combined ratio in the first quarter included 2.5 points from catastrophe losses. This was primarily the March tornados that swept through the Midwest, versus 1.7 points of cat losses in the first quarter of 2005. These cat losses matched our planned cat load for the quarter of 2.5 points.

The combined ratio also reflected 2.1 points of prior-year favorable reserve development. The reserve development was primarily in auto, with $20.8 million for accident years for 2004 and prior, due to lower-than-expected bodily injury severity. We also had favorable development in our special accounts facility of $9.5 million.

Let's look at each of the segments, beginning with Auto. The combined ratio for the quarter was 92.2%, compared with a combined ratio of 95.7% in the first quarter of '05. This quarter's ratio included three points of a favorable prior-year reserve development, and 1.2 points of cat losses. We continue to expect that Auto will deliver at or below our targeted combined ratio of 96% for the year.

On the subject of Auto loss cost trends, our paid trends rose just slightly, but we continued to see improvement in our newly reported incurred loss cost trend, as we did in the fourth quarter. In the newly reported, which is a leading indicator of trend, the year-over-year rise in auto severity was lower in the first quarter than in the fourth quarter, which in turn, was lower than in the third quarter of '05. This is extremely good news, as the trend in the first part of 2005 of increasing growth in severity appears, as we suggested last call, to have been reversed.

We continue to see slowing growth in the Auto market, and market conditions are generally consistent with what we saw throughout 2005. It's competitive, in most cases rational, meaning that rate reductions or increases seem to be in line with loss experience, although there are still exceptions. We are starting to see signs of increased discipline from competitors that perhaps haven't been as disciplined in the past, with rate increases in some states, and even policy terms going from things like 12 months to six months.

In addition to rate activity, advertising for auto continues at a fevered pace, so obviously it's a very competitive market. The result for us is that net written premiums for Auto were 3.7% lower in the first quarter, than in the same period a year ago. However, within this statistic, we have net written premium for Preferred Auto down just slightly at 1%, while Standard Auto was down 5% and Nonstandard was down 21%. A similar story in PIF, or policies-in-force, which were down 1.4% from a year ago. But Preferred PIF actually increased 0.4%. Retention at the end of the first quarter was 79.1%, compared to 80.3% from the year-ago quarter, and 79.5% at year-end. This is driven by Nonstandard, again.

As a matter of fact, we have held the retention of preferred customers at 85% over each of the past six quarters, and 78% of our Auto policies in force March 31st were preferred risk, which was up a point from the end of the first quarter '05, while nonstandard risks were 7% of total PIF, which was down a point from a year ago.

This indicates what we believe, which is that our underwriting models enable us to match rate with risk more accurately than our less-sophisticated competitors. This gives us an advantage in the marketplace, as we can offer lower prices to higher-quality risk, and let others insure underprice lower-quality risks. Mistakes in pricing and lack of underwriting discipline is always seen first in the nonstandard world.

During the quarter, we continued to roll-out our updated auto product, which is now in 33 states. This update further increases the sophistication and pricing accuracy of our automated underwriting, and it allows us to base our vehicle liability rates on a by-vehicle basis.

In 2006, we are looking to attract new auto customers from things like the continued rollout of our Auto product that I just mentioned. That will be in another six states in the second quarter of '06. Again, this enhanced version of our underwriting model will help us attract new business as we are able again, to match risks more accurately with price. Another step is that we are continuing to add products to our Safeco Now platform.

We added Motorcycle to the platform in '05, and this helped broaden our relationships with agents. In 2006 we are going to roll-out our Umbrella product. Our motorcycle growth has been double-digit since we put it on our Safeco Now platform. We are also continuing appointment of new agents, especially in geographic areas where we are under-represented. Through careful analysis, we have identified the specific agents we want to have and in the process of putting them - giving them appointments with Safeco.

We have already appointed 287 new Personal Lines agents through April, and our national sales team is working with them to make sure they are up and quoting policies on Safeco Now. We have plans to add more agents, so we expect these new agents to start generating sales in the second half of the year. Now let's talk about Property.

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Our Property products continue to perform very well. The combined ratio for Property in the first quarter was 79.3%, including 10.1 points for cats. In the year-ago quarter, the combined ratio was 75.4%, including 8.6 points for cats. We continue to expect that Property will deliver at or below our targeted combined ratio, 92% for the year.

During the first quarter of 2006, our Property loss cost increased by a mid-single digit percentage, mainly due to frequency. This followed three years of flat-to-declining loss costs, and having our frequency at historic lows.

We're also seeing competition heat up in the Property Lines, and our net written premiums were down 2.4% from the same quarter in '05. Our ending PIF was down slightly from a year ago. As you know, we began the non-renewal of approximately 30,000 Florida policies in 2006. We expect this to offset growth from new business in other states. Half of our states, though, did have a positive PIF in the first quarter, both year-over-year and sequentially. Our new business policies declined in the quarter, down 1.1%, following several quarters of robust growth.

