Q2 2018 Earnings Call

Company Participants

- Charles Brindamour, Chief Executive Officer and Director
- Darren Christopher Godfrey, Senior Vice President of Personal Lines
- Kenneth Anderson, Vice President, Investor Relations and Treasurer
- Louis Marcotte, Senior Vice President and Chief Financial Officer
- Patrick Barbeau, Senior Vice President of Claims

Other Participants

- Brenna Phelan, Analyst
- Christopher Campbell, Analyst
- Doug Young, Analyst
- Geoffrey Kwan, Analyst
- Jaeme Gloyn, Analyst
- Kai Pan, Analyst
- Mario Mendonca, Analyst
- Meny Grauman, Analyst
- Tom MacKinnon, Analyst

Presentation

Operator

Good morning. My name is Sarah, and I will be your conference operator today. At this time, I would like to welcome everyone to the Intact Financial Corp. Second Quarter Results Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer session. (Operator Instructions)

Thank you. I will now turn the conference over to Mr. Ken Anderson, VP, Investor Relations and Treasurer. Please go ahead, sir.

Kenneth Anderson {BIO 16846692 <GO>}

Thank you, Sarah. Good morning everyone and thank you for joining the call today. A link to our live webcast and published information for this call is posted on our website at intactfc.com under the investors tab. As a reminder, the slide presentation contains the disclaimer on forward-looking statements, which also applies to our discussion on this conference call. Joining me here in Montreal today are Charles Brindamour, CEO; Louis Marcotte, CFO; Darren Godfrey, SVP of Personal Lines; Alain Lessard, SVP of Commercial

Lines; and Patrick Barbeau, SVP of Claims. We will begin with prepared remarks followed by Q&A.

With that, I will turn the call over to our CEO, Charles Brindamour.

Charles Brindamour {BIO 7012323 <GO>}

Thanks, Ken. Good morning, everyone. Thanks for joining us today.

Last night, we announced second quarter net operating income of the CAD1.38 per share driven by solid underlying results including improved personal auto performance. OneBeacon also delivered strong results adding approximately CAD0.12 to our net operating income per share and net investment income grew by 28%.

Early in the quarter, however, many of our customers in Central Canada faced the consequences of three severe storms. These CATs impacted net operating income per share by CAD0.75 almost twice the expected level, but as usual our troops across the country work tirelessly to help get customers back on track.

Topline growth as reported was 16% driven primarily by the addition of OneBeacon. And when I look across our entire North American operation, on an organic basis, the portfolio grew by about 2%. We're seeing strong growth in profitable segments on the back of favorable market conditions and in segments where profitability actions are in progress, we saw topline declines as expected, a clear sign that our people across North America are executing quite well.

The overall IFC combined ratio was 96.1%. The Canadian performance at 96.6% reflects improvement in personal auto and strong underlying fundamentals and personal property and commercial business.

Our US operations delivered a solid performance with a combined ratio of 93.8% as we drive towards a sustainable low 90s level. Book value per share grew 15% over the past year. Operating ROE was 12% and we ended the quarter with the total capital margin in excess of CAD1.2 billion.

When we compare ourselves to the industry at the end of the first quarter, we outperformed by 660 basis points on ROE well above our target of 500 basis points. But to be clear, while we exceeded our ROE outperformance target, I'm not happy with 12% ROE and we remain focused on actions to return the ROE to the mid-teens.

Let's look in more detail at our results by line of business starting with Canada. So, as we anticipated, our personal auto portfolio continues to shrink as our rate actions started a full 18 months ahead of the market. We expect that trajectory to reverse in the coming year as the market continues to firm up.

In the meantime, we're seeing bottom line benefits. The combined ratio of 95.6%, improved 2.2 points compared to last year, driven by stronger underlying performance and lower expenses. This was despite 2.3 points of unfavorable prior year development, which was largely isolated to pre reform accident benefits in Ontario.

The underlying current accident year loss ratio declined almost 3 points to below 70%. Excluding pools and the impact from lingering winter weather, we see close to 5 points of improvement year-over-year. Our action plan in risk selection and in claims are delivering results in our view and showing signs of taming inflation. But we have more to do, our actions on all fronts will continue and we expect to reach at mid-90s run rate by the end of the year.

The environment in which we compete continues to tighten with capacity constraints and rates increasing. Industry growth in the first quarter was above 6% and we saw further rate increases across the country in the second quarter.

We've also seen sustained growth in residual markets confirming our view that the market is firming fast. This environment supports our profitability improvement plan and we expect mid-single-digit growth for the industry in the coming year in that segment.

In personal property, premiums grew by 2%, while rates are up, our actions in auto are putting pressure on growth in that line, given many of our customers have a joint home and auto policy. The combined ratio in property for the quarter of 102.7% was disappointing, but includes more than 18 points from CATs.

That said, I'm pleased with the underlying performance where our strategies over time have been fairly successful and proven to be sustainable. Personal property continues to be positioned well for the future. The outlook on property is also favorable as changing weather patterns and elevated catastrophe losses support continued for market conditions. The industry grew north of 5% in the first quarter, and we expect mid-single digit growth over the next 12 months.

Looking at commercial lines in Canada, top line growth was quite strong at 7%. We saw accelerating growth in both commercial P&C at 6%, and commercial auto at 8%. The combined ratio was 92.9% despite close to 7 points from CAT, three times the expected level.

The underlying fundamentals of this business remain strong, and the outlook is trending favorably where we expect mid-single digit growth for the industry in the coming year. Given our loss ratio outperformance in this line is north of 10%. We're uniquely positioned to take advantage of a firming environment with a very strong footing of profitability.

Turning now to results for our US commercial segment, premiums of CAD374 million bolstered IFC's top line growth significantly. On an organic basis, growth was 2%, including low double-digit growth in the segments we're focusing on for expansion.

We saw declines in segments undergoing profitability improvement as we expected. The combined ratio of 93.8% is an improvement of 1.5 points over last quarter and a second sequential improvement since closing. Strong progress has been made on synergies and we will provide more details in his remarks.

We continue to monitor this business very closely as we work towards a sustainable low-90s combined ratio. We're well on track to deliver mid-single-digit run rate accretion to net operating income per share by the end of 2019.

Looking at the US specialty industry outlook, market conditions since the transaction closed and evolved better than anticipated with modest upward pricing trends continuing. Overall, we expect low-to-mid-single-digit industry growth for US specialty over the next 12 months.

Turning to strategy, digital engagement with our customers is an important lever in our customer-driven strategy. In May, we launched the Intact Insurance mobile app across the country together with that belairdirect's app we now have an place in industry-leading platform to connect with our customers like never before.

Ad features include amongst others electronic proof of insurance, document access, claims filing, claims tracking and so on. In the coming weeks, the app will also integrate our latest telematics offer, which is also very popular with our customers. We see mobile users engage with us more than twice as often as users of other digital platforms, but this is meaningful progress and highlights the potential to come from our leadership and digital engagement and customer driven transformation.

So in conclusion, while the weather impacted results, the resilience of our platform was evident in the quarter. Actions to improve performance are paying off and market dynamics continue to evolve in our favor. Commercial lines in Canada are performing well and we're taking advantage as growth momentum takes hold.

In personal auto, there's more work to be done, but our action plan is gaining traction and underlying performance is improving. We're on track to bring the auto combined ratio run rate to the mid-90s by year-end. Profitability in our US franchise is improving nicely towards our low 90s goal and we're moving fast to capture growth opportunities.

IFCs financial position is strong and we're gaining momentum. Our strategies, initiatives and discipline position us well to deliver on our financial objectives to outperform the industry ROE by at least 500 basis points every year and grow our net operating income per share by 10% per year over time.

And with that, I'll turn the call over to our CFO, Louis Marcotte.

Louis Marcotte {BIO 18040440 <GO>}

Thanks Charles, and good morning everyone.

For the second quarter, net operating income of CAD201 million improved 4% over last year despite almost CAD40 million of additional cap losses. The improvement was driven by personal auto results, investment income, and one beacon which contributed CAD21 million of new underwriting income to our quarterly results.

Our balance sheet is strong with over CAD1.2 billion in total capital margin and debt to total capital ratio of 22.5%. Book value per share is up 15% year-over-year and 3% since the end of the first quarter.

Let me provide some additional color on our second quarter results starting with Canada. The combined ratio in personal auto improved 2.2 points over 2017 as we made good progress this quarter.

The overall improvement of 5 points to the underlying current year loss ratio that Charles discussed was driven mainly by a 5% rise in earned rates, combined with the decline in both frequency and severity. While there is more to do, the results demonstrate the effectiveness of our action plan. In terms of new premiums, our written rates are up 5% at the end of Q2.

The personal auto combined ratio run rate is estimated by removing the noise from unusual weather, normalizing for prior year development and pools and adjusting for seasonality. On that basis, we estimate the combined ratio run rate to be approximately around 97% at the end of second quarter, one point better than where we stood at the end of the first quarter on an apples-to-apples basis. We are encouraged by these results but we will maintain our efforts until we have reached our mid-90s run rate on the sustainable basis.

Our Canadian expense ratio remains low and stable at 29.4%. We have been able to diligently manage expenses while reinvesting in brand and technology to support our customer driven strategies. We expect the expense ratio to remain at current levels for the remainder of the year.

Our distribution business is strong and added CAD52 million to operating earnings in the quarter. We still expect to grow this income stream by 10% in 2018 driven by broker network growth and profitability improvements.

Now turning to US commercial. We reported a solid 93.8% combined ratio driven by a healthy underlying current year loss ratio of 56.5%, minimal prior year developments and a respectable 37% expense ratio.

Although there is still more work to be done as we move towards a sustainable low-90s level, our Profit Improvement Plan is proving to be effective so far. We realized almost US$6 million of synergies in Q2 and $10 million year-to-date. We have now reached our $25 million run rate target ahead of schedule. Savings have been realized across IT, Investment Management, shared services and reinsurance costs. Near-term, we expect the expense ratio to remain steady around 37%.

On the claims front, we have already begun to internalize legal work and we expect most of the benefits to materialize towards the back end of our profitability plan. With regards to improving OneBeacon's lines of business, we are seeing good progress on the lines undergoing profitability improvement plans, but the benefits are also back ended in terms of timing. Further development was minimal in the quarter as expected and we still have significant capacity remaining on the adverse development cover which we purchased at closing.

Net investment income increased 28% in Q2 to CAD134 million. Our investment team completed the integration of OneBeacon's investment portfolio faster than anticipated and were able to optimize the structure of the portfolio based on facts and capital considerations across countries.