Our multi-variate segmented model in Home continues to offer us opportunity to compete effectively in the highest tiers of risk quality, and the accuracy of our automated underwriting model, including our discipline of fully pricing in cat loads on a state-by-state basis, means we'll be less competitive for lower quality risks. Adding our landlord protection insurance to the Safeco Now platform makes it easier for agents to write that product as well, which has been in high demand, and we are posting strong growth in that product line.

Now let me talk about Commercial Lines. Let's begin with what we call our SBI Regular. It's the segment focused on small-and mid-sized business, and is our largest component within Commercial Lines. SBI Regular posted an excellent combined ratio of 87.7% in the first quarter, including 2.5 points for cat losses. The combined ratio for SBI Regular in the year-ago quarter was 84.6%, including 0.7 points for cats. Loss costs were flat, with frequency decreases offset by mid-to single-digit severity increases.

We expect loss costs to move up as frequency flattens out. Pricing for the quarter was down 2%, which is consistent with the past two quarters. In commercial lines, market conditions remained competitive. The small business segment seems to be competitive but rational, while mid-sized competition is a slightly less rational and certainly more competitive.

Our net written premiums were down 3% for the first quarter of '06, reflecting the market. However, our core modeled lines for small business, BOP, Auto and Workers Comp, were up 4% in PIF, while our other lines were down 5%. PIF was up 2% for small commercial, and down 8% for mid-market lines. Retention was down one point to 79.2%.

So, we continue to see stronger results in terms of growth in our small commercial lines, which have been fully automated since 2003. We expect some improvement in overall growth due to continuing enhancements of our automated products, new points of distribution and additional price flexibility for renewals, given our current profitability. You may recall that we added our package policies, that we call CMP, for premiums up to $20,000 to our automated quote-and-issue platform at the end of 2005. We are very pleased to report that new business policies for CMP were up 3% for the quarter, with February and March being up +11%.

We also added 207 new agents for commercial lines through April. So, profitability across Auto, Property, and Commercial remains very strong. But don't let the lack of top-line growth mislead you into thinking that there's any complacency here at Safeco. We are engaged throughout the organization in making changes to the way we do everything, from our marketing of products, to handling of claims, to our internal tools for managing the business. There is a lot of exciting work going on.

We are revitalizing our own (Best Practices) effort in the Product Management and Sales organization, so that it's easier for our state teams to build their success from what has worked particularly well in other states. Remember, we manage on a by-line, by-state basis.

A great example of this recently was the opportunity to re-launch one of our larger states. Because of product changes in Auto, Home and Commercial Lines all occurring around the same time, our Personal Lines and Commercial Lines product teams worked with Sales, Communications and Marketing to create a broad promotional campaign directed toward agents. The state team initiated a launch meeting statewide, and we attracted more than 1,000 attendees. Agents are very excited about launch, and the growth we have seen since then has been very exciting to us. That type of effort will continue on a by-product, by-state basis. And where we can, we'll leverage multi-products in each of those states.

With that, let me turn it back to Paula.

Paula Reynolds - *Safeco - President and CEO*

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Thanks, Mike. Overall, we hope you will agree that it was a very strong quarter with excellent underwriting profitability, return on equity, growth in book value, and top line growth reflecting market conditions. In other words, it was another "no-surprises" quarter for Safeco. Our commitment to maintaining underwriting discipline is deeply ingrained here at Safeco, and I don't think you have to worry about anything changing there.

However, we are planning to grow this company-profitably. I think that the growth really has to do with refining some of our tactics, and having a sense of urgency about deployment. In other words, we're not going to join an underwriting cycle of reducing prices, but there are a lot of things that we can do correctly in terms of tactics and urgency, that can improve top-line performance.

We've laid out four goals for 2006, which are, I believe, critical to our long-term success, and I need to make it clear that with record levels of profitability and our excellent financial position, we're working to transform Safeco from a position of strength to a long-run of significant success.

So these four goals are both diagnostic for the near-term and very critical as foundational steps for the next several years. I promised you that we would give you mileposts around our progress, and so we will create some benchmarks in each area for you. You can look forward to our call in early August, where we will lay out some of these benchmarks in detail, so that you can track our progress.

Our first goal is to begin to market our products in ways that mirror the diversity of consumers and their buying preferences. What does that mean? That means that we're looking at ways to expand our reach beyond the independent agent channel, but in ways that are consistent in our support for the independent agent channel.

We're already direct from the standpoint that a small percentage of our sales currently come to us directly from consumers on our website, **www.safeco.com**. But frankly, we haven't put much effort into this - and the consumers who have purchased on our site really deserve credit for their perseverance, as our site is a little on the clunky side.

We know that an increasing number of consumers are choosing to shop for and purchase their insurance online, and we simply have to be more consumer-centric. We believe that smart insurers will follow the path laid out by our financial services brethren in banking to serve their customers online, or where and when they want to be served. So we intend to leverage our rather significant store of consumer data, together with our automated underwriting models and easy-to-use application capabilities, to reach out to more consumers.

This is more of a long-term development plan, but we've also identified some areas where we can begin now to penetrate this market with a little bit more clarity. One thing is very clear here: you can be sure that Safeco will not be launching a several-hundred-million-dollar advertising campaign driving traffic to call centers.

To be effective, we're going to have to be very focused in our marketing to specific groups of consumers, which we will do at far lower channel cost, through targeted online advertising and targeted direct mail. So, this is more of a threading-of-the-needle strategy than a big, bold, advertise that we're "cheaper," and drive people to the phones.

What's most important about our plans to expand distribution are: first, direct sales are not expected to be a significant driver in the near-term, and independent agents will clearly generate the vast majority of our sales for the foreseeable future. But we recognize that more and more consumers are choosing to purchase insurance online and we're working to figure out how to best capture our share of that business.

Our second goal is to make meaningful progress to becoming a low-cost carrier. I mentioned this in the last quarter, and I think we've made some rather remarkable progress since we talked to you in late January, about how we are going to get our expenses down to levels that match or beat those of our high-performing peers. First of all, we've engaged in an enterprise-wide business process improvement analysis. Terri Dalenta, whom many of you met at the November analyst meeting or have heard on the phone, in conjunction with a lot of our reserve work, heading up this incredible effort. She and a small team of our most talented individuals in the company are looking to identify opportunities for streamlining the major business processes throughout Safeco. Everything is on the table, and so I expect to share with you the timeline and cost savings, and any restructuring charges, on future calls. But we're already taking action in many areas.

One example: This quarter, we announced a change in our real estate strategy. We currently have 78 physical locations across the United States, and we decided that we didn't need to be in the business of owning and managing real estate, especially with land values so high, and commercial space, we think, relatively weak in a number of areas. And leasing office space frees up capital that gives us greater flexibility.

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So, for example, in the Puget Sound area, we've cancelled our plans to consolidate employees in a single expanded headquarters that we would have built ourselves. Instead, we'll be leasing offices, and we're not going to be leasing as much space as we plan to build out, because we'll structure more virtual offices with employees working from remote locations. This shift in our real estate strategy for the Puget Sound region offers us annual savings roughly in the $12 million range.

Next, there's a world of possibilities for doing things smarter and at lower cost within this industry at Safeco. And I've been asked the question of, well, didn't Mike McGavick when he was CEO do a reduction in cost? And the answer is, yes, he did, but in the meantime we grew our policy accounts, we grew a lot of our infrastructure for that higher policy count, and as we flattened out our growth, we haven't turned around and redialed expenses, and so there is a lot of opportunity here to reduce expense levels.

On the Business Process Improvement front, we have conducted extensive due diligence work, investigating various outsourcing options for some of our non-core functions. We've also identified Business Process Improvement metrics that can keep us focused on our progress towards becoming a low-cost provider. This was sort of a twinkle in my eye in January. The fact that we have this team together, that we've done the real estate strategy, that we've been offshore looking at outsourcing options, that we've been onshore, looking at outsourcing options, and that we've run these what we call whiteboarding exercises on the 'to-be' state of Safeco, which is a greatly streamlined version of the 78 places that we do business today - I think that that really is remarkable progress.

As I said, we're still in the process of setting the longer-term objectives, and we're not going to give you a number today, but here's how we're thinking about it: we want to be the number one or number two provider in each of our agents' offices, which means that we're going to put processes in place that continually improve our operating efficiencies over time. So, as I said, we'll have some BPI metrics for you that we're going to be tracking against which we'll talk about next quarter, along with updates on the planned savings and the restructuring charges.

Our third goal is to build our infrastructure and technical capability, to capitalize on the opportunities to be more consumer-facing while lowering our cost structure very considerably. We're going to continue to invest in the business and the technology that supports it. I am really excited to have Bill Jenks newly onboard to lead our IT transformation. Bill comes to us with many years of experience in the industry with very high-volume customer transactions.

Bill is here in the room with us, if you have questions that you want him to field, but I think the way in which our key folks have already embraced Bill in just a couple of weeks, is really quite noteworthy. His first priority is an end-to-end study of our IT architecture, to help us prioritize our IT projects and building the future of the company. He keeps his eye on the ball every day around continuous operations and high quality.

I'm convinced that we can, and must use technology and BPI to bring down our expense ratios to levels that enhance our future ability to compete, while delivering better service, noteworthy service, singular service, to our distributors and customers. It's what I did at AGL Resources, so I know it can be done.

And it's not that I'm a hammer so Safeco must be a nail, I just think that the opportunities here are so ripe to be exploited. We're so fortunate; we're in the backyard of Microsoft, Amazon and others who have innovated in this space, so we have lots of examples that can influence us as we find our own way.