They also leveraged the transition to accelerate the reinvestment of fixed income securities at higher yields. These changes were made without increasing the risk envelope. We now expect to report slightly north of CAD500 million in net investment income in 2018.

A few words on our balance sheet. We ended the quarter in a strong financial position with a total capital margin in excess of CAD1.2 billion. In Canada our MCT was two 201% and in the US, the RBC regulatory capital stood at 405%. Both well above minimum required levels.

During the quarter, we took advantage of positive market tone and strong investor demand to issue CAD250 million with Reset Preferred Shares with an annual yield of 4.9%. The issue brought preferred shares to 10% of our capital structure consistent with our long-term target. The issuance has minimal impact to net operating income per share plus strengthening our balance sheet and providing additional capital to pursue growth opportunities.

In conclusion, our personal auto profitability plan is showing progress and the underlying performance in our personal property and commercial lines remain solid. OneBeacon is well on its way to meet our profitability targets and establish its position as a leading North American specialty insurer.

Overall I am very pleased with the progress shown at this quarter, but we will continue to work and ensure the sustainability of these results.

With regards to net operating income share growth, we have multiple levers to meet our 10% growth objective. These include improving our personal auto results, the addition of OneBeacon's earnings higher investment income and growing distribution results. In addition, current market conditions are increasingly conducive to organic growth and Personal Lives.

And finally we have a strong balance sheet at our disposal to capture inorganic growth opportunities. I am therefore confident in our ability to meet our growth target over time.

With that, I'll return the call back to Ken.

Kenneth Anderson {BIO 16846692 <GO>}

Thank you, Louis. In order to give everyone a chance to participate in the Q&A, we would ask that you kindly limit yourselves to two questions per person. If there is time at the end you can re-queue for a follow-up. So, Sarah, we are now ready to take questions.

Questions And Answers

Operator

(Operator Instructions) And your first question comes from the line of Geoff Kwan from RBC Capital. Please go ahead.

Q - Geoffrey Kwan {BIO 7413168 <GO>}

Hi, good morning. First question is on personal auto, when I think about and the level of - or how should we think about your level of conviction around that your target of reaching the mid-90s combined ratio by the end of the year like if you were to rank it on a scale of 1 to 10, how do you feel about it today and where would you've been at the start of the year? And then also if I can ask on the year-over-year trend in the DPW or number of insured risks, when do you expect that to start to stabilize and then maybe start to improve?

A - Charles Brindamour {BIO 7012323 <GO>}

So to start with the last part of your question, I'll ask Darren to talk about the marketplace as we see it now, the lag in competitive position and sort of timing you see from a top line point of view. And then give your perspective on convictions, but I'd encourage you not to go into a scaling.

A - Darren Christopher Godfrey {BIO 19791482 <GO>}

Yes. So, thanks, Charles. So, I mean, I think initially as Charles said, definitely the market capacity continues to tighten. So we see right momentum pretty much coast to coast from most players. We see residual markets continuing to grow in fact, Facility Association which is a sign that we look for in the marketplace around capacity, it was well up also in the quarter, markets are tightening eligibility rules et cetera. So, all of this is pointing to a continuation of the hardy market which will support our plan.

Now as far as growth is concerned, clearly when we look at sort of say in the last 24 months, even though the gap between the position that we've taken on rates and what the industry has taken is declining that gap is declining. The industry still is a fair way behind, but we are at sort of in an activity in the last 24 months.

So, when you look at the industry results, combined ratio as well in excess of 100% supported by favorable PYD, clearly there's this further inadequacy within the marketplace. So we expect further rate increases to come from the industry. Now that does take some time obviously, there's filing processes to go through. So, while that process continues from approval standpoint, we expect to see that, that firming up, we'll very much continue very much in the near-term.

I think from an intact growth standpoint, you're right there, Jeff, in terms of, we continue to be challenged from a short-term standpoint. I think in the near-term as that gap on rate shrinks we'll still see some of that pressure.

However, I would suggest though the growth opportunities will become available in the near-term which we will be very cautious in terms of how we assess those opportunities as we move forward on our profitability action plan. But from an action plan standpoint, we're continuing to drive rate increases. We're continuing to drive risk selection segmentation.

So, coupled with that with the market conditions we believe we're well placed from a profitability standpoint with a growth opportunity still I would say a little bit in a few more quarters still to come.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. I think that is a good summary. You know over a year ahead of the industry on rates and I think that, that will take time to peer in and it's to regulate that line of business, so I suspect that trajectory will change but not at the same speed as you see it in other lines of business and we're quite fine with that.

With regards to our conviction, when I look at the actions that were taking place, I -- my conviction is the execution on that is north of nine and the reason why I say that is because we've done more than what we said we do and I think, if sitting here in Q2 with 5% rate increases return and 5%-ish earning, I think that there is momentum there and there's a lot of work done on risk selection and in that way, and team and claims are gaining traction as well with their claims action plan.

So when I look at the execution, I'm pleased with what I see in me. People are focused and they know that this is all hands on that. I think the -- we're seeing, we're on track to hit the mid-90s run rate by year end, it is the - fairly a long tail line of business. There is risk around trend and that's why I'm not going to give you an overall score, but on track is how I would summarize where we are at this stage.

Q - Geoffrey Kwan {BIO 7413168 <GO>}

Okay. And just quickly my second question. I think you recently increased your investment in Metromile. And maybe thinking about that part of your business, not just Metromile, but some of your other investments. Are there any key learnings that, that is observed over the last sort of bit and how that may apply to your existing businesses, whether or not in Canada or even in the US?