Fourth goal, really the most important at the end of the day, is to continue to deploy our capital to provide meaningful returns to our shareholders for the long run. You've already seen some active capital management in 2006, where we've completed over $270 million in share repurchases during the quarter. We announced an additional action yesterday, which was the sale of SFIS, our forced-placement, lender-based property insurance business. The sale of this business frees up about $75 million of capital.

In 2004 and 2005, this business represented a disproportionate share of our total cat losses. This business didn't fit with our core business strategy because of its specialty nature. So, as a result, we've sold this business to a company that is more keen to make those additional accounts part of its business model.

Throughout the year and beyond, you should expect us to continue to look for opportunities to return excess capital to shareholders, even while we're assessing carefully where to invest in the business. We have a board meeting that starts this afternoon and runs through tomorrow, so you can imagine that that topic will be very much front and center.

And I think you can reasonably expect that whatever we announce in terms of our technology, capital deployment will be supported by business cases where we demand that the IRR of that capital deployment be competitive with what we would do on otherwise repatriating capital.

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So, with that long expose into everything you ever wanted to know about Safeco, we'd like to open it up to your questions.

QUESTION AND ANSWER

Operator

[OPERATOR INSTRUCTIONS]

We go first to Matthew Heimermann with JPMorgan. Please go ahead.

Matthew Heimermann - *JPMorgan - Analyst*

Good morning, a couple quick questions, both related to distribution. First, some of the agent appointments you're talking about making; can you give us all little bit of insight into geographically where these agents are coming from, and a sense of why they are looking to Safeco to be a market. I guess I'm trying to get a sense of what markets aren't serving them, or what markets currently do serve them, and where you fit in the mix of that.

Mike LaRocco - *Safeco – President and COO*

Hi, Matt, this is Mike LaRocco. We are really appointing across the country. A greater percentage of our appointments are probably coming in the areas where you would guess we are less represented. So, if I had to just break out geographically, I would certainly say the Southeastern United States and Mid-Atlantic states are probably going to get a disproportionately larger number of appointments. And as you come west, you will see us adding agents all the way, including right here in Washington, and states like Oregon, but there's going to be significantly less.

So, on a percentage basis, as you go east, particularly southeast and into the Mid-Atlantic states, you'll see that being our main area for appointments.

As far as the interest in Safeco, it's been great, and the main reason is that if you think about it from an agent's perspective, there are really only three national companies that reach out, obviously, across all states and have the suite of products. Where we place Small Commercial, Mid-Market Commercial, Home, Auto, the Special Lines and of course our Surety products, we reach the vast majority of their customers. And so we're matched up from a shelf space standpoint.

Secondly, more and more agents are distributing in a number of different states or locations, so we have the national reach, and by having a national size, we have a more stable relationship with them. Third, and I think perhaps most important, is service, and ease of doing business.

We offer our agents one single platform. Nobody else does this on a national basis. So, when they sell Safeco products, they're doing it off of one platform, whether it's auto, home, umbrella, small commercial, BOPs or whatever - and that is very, very attractive to our partners, wrapped around what we believe is the best claims service in the industry.

Mike Hughes - *Safeco - SVP, Business Insurance*

This is Mike Hughes on the commercial side. I just want to add to what Mike LaRocco just said. We have recently come out with a new product, our quote-and-issue on CMP, which is really a small to mid-market product, and it’s getting tremendous interest from our agents, which we feel very good about. We've appointed 207 new agents this year, thus far.

Matthew Heimermann - *JPMorgan - Analyst*

Now, can you give just a little bit of insight on the comment on fitting the agencies. Is the mix of business that these new agencies have similar to your existing business mix, or is it slanted one way or the other, commercial or personal?

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Mike LaRocco - ***Safeco – President and COO***

It's generally similar. As you write BOPs in commercial auto, those product lines, because of the modeling and the segmentation that we do, and the fact that it's on a similar platform, is giving agents that may have traditionally been a little bit more personal lines oriented a lot more comfort as they reach into the commercial lines side.

So when I suggest to you that they look generally like our agents that we've appointed in the past, that's probably fair, but on the agents themselves, they're evolving along with the product development that we're seeing, which is why we're optimistic about the future.

Matthew Heimermann - ***JPMorgan - Analyst***

Thanks. I'll hop back into the queue.

Operator

Gary Ransom, Fox-Pitt Kelton.

Gary Ransom - ***Fox-Pitt Kelton - Analyst***

Good morning. I was wondering if you could give a little more color on the severity trends. You mentioned that the reported trends are more moderate. I don't know if you could quantify that a little bit and maybe give some differentiation of Bodily Injury (BI) and Physical Damage (PD)?

Mike LaRocco - ***Safeco – President and COO***

Yes, Gary, this is Mike. As we've suggested on the last call, we continue to see the newly incurred severities on bodily injury go down on a year-over-year basis and a quarter-to-quarter basis, and the newly reported on an accident year basis is down from about 10% to 8%, and accident year without a lag is about 7%, down from a high of about 9.4%.

So what we're seeing on the bodily injury is the trend going down, and it's not surprising to us, because, again, some of the increase was shift-related. Some of the decrease is stabilization in that, and quite frankly a much more stable book. We wish we were writing more new business, but as you get more seasoned business on your books, and severity is much worse and frequency is higher for new business, as compared to seasoned business.

So, since we have a greater percentage of our business that's more seasoned now, we're getting some benefit from that, as well. From a Property damage standpoint, I'll send it over to Neal.

Neal Fuller - ***Safeco - Vice President - Finance and Treasurer***

Hi, Gary, it's Neal Fuller. Property damage tends to be fairly flat right now. We're seeing newly reported loss cost trends in the low-single digits, and that basically is made up of low-single digit severities with low-single digit declines in frequency.

Gary Ransom - ***Fox-Pitt Kelton - Analyst***

Okay, thank you very much.

Operator

Josh Smith, TIAA-CREF.

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Josh Smith - ***TIAA-CREF - Analyst***

Thanks. I just had a quick question on the tiering. I mean, everyone has their own tiering model. Doesn't it ultimately come down to what tiering product gives you the best loss ratio? Looking at combined ratio, and seeing that several of your large competitors have put up numbers in the mid 80s where you're at 92.7% and I'm just wondering how you reconcile having a better product than at least some of them, which having a much higher combined ratio. I realize it's up a few points versus the expense ratio, but not enough to make up for the gap.

Mike LaRocco - ***Safeco – President and COO***

Hi, Josh. This is Mike again. There's a big difference. All tiers are not created equal, and when companies talk to you about segmenting and tiering, there's a few additional questions that probably need to be asked to really understand the level of sophistication in terms of is it tiering that just goes into the underwriting piece, in other words, in terms of the selection piece, or does it also develop tiering into the pricing of the business once you get it into one of the tiers themselves.

Do companies do multi-variate analysis or is it a univariate analysis? And, really, if you look at the pricing in terms of the ability to change your rates for liability by vehicle and symbol rating, of that and even on physical damage symbols, we're now using our own data as opposed to using industry data, which most of our competitors are using.

The level of sophistication around territory analysis and how segmented folks are - when you apply all of that, and then you look simply at the combined ratios, it can also be misleading. Some of our competitors have been at it longer and, depending on the experience and the percentage of the book, that may be at five years plus or 10 years plus and on an overall basis, could be very misleading versus what are the new customers coming on at and how is that business earning through the book.

For example, with us, as we've moved to the sophisticated models, we capped our rate changes for customers as they converted from our old product to our new one. We're just now coming through the last release of those caps. So we knew going in that we were going to have slightly higher loss ratios and combined ratios based on the capping, but we wanted to protect the customer base as best possible.

We also applied all of our tiers to our entire book. A lot of our competitors are only doing their tiering on new customers as opposed to applying it to in force, so there's a lot of difference out there and we have a lot of confidence in where our models are.

Josh Smith - ***TIAA-CREF - Analyst***

No, I understand the sophistication and all of the metrics that you mentioned, and I understand that in terms of growing your business more, you're going to have a higher loss ratio before the business seasons. But as far as applying that to your entire book, I would think that that would help you, rather than hurt you. But it is your ultimate goal as the book seasons that your combined ratio would be closer to that of your peers, or should it be several points better, given that you have a more sophisticated pricing model?

Mike LaRocco - ***Safeco - President and COO***

What we're doing is pricing our target. So, we don't price to our competition, we price to our target. And our target is a 96% combined ratio for Auto. So, our ultimate goal is to have the level of sophistication and consistency in our pricing that would allow us to meet on a consistent, year-in and year-out basis, that 96%. There can be all kinds of influences that happen to you on a quarterly basis, certainly, but even on a year-over-year basis, that might allow you to be better than that, and we're seeing some of that now because of the frequency trends and some other issues that have worked their way through.

But the real key there is being a consistent pricer. We've seen some of our competitors, as I suggested in my comments, who maybe were very, very competitive and all of a sudden we're seeing high-single digit, low-double digit rate increases get filed. We're seeing our competitors change their policy terms. They're doing silly things like having annual policies in auto insurance and all of a sudden there's a strategic change to six months.

So there's a lot of issues out there that really go to consistent pricing, as well.

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Josh Smith - ***TIAA-CREF - Analyst***

Okay, I guess my only point, and I'll leave it there, is that why go through all the effort of tiering if ultimately somebody who's not doing a great job is able to get such a low - a much lower combined ratio without going through all the hoops.

Paula Reynolds - ***Safeco - President and CEO***

Well, let me just jump in here, because you can't look at a quarter or six months in order to determine whether the investment in modeling - I mean, step back, Josh, and think about it. It's not like you do your analysis without the benefit of models to be predictive around company performance. So it would be inconsistent for us to be looking at the risks of 3 million people and just continue to try to do it on a manual basis without the benefit of models.