A - Charles Brindamour {BIO 7012323 <GO>}

We have the number of investments in our venture portfolio that are centered. Is your question about personal automobile or just learning in general lot of the --?

Q - Geoffrey Kwan {BIO 7413168 <GO>}

We do learnings -- I know mostly investments are in the personal auto side so maybe focus a little bit more on that I guess?

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. Well, I think that the ventures are centered around data and AI, they're centered around new forms of distribution and mobility to a certain extent. And as you know, when we look at the very long-term future of personal automobile, we have said that what matters here is us leading in data emission out of vehicle and telematics, us leading in sharing which is also part of our venture strategy and keeping an eye on what's happening on the autonomous front of thing leading into commercial automobile as well as ownership of the car pool ships.

Q - Geoffrey Kwan {BIO 7413168 <GO>}

Okay, thank you.

Operator

Your next question comes from the line of Kai Pan from Morgan Stanley. Please go ahead.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you. Good morning. And I hope you guys have a collective sigh of relief. So my first question is on the personal auto, which is follow-up. And I wanted to elevate that because you mentioned the underlying seasonally adjusted 97%. If you start with 95.6% reported, you take out the 2.3 points unfavorable and then you take up the 2 points of these one-off items, which imply you need to sort of seasonal adjust almost 7 points. I just wonder is that correct or not? And also can you give a little bit guidance to see what seasonal adjustments for the third quarter and the fourth quarter as well?

A - Charles Brindamour {BIO 7012323 <GO>}

So I guess on the seasonality part, we would move it roughly between 25 points here and it's not a precise calculation, we go back into history, short and long-term. So it's a fairly wide range of seasonality. We would use probably 3 to 5 points of seasonality to measure and come up with our 97%, I would say, Q2 is the --

A - Louis Marcotte {BIO 18040440 <GO>}

97 would be at the upper end of the seasonality range.

A - Charles Brindamour {BIO 7012323 <GO>}

Absolutely, yeah. And Q2 is also the one that has the most favorable seasonality impact. So in providing the run rates, I think it's a fair measure to compare with where we were at Q1. And I would say the expectations on other quarters is a bit less drastic than it has been in Q2. So we don't -- we have not published exactly the seasonality for line of business, but they would be certainly less important than the one we've used in Q2, which is the most significant seasonal difference.

Q - Kai Pan {BIO 18669701 <GO>}

Okay, great. And then my second question on catastrophe losses because of last three years, you've been pretty adequate it. So I just wonder will you be able to update the 275 annual guidance or more importantly, how do you pricing in, or in recent selection these seems to elevated level of catastrophe losses?

A - Patrick Barbeau {BIO 18476397 <GO>}

Yeah. We regularly update our projected cats for many reasons for pricing as you point out, but also to reflect in those projections the learnings we get from every new event. This 275 million was updated last November.

And you look at the averages over the 5 years, 10 years, 15 years and when you use that as - if I focus on 5 years and 10 years averages over the past you need to factor in the fact that at least two of the events during that period I'm referring to the forest fires at Fort Mac and some of the floods in 2013 and repeat periods that longer than those 5 years and 10 years and you need to move those out.

But when you do so that's how we came to a range that was around 275 million at the end of 2017. We will continue to update that on a regular basis. But at this point nothing points out to a different number with the recent experience even if it was somewhat more elevated than that in the first half of the year, this is a short period of time to adjust that.

A - Louis Marcotte {BIO 18040440 <GO>}

Yeah. And from a pricing standpoint as Patrick alluded to internally we did a lot of work in terms of what is our expected level of CATs. We incorporate that very much into our pricing strategy, but also in turn in terms of our product design as well too. So I mean, I think that as weather evolves and if we feel as if that is a shift in weather and so forth, we will obviously clearly look at both price and product. We're not there yet today clearly, in terms of our expected levels to increase from a CAT standpoint. What I would say though from thickening particularly from a personal property standpoint, yeah, even though we do see elevated levels of CAT in Q2, this is a product that continues to be well sustainable. We continue to see strong results from an online standpoint. Even though Q2, even though '17 was elevated. 2017 itself turned out to be still another strong year as well too. So our view in terms of sustainability of that particular product has not changed at all given what we've seen in the quarter and we are well placed from a personal property standpoint.

A - Charles Brindamour {BIO 7012323 <GO>}

And if I come back to your first question, Kai, in terms of the impact of seasonality. You look at the combined ratio in Q2 at 95.6 to neutralize it, or CATs or pools or PYD you get to a combined ratio of about 91.5 to 92, okay. And then Louis, talks about the seasonality range of 3% to 5%, we sort of go at the upper end of the range you go from 92 to 97. So that's sort of how we're thinking about it and giving you a sense for where we think we are and the fact that we are on track to hit the mid '90s clearly given where we are now by the end of the year.

Q - Kai Pan {BIO 18669701 <GO>}

So, if frequency severity remains favorable there is a possibility you could overshot to the 95% target by year-end?

A - Charles Brindamour {BIO 7012323 <GO>}

You know, where if I sum up, where I think we are, I'd say on track.

Q - Kai Pan {BIO 18669701 <GO>}

Okay, great. Good luck.

A - Charles Brindamour {BIO 7012323 <GO>}

Thanks.