And so at the same time, to Mike's point around seasoning, it takes a while to see in that book, that consistency. And I think if you look at our performance from early model time to now, versus you see much more consistency, and you see us not jerking the rates up and down all the time, but making very fine-tuned changes. So, I think that's just the sort of commonsense logic ought to prevail here as you look at our business results; that the investment in modeling has been highly beneficial to the company's consistency of earnings growth.

Josh Smith - ***TIAA-CREF - Analyst***

Okay, thanks a lot.

Operator

Charlie Gates, Credit Suisse.

Charlie Gates - ***Credit Suisse First Boston - Analyst***

I guess it was Mike who was comparing Safeco's national platform to the two other companies, and I assumed basically that he was making reference to the Travelers and the Hartford. I think you were making a point, which I missed, frankly, about how your platform could be distinguished with those platforms.

Mike LaRocco - ***Safeco - President and COO***

Charlie, there's a couple of things. One, I think there's only three national P&C writers in the independent agent chanel, which I think is an advantage for all three of us, including the other two, which is terrific. We believe that the uniqueness of our Safeco Now platform is very real, from the standpoint that the underlying architecture and the system that runs Safeco Now can be applied across all of our product lines.

We don't play in some of the very large spaces that some of our competitors do. We're not international. We are focused on small commercial home and auto. So when you apply our products on one single platform, our agents can learn that platform and sell all of our product lines. That's the point I was making.

Charlie Gates - ***Credit Suisse First Boston - Analyst***

I guess the only other question, and maybe I misheard you. Did you opine that the industry's problems with personal auto have historically had their genesis or beginning with nonstandard, or individual company's problems? I'm not sure that's completely true.

Mike LaRocco - ***Safeco - President and COO***

No, I'm not saying that at all. What I'm saying is nonstandard, as a matter of fact having grown up in nonstandard, I think it's always been the most profitable segment of our business, and I'm a big fan of nonstandard auto insurance. What I said specifically is, nonstandard auto always is

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the leading indicator of trends in our business, and you typically see your severity and frequency activity on the nonstandard lines, prior to seeing it in the other lines of business.

Charlie Gates - *Credit Suisse First Boston - Analyst*

Thank you.

Mike LaRocco - *Safeco - President and COO*

You bet.

Operator

Ron Frank, Citigroup.

Ron Frank - *Citigroup - Analyst*

Mike, I want to try and make sure I understand the significance of when you talk to us about growth on the automated platform versus total growth. Isn't there some degree of cannibalization of your nonautomated product or your nonautomated policies in force by the automated platform, that would naturally create a gap between the two, or am I exaggerating that influence?

Mike LaRocco - *Safeco - President and COO*

Yes, I'll start and then ask Mike Hughes to jump in as well. The answer is 'no' because they're not the same product. So, in other words, as we add products to the automated platform, they're no longer - they can't be cannibalized, because they're not in the same place. The best example, which I'll ask Mike Hughes to add to, is our package business. We don't have all of our package business on Safeco now. We have certain classes of businesses that are the ones that we could model appropriately. We'll add more as we go. That's the best way to explain the lack of cannibalization, because those lines go on the platform, other lines remain off.

Mike, you want to add to that?

Mike Hughes - *Safeco - SVP, Business Insurance*

Charlie, we're not competing against the model versus non-model. We're not competing against each other. CMP as an example, we have most of our classes of business modeled up to a $20,000 premium. So for the small and mid-market CMP business, it's quoted through our modeling.

For the larger CMP business, it's quoted traditionally, but you can't go between the two. It's either modeled or not modeled.

Ron Frank - *Citigroup - Analyst*

Okay, and a detailed question, the $9 million of reserve release for lender-placed property insurance, I'm assuming that's the business that's going away?

Mike Hughes - *Safeco - SVP, Business Insurance*

That's correct.

Ron Frank - *Citigroup - Analyst*

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Okay, thanks.

Mike Hughes - ***Safeco - SVP, Business Insurance***

And that was property business 2005 [inaudible].

Ron Frank - ***Citigroup - Analyst***

Okay. Okay, great. Thank you.

Operator

Tom Purcell, Viking Global.

Tom Purcell - ***Viking Global - Analyst***

Hi, just a quick question on the share repurchase. With the announcement you made in February, it looks like you completed most of that in March. Did I read the release correctly? And then you spoke a bit about capital repatriation. In terms of the pace that you showed in the first quarter, can you talk about what that may or may not indicate for the balance of the year? Thanks.

Paula Reynolds - ***Safeco - President and CEO***

Well, we did complete the $270 million of repurchase in Q1 a little bit drifted into early April. We will be talking to our board about capital repatriation tomorrow, and then we'll have more to say about it. But I think it's safe to say that we do have more capital to repatriate, and it's really just a case of pace and vehicles.

Tom Purcell - ***Viking Global - Analyst***

Great. Thanks a lot.