Operator

Your next question comes from the line of Tom MacKinnon from BMO Capital. Please go ahead.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Yeah. Just two quick questions. One with respect to in personal property I know in the quarter, you talked about an increase in large fire losses, that certainly has been something that is in the news of late. So maybe you can talk about some of the large fire losses that are happening this summer. And what you see as impacting your results, if any for the third quarter, and I have a follow-up?

A - Charles Brindamour {BIO 7012323 <GO>}

Yes, Tom, let me ask Patrick, who is keeping an eye on these things to give you his perspective.

A - Patrick Barbeau {BIO 18476397 <GO>}

Yeah. So maybe the first thing to clarify is the fire losses we are referring to for Q2 are single fires, not really related to the forest fires that we have seen in the news, so that our two different thing. There has been -- whether has been good and dry which created more forest fires overall in Canada.

So far this year more than a thousand have been active at different point in times. Most of them are quickly put under control. Right now, there's about 30 of those fires that are said to be not fully under control. Only two of them are representing potential threat to living you know surrounding communities, one in Northern Ontario and one in Central B.C.

But they're still quite far from the communities. We're monitoring all of them on the -- on a daily basis. And -- but no imminent threats from the existing forest fires at the moment.

Q - Tom MacKinnon {BIO 2430137 <GO>}

And of that, I think your guidance for CAT losses, is that still in the 275 million annually, is that --?

A - Patrick Barbeau {BIO 18476397 <GO>}

Yes.

Q - Tom MacKinnon {BIO 2430137 <GO>}

And you expect half of those generally to be in the third quarter, is that right?

A - Patrick Barbeau {BIO 18476397 <GO>}

Yeah, we haven't really changed that.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Given you know that we had higher than expected CAT losses in the first quarter and in the second quarter. Do you think is it necessary to revisit this 275 number. I mean, (Multiple Speakers)

A - Patrick Barbeau {BIO 18476397 <GO>}

Yeah. So we talk about this every quarter, but the reality is we've updated it in November, re-updating it within the year given that we base ourselves on long-term averages would be a bit too fast.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Yeah.

A - Patrick Barbeau {BIO 18476397 <GO>}

And it doesn't take long. Although we expect Q3 to be half because of historical statistics, it may not be that way. So I think, it would be fair for us to really take another good look at the end of November, a year after we've updated the last years and update that if necessary.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Yeah.

A - Patrick Barbeau {BIO 18476397 <GO>}

Doing it faster would be, I think a bit too soon, given the lumpiness of the CATs.

Q - Tom MacKinnon {BIO 2430137 <GO>}

I understood.

A - Louis Marcotte {BIO 18040440 <GO>}

Yeah. And, I think, Tom that that's your observation on a quarterly basis is right in my view. When I look at personal prop and I look at the last five years, so six months into the year into 2018 in personal prop combined ratio is 96, okay.

In 2017, for the whole year, 89, in 2016, 91, in 2015, 86, in 2014, 89, so caps are creating noise, but it's overall been helping the demand for the product. And I think, the product is priced to do well in periods of caps. I understand it is indeed noisy and that's why we often disclose if we think disclosure is towards the end of the quarter to make sure that most of you are on it or all of you.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Thank you. And any commentary on personal auto rate increases that you filed for in the second quarter and in the third quarter?

A - Charles Brindamour {BIO 7012323 <GO>}

I'll ask Darren to share his perspective on that.

A - Darren Christopher Godfrey {BIO 19791482 <GO>}

Yeah. I mean I'll be careful with my comments here, given the competition. But, I mean, we continue to assess where we can take rate increases. We continue to file very slowly from province to province, but where we feel as if market conditions are sufficient such that we feel as if we can take rate, and also there is a need for take rate.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Yeah.

A - Darren Christopher Godfrey {BIO 19791482 <GO>}

It varies coast-to-coast, but that's probably as far as probably do you want to get that, Tom.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah, thank you. The Q2 numbers are routing some jurisdictions. We've taken rates in a few places.

A - Louis Marcotte {BIO 18040440 <GO>}

Yeah. There's obviously sometimes - I mean you're right, Charlie, in terms of Ontario numbers are out, the Alberta numbers are out, sometimes we will see quarter-over-quarter a little bit of difference between our actions and the industry actions, sometimes there is timing differences, sometimes like you know for example, in Q2 on the fiscal numbers, it'll show minimal rent increases from us, but you'll also see that we took more in Q1. So, you see a little bit of noise there.

A - Charles Brindamour {BIO 7012323 <GO>}

Well, you know, overall, I'll say this. So the market is firming up. There is a big line to catch up before our price point is becoming competitive. We are open to growth at our conditions and we are still on the mindset of getting rate where needed, or where we can. And therefore we have plans for the fall as well as '19 and we're working on that.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay, thank you.

Operator

Your next question comes from the line of Meny Grauman from Cormark. Please go ahead.

Q - Meny Grauman {BIO 15238080 <GO>}

Hi, good afternoon. Just a question on physical damage costs. If you could just talk to that specifically and so, any commentary for the quarter especially, when it comes to the rate of inflation and how that's tracking the 4% trend?

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah, Patrick?

A - Patrick Barbeau {BIO 18476397 <GO>}

Yeah. So we've talked about physical damage pressure in costs in the past. It's been -- for at a time even somewhat higher than the 4% you're quoting. We said that in Q2, it was actually a decrease in overall security in cost for auto.

And when I look specifically at the cost of PD, our action plans and claims was targeting three main components of that PD cost that was the actual cost of the parts and repairs, there's the cost of rentals and towing fees and there's also some other fees around storage for total loss and all that. And we're working on all three fronts.

What we see in Q2 is that well, those plans we're targeting to temper the inflation and we see that the inflation coming from the cost of parts and cost of repairs is still there. But, some of our actions have brought them down and I can give you a few examples of what we're starting to see in Q2 from claims perspective.

One key example is the cost of rentals. We have reduced our cycle time by close to two full days with our action plans and repairs and total loss. That has reduced the rental cost by slightly more than 10%.

Compared to prior quarters and this is a key portion because we can actually benchmark ourselves with the industry and we see that that reduction has created a bigger gap between us and the industry so that a portion of the severity trend that we can link back directly to our actions.

From an actual cost of repair perspective, we've seen the cost of repair over also parts and labor together slightly go down year-on-year in Q2, which is the first quarter we've seen that in a while. So, we can link back some of those components.

So, overall, this quarter the severity was actually down, but we're seeing a good portion of that coming directly from our actions. There might be some situations from quarter-to-quarter that explains the rest.

Q - Meny Grauman {BIO 15238080 <GO>}

Thanks, Patrick. And if I could just ask another question on just the regulatory landscape, we had an election in Ontario. It sounds like especially in Ontario, but across the country it's pretty benign, but I'm wondering if there's any specific regulatory issues that are on your radar screen, anything that you're worried about?

A - Charles Brindamour {BIO 7012323 <GO>}

Darren, why don't you give your perspective on the regulatory landscape from coast-to-coast focused on automobile insurance?

A - Darren Christopher Godfrey {BIO 19791482 <GO>}

Yeah. I mean, you're right, we haven't really seen material changes in the regulatory landscape, but honestly as you alluded to election in Ontario, it's still very early days, it's still going through a transition obviously both from an ISP standpoint and from an industry standpoint, very big proponents of the March report so we're really gearing up from a GR standpoint there, but otherwise really no other significant changes.

The only other maybe the subtle change that I would mention would be in Alberta in particular, the government bought out a slight amendment to the minor injury definitions in Alberta.

So, really as we've talked about in the past two issues in Alberta around minor injuries, one is TMJ and the other one is around chronic pain. I'm very much simplifying, but that were the two sort of major streams. So they brought about a change in a minor injury definition, really addressing the TMJ issue to a fair degree. And these were effective on June 1, so all claims post June 1 would now apply under this new definition.

When we look at Alberta, when we look at the industry's results for Alberta and the inadequacies that exist there in the industry, there's more work that still needs to be done from an MIR standpoint, but we're encouraged to see early signs about the government addressing some of the cost pressures that we see in Alberta. So that's probably the only I would say the change that we've seen from a regulatory environment in the last quarter

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah,I think that's exactly right, Darren. I will add that in dialogue over the years with the party in power in Ontario, they've been very receptive to the notion that automobile insurance is very, very competitive. And that making changes to the approval process to unleash competitive forces to a greater extent is seen as a good thing.

And therefore I think this is an area where I'm hoping that we will in the context of the Ontario marketplace have a more dynamic sort of pricing environment that would be good I think for consumers in the long run. And I think the party in power certainly gets that.

I think that when I think about the political and regulatory landscape from coast to coast at the moment, and I look back to our experience as a firm going through cycles, I would say that we're in a period that indeed appears to be benign from a regulatory point of view. But we're in a period, where the market is firming up meaningfully and that means, rates are going up across the land.

It means that capacity is tightening up a number of insurers who sat on their hands as inflation was catching up with them who sat on their hands when it comes to taking rate actions are sitting out there not really wanting to write business at the moment.

This tends to fuel growth in non-standard or residual markets which we've highlighted. We've seen growth in that segment. We've mentioned that to you guys in the past couple of quarters and this elevates the tension so to speak.

There's no meaningful issues at this stage, but it is a riskier regulatory environment when capacity is tightening up and we're working with regulators across the land to make sure they understand the environment and also what they can do about it to improve the dynamics of the marketplace and I do believe that the change that Darren's talked about in Alberta is a very concrete sign, the government seeing inflation, seeing the market tightening up a bit and doing their part to improve the availability of driving for Albertans and therefore, I'm encouraged by that.

Q - Meny Grauman {BIO 15238080 <GO>}

Thanks for the detail.

Operator

Your next question comes from the line of Mario Mendonca from TD Securities. Please go ahead.

Q - Mario Mendonca {BIO 2450557 <GO>}

Good morning. Just a quick question. First Louis, you concluded your comments with - you reiterated the 10% growth in net operating EPS. Now, what I'm trying to understand is, was -- would you suggest that that applies to 2019. And the reason I'm asking the question is, there's so much that went poorly early on in 2018, the cat losses, the usually bad weather, the - all the significant improvements you're making to auto, there's a good long list that can go, if you're not the least of which is OneBeacon as well, that would suggest 2019 has to be a lot better than 10%. So I'm asking you is, when you talked about the 10%, you emphasized it. Were you trying to send us a signal that the 10% is relevant in 2019 or is there some other message here?