Operator

Gary Ransom, Fox-Pitt Kelton.

Gary Ransom - ***Fox-Pitt Kelton - Analyst***

Yes, I just wanted to follow up again on the comments that you made, Mike, about the competition, some that were perhaps not rational or not disciplined before correcting themselves. Do you think they were seeing losses? Is that what was happening? What was it that made them open their eyes?

Mike LaRocco - ***Safeco - President and COO***

Well, Gary, I'm struggling to make sure I can run this one well enough. I can't figure out what's driving these guys. I assume that the same things that anyone would see, which are early indications of loss cost deterioration versus the rate level. It's really hard for me to know what they're thinking.

Gary Ransom - ***Fox-Pitt Kelton - Analyst***

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Maybe if I were to ask this in a different way; if we look at a lot of the competitors, they have these combined ratios in the high 80s, and everyone's target is something in the mid-90s, and presumably the current combined ratios will move toward that target at some point in time in the future.

How do you think you're going to get there? Will the industry do it to itself like it has done in the past and everyone eventually cuts prices, or will it happen in some other way?

Mike LaRocco - ***Safeco - President and COO***

Well, I'm more confident today than I have been. Again, it's why I'm surprised on the modeling question. While the level of sophisticated modeling may vary, the fact that companies are better understanding how to match rates with risk, gives me more confidence that the cycles we've seen in the past are going to be much softer and indicative more of macroeconomic change. So, I'm confident that the movement back toward the mid-90s, as you suggest, will be much more disciplined.

I think the rate decreases that we're now seeing - we're seeing a lot of minus twos, minus fives in certain states, but you're not seeing across-the-board rate decreases. You're seeing them targeted to the segments that deserve the rate decreases. I think the discipline and the modeling sophistication that is starting to be felt. I think the challenge that you face is that could we get forced back to those numbers, potentially, if there's bad behavior.

I really believe that some of the better writers in the industry are going go to keep their discipline, even if others don't. So I can't speak for the whole industry. I can just guarantee you that we will remain disciplined.

Gary Ransom - ***Fox-Pitt Kelton - Analyst***

So, I guess I can infer that the most likely scenario, if Safeco was going to get there, it would happen gradually, or relatively slowly.

Mike LaRocco - ***Safeco - President and COO***

Fair. That's fair.

Gary Ransom - ***Fox-Pitt Kelton - Analyst***

Thank you.

Operator

Jay Gelb, Lehman Brothers.

Jay Gelb - ***Lehman Brothers - Analyst***

Thank you. First, Paula, I had a question on the expense saving comments you made. I just want to confirm, will you by the second quarter conference call be able to quantify the size of the restructuring charge and the related expense saves?

Paula Reynolds - ***Safeco - President and CEO***

Yes. I think our current plan is to give you the total magnitude of what we think the reduction in expense needs to be. And our goal right now is to get, on a run-rate basis, to a number by the end of 2007. So we'll be able to give visibility to that, and we will be able to give you a range of restructuring charge for both 2006 and 2007, because we think that we'll probably have restructuring charges in both years.

Jay Gelb - ***Lehman Brothers - Analyst***

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Okay, and then separately, do you think the cost of the technology investments running through the P&L will be more than offset by other expense savings?

Paula Reynolds - ***Safeco - President and CEO***

Well, Bill Jenks has been here as short as two weeks now, and he's trying to sort that. It's an interesting thing, Jay. I think perhaps by saying in the first quarter at all that we were going to invest in technology and we wanted to understand what that technology spend was prior to any final decisions on how much capital we would repatriate this year, I think it probably set the bells off for some analysts.

But my current sense, and if Bill wants to chime in here, I'd certainly encourage him to do so, is the fact that whatever the incremental technology spend is, some of it will be obviously offset by the expense savings that we achieved. And, probably, the numbers that we're currently looking at would not seriously affect our plans for capital repatriation. In other words, they'd be kind of noise on the margins, relative to the amount of capital repatriation most people are modeling in right now.

Jay Gelb - ***Lehman Brothers - Analyst***

And then just to clarify, you have expense-saving opportunities over and above technology, right?

Paula Reynolds - ***Safeco - President and CEO***

Oh, absolutely. I mean, this place is rife with opportunities. I walk through here and I'm just so excited that we have such an opportunity to modernize this company, and do so many business processes more efficiently. I think the thing is it's a little bit like going on a diet; you'll hit a couple of plateaus, but then the whole opportunity to be more nimble and light becomes positively intoxicating.

Jay Gelb - ***Lehman Brothers - Analyst***

Okay. And then, separately, on the M&A announcement regarding the financial institution business. How should we think about that strategically? Is this sort of the beginning of your process, or should we expect more things to come?

Paula Reynolds - ***Safeco - President and CEO***

I think that really this one should come as no surprise. It's a business that is sort of buried deep in Safeco with 2% of premiums and not a big contributor at the net income line. So it was an obvious candidate, but sort of buried in the detail.