A - Louis Marcotte {BIO 18040440 <GO>}

Well, I think I was - I'm not trying to give specific for guidance for 2019, I was trying to share the elements of upside that we see as levers. The conditions are favorable, as Charles alluded to and also growth is clearly a key target for us. And we certainly are working on those levers to make sure that we get to that target over time. But I was not very specific, I was not pointing at 2019.

A - Charles Brindamour {BIO 7012323 <GO>}

No. I think the reason why we like that objective is because it's not a plain growth objective. It's an objective that has a number of levers to move the needle. And I would say when I look at where we are right now, on each of those levers, I see upside. What can drive NOIPS growth, organic growth? Well, the market is firming up. Automobile on 12 months you should see better organic growth there, we've seen commercial lines is growing at 7% at the moment. So when I look at the NOIPS component, the organic growth lever is certainly purely positive. When I look at margins, we're working hard on auto, OneBeacon is improving and property and commercial lines are doing well. So I look favorably at this lever as well.

When I look at capital, we have a strong capital base. There's a lot of opportunities in the market. I'm hoping we can use our capital base to be a accretive to earnings as well. And so, not at all moments in the cycle you have all the levers lined up to contribute to nice growth and I think this is a point in time where most of those levers should move in the same positive direction. Won't go beyond that to talk about a number, but I would say that there was good alignment between what can move the NOIPS here very clearly.

Q - Mario Mendonca {BIO 2450557 <GO>}

So bottom line for both of you, the 10% was not a reference 2019?

A - Charles Brindamour {BIO 7012323 <GO>}

No.

Q - Mario Mendonca {BIO 2450557 <GO>}

Okay. Let me move on to something else then. Maybe you've already discussed this, I missed it. There was references last quarter to reserve development personal auto being neutral. And this quarter, obviously didn't work out that way. So a couple of things. What - - what played out this quarter that was disappointing? And then secondly what's your outlook?

A - Charles Brindamour {BIO 7012323 <GO>}

Ken, do you want to give your perspective.

A - Kenneth Anderson {BIO 16846692 <GO>}

The activity - the adverse development we've seen in Q2 for personal auto was limited to accident benefit coverage in Ontario as limited to a large part and more specifically to a couple accident years prior to the reform of June 2016. Clearly, people are trying to get as much as they can from their claims or before the new regime. But that has a - there's a limit to that as we close more and more of the files from those prior years.

And from a claims perspective, when we get those requests, we are being careful at the moment in our reserve and we're putting up the reserve. That's really what happened in Q2, really isolated to one line of business and it might be important to mention that the type of claims that has developed in Q2 are specifically linked to what the reform of 2016 is trying to address.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. I think that's a very good way to put it. It is surgical and it is people and entrepreneurs so to speak trying to get the most out of the previous regime pre-reform. Now the thing we're observing Mario that we're not giving full credibility to at this stage is that, while there is more demand for CATs and accident benefit for those two accident years. The demands that actually translates into CATs or what I would call the concession rate for CATs is actually coming down. And that is only partially reflected in how we're reserving.

Q - Mario Mendonca {BIO 2450557 <GO>}

The concession rate being what you will accept as a CAT.

A - Charles Brindamour {BIO 7012323 <GO>}

Exactly.

Q - Mario Mendonca {BIO 2450557 <GO>}

Usually and that's coming down. So that's a positive, but generally reflected there yet.

A - Charles Brindamour {BIO 7012323 <GO>}

Not fully.

Q - Mario Mendonca {BIO 2450557 <GO>}

Okay. And so your outlook then on this matter, let's say over the next few quarters neutral or unfavorable?

A - Charles Brindamour {BIO 7012323 <GO>}

I'd say neutral and it can go either way, it's a right way to think about it neutral and in aggregate for the organization we've guided towards 2% to 4% at the lower end of that range in the near to mid-term in part because of interest rates which put some lead to a lower provision for adverse deviation. And in part because of the period we're in, in automobile insurance at the moment when we're taking a cautious look at some of the improvements we're seeing.

Q - Mario Mendonca {BIO 2450557 <GO>}

Helpful . Thank you.

A - Charles Brindamour {BIO 7012323 <GO>}

Thanks.

Operator

Your next question comes from the line of Doug Young from Desjardins Capital. Please go ahead.

Q - Doug Young {BIO 5640851 <GO>}

Good morning. Just following on that question around the prior year reserve developments. And again what you said Charles about concessions and what not, but is there any way to put this in, in different perspective in terms of meaning how many pre-2016 Ontario auto claim flows are left open. What's the closing rate that we're going through? And are you assuming essentially in most of these cases, the worst potential outcome from the CAT stocking, or is there any other way to kind of put this in perspective?

A - Charles Brindamour {BIO 7012323 <GO>}

Tricky to get into numbers. The point I'm making is that it's not because you say, you're being catastrophically injured that you actually are, right. I mean, there was a certain stream of catastrophically injured people that needed real care.

And then, when the reforms came in June 2016 reducing the ability to claim psychological damage as a trigger to become catastrophically injured. We've seen, now that people claim that to a much greater extent and entrepreneurs working around the automobile insurance base do that and our acceptance of those claim is coming down and we're only partially giving credibility for this.

Now the numbers we're talking about are actually very small numbers but as you know a cat in automobile insurance is worth CAD1 million or more, where the stage before and which is called basic claim would be in the tens of thousands of dollars. So to actually put a number on the number of cats that one can get, I mean, it's pence of cats. It's not hundreds nor thousands, they swing but 6, 7, 8, 9, 10 of them are worth CAD10 million.

And that's the sort of swings you're seeing in the results and we're taking them to a certain extent at face value for now until we see that those reforms become effective and until we see that the concession rate actually holds at a lower level. But it's - you know Doug, I'll take your question into consideration and either ahead of roadshows or ahead of next quarter, we'll think of a different way to present it if there is a good one that can be publicly disclosed.

Q - Doug Young {BIO 5640851 <GO>}

I appreciate that. The second is just back to the 97% that you were talking about, I mean, I guess the simple way to think of it for Q4 or for Q3 or Q4 is, we take the combined ratio, we back up the prior year reserve development, we back up the cat, so you get to a current year accident combined ratio. And if that current year accident combined ratio is 97% or better and if it's 97%, Charles that you're saying basically, you would say that you hit your target in terms of a run rate mid-90% combined ratio, is that essentially the way to think of this?

A - Charles Brindamour {BIO 7012323 <GO>}

That's, yeah, that's not a bad way to think of this. I'm not sure I'd say that at 97%, Doug, but right because when we say mid we're sort of thinking about mid here, but that would be a good way to do this. In aggregate, we want the line to be in that space all-in just to be clear.

When we track our progress, we're trying to make sure that the one-offs don't cloud our read where we are one way or another and I think we just laid out very clearly that if you take the upper end of what we view as seasonality range this is how we think about how much more work is needed at this stage and we think that what's in the pipeline will get us there and that's why I conclude here that we're on track.

Q - Doug Young {BIO 5640851 <GO>}

So, I guess that's why I'm getting confused. Just like is 97, and the 95, or is it essentially in Q4, you basically you want the auto combined ratio to be 95?

A - Charles Brindamour {BIO 7012323 <GO>}

You know, I think we want the run rate in Q4 to be in the mid '90s, when you take seasonality into consideration, basically.

Q - Doug Young {BIO 5640851 <GO>}

Okay. And then just lastly, just you mentioned the risk-sharing pools a few times and it looks like the residual market looks like the results have been fine. But the risk-sharing pools I guess when I look at the expected combined ratio for this year is about 167% and as you mentioned this pool is growing. So and I know I've asked this before and hopefully we can kind of get a little bit of a different flavor to it. But does that concern you and if not, why not? And I know you probably put in business in that is higher combined ratio, but net-net it's not a drag and as you mentioned it's a 1 point drag year-over-year on the current year loss ratio in personal auto. So I'm just hoping to get a little color.

A - Charles Brindamour {BIO 7012323 <GO>}

I think it is true that the pools, the business that is in the pool is performing poorly. But what matters is, how poor a business you seen in the pool compared to the business that's in the pool, and our track record from that point of view has been very good. In fact, we've been ceding worse business and the business that there is in the pool. And I don't think the pool is actually a structural drag to our performance. And Darren, you might want to share your perspective on this.

A - Darren Christopher Godfrey {BIO 19791482 <GO>}

No, absolutely. I think a little bit more context I can provide there. Within the quarter itself, so Q2-over-Q2, yes, we did talk about pools did impact the current accident year by a 1 point. But pools also favorably impacted the PYD for a 1 point. So if you're looking in aggregate in particular in the quarter, pools had zero impact in totality in Q2.

Now, when we look year-to-date, pools are actually favorably impacting our combined ratio by roughly 0.6 points which is very much in line with our long-term expectations. We're going to see -- as we have seen in the past, we're going to see some noise from quarter-to-quarter. We're going to see noise between current accident year and prior accident years that will continue.

Obviously, there's an element of the pools as you talk about the assumed element that we're not reserving that, that's coming from the industry. So we do tend to get a little bit of noise. I would expect that. But pools itself historically and also year-to-date, I think, are a source of gain for us from a combined ratio standpoint.

Q - Doug Young {BIO 5640851 <GO>}

That's helpful. Thank you.

Operator

Your next question comes from the line of Christopher Campbell from KBW. Please go ahead.

Q - Christopher Campbell {BIO 20262752 <GO>}

Yes. Hi, good morning.

A - Charles Brindamour {BIO 7012323 <GO>}

Good morning.

Q - Christopher Campbell {BIO 20262752 <GO>}

I guess, this first question is on OneBeacon. What are you seeing in terms of actual versus expected loss trend in those liability lines? And are there any US liability trends you're keeping an eye on?

A - Charles Brindamour {BIO 7012323 <GO>}

Well, I would say right now on the liability trends that we're keeping an eye on, although we're very little affected well, but we're looking at it is everything regarding sexual harassments. On the sexual harassment side, we have no coverage on our D&O business, but we have a bit of coverage on the management liability side. And clearly that's something where, although, with small increase in number of losses, but there is are -- normally very small one. This is clearly a trend we're looking at right now. And this is one of the line of business where we're taking action plan to address some of the issue we have in management liability.

Q - Christopher Campbell {BIO 20262752 <GO>}

Got it. And you're not seeing any uptick in any of the casualty lines, their loss cost trends above what you would be expecting?

A - Charles Brindamour {BIO 7012323 <GO>}

No.

A - Louis Marcotte {BIO 18040440 <GO>}

No.

Q - Christopher Campbell {BIO 20262752 <GO>}

Okay. Got it. And just second question on the personal auto trends now. Was there any benefit or estimated benefit that you would be getting