And because of it being really disproportionately cat prone, it absolutely couldn't be a part of the core business. I think that Mike McGavick did a very nice job of shedding the businesses that we needed to be out of. So, I don't think that you'd see any particular plan around more shedding of business lines. I think the real estate is probably the area where we're going to sort of shove some more stuff out of here.

It's basically around capital deployment and good use of capital, so that's the broad strategy. There is nothing more to it than that.

Jay Gelb - ***Lehman Brothers - Analyst***

Okay, thanks. I'm looking forward to the details.

Paula Reynolds - ***Safeco - President and CEO***

Thanks, Jay.

Neal Fuller - ***Safeco - Vice President - Finance and Treasurer***

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Operator, we've got time for one more question.

Operator

Thank you. Our last question from the site of J.F. Tremblay with HSBC. Please go ahead.

J.F. Tremblay - *HSBC - Analyst*

Good morning. I had a question for Paula. You laid out four specific goals for 2006 and that was very helpful. I'd like to focus on the first two. So, on distribution, can you tell us how much of your direct sales strategy you've shared with agents, and how you intend to manage that conflict? And then, on the second point, your efficiency initiative, the BPI processes are not always welcome by employees. Can you tell us a bit about that? Just to paraphrase your comment on the first major press release, basically, I'm asking you to tell us how you avoid getting hit by the boom as you tack.

Paula Reynolds - *Safeco - President and CEO*

Right, well, obviously one has to try to be agile on the one hand, and thoughtful on the other. Let me talk about distribution first. Mike LaRocco and the team have had a very thoughtful and comprehensive communications plan that they've been deploying with agents, either through conference calls, meetings with agents, communications. We've touched thousands of agents already.

And, not surprisingly, they fall into several camps that we kind of laugh around here and say 9,000 agents, 4,000 or 5,000 opinions. But I think that by and large, the ones who are most commercially aware acknowledge that this is a move that had to be undertaken, and some of them have said, well, what were you waiting for? And there were others who were disappointed, but as a practical matter they don't have an obvious antidote to what the Internet is doing to change the business.

And so as we've continued to have the conversations, we've tried to address those that have a lot of emotional negative response, and showed them a lot of the data that has moved us to it. And, importantly, and I think we said it in our prepared remarks, we want to enter the Internet in ways that support the agent role. One of the things with the demographics, young people are such that they want to go to the Internet and they don't necessarily want an agent. But as you have more assets you want to protect, then you do want to go to an agent, and we want to be able to enable that.

Similarly, in what we do with direct marketing, we want to continue to afford somebody and encourage somebody to go to an agent, if that's their preference, or go to the Internet if not. So you see us, and I think agents understand this, making a lot of effort to create programs and rules of the road that do not prejudice the market against the agents at all, but simply to capture in the channel those people who did not choose to go to an independent agent.

I think Mike talked as well about the relaunch we just did in one state and the meeting we had with 1,000 agents. I think that there is a strategy here that basically says, hey, look, folks, we have been preoccupied over the last several years with a lot of things that have been very internally focused about fixing our business, but we're out of that period. And a lot of our effort in the go-forward is very focused on you, the market, and supporting you better.

So, as we do these relaunches in various states, as we make product changes, modest pricing changes, create better packaging on the advertising and the way the product is presented, that is the way of supporting the agents, and so you'll see a lot of that from us. So that's the thinking on distribution.

With respect to business process improvement, in many ways, it's got the same quality as communicating very honestly, over-communicating, if you will, with employees. And I don't think that there's anybody walking around this place who doesn't believe that, in fact, in order to be the number one or number two carrier in every agent's office, we have to make sure that we keep our expense ratio down. Everybody understands that.

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Now, obviously, when you get down to the granularity of is my job affected by it, is my scope of work affected by it? We have to communicate, and we have to be very fact based. And that's why we've gone to a business process improvement where we do end-to-end business process analysis rather than saying, oh, we're coming through here and we're taking an X percent across-the-board cut.

And so when we say how do I navigate over those shoals? Well, having done this before, the experience is try to avoid at all costs the arbitrary percentage across-the-board cuts you get there and be more thoughtful about the business so that you can look employees straight in the eye and say what you're doing here is what's good or Safeco. And I find that if we do what's good for Safeco and we communicate early, and we allow people to see the plan and begin to plan, take away some of the disgruntled quality that can sometimes happens during these processes, as a practical matter, and we also unleash the power of lots of people in the company who have passion to change and improve the place that have themselves empowered to do so.

So that's kind of my management philosophy, as well as how we're going to attack the problem.

J.F. Tremblay - ***HSBC - Analyst***

Thank you.

Neal Fuller - ***Safeco - Vice President - Finance and Treasurer***

Thank you very much for your time today. I'll be available, and Karin Van Vleet will be available for follow-up questions. This concludes our conference call. Thank you.

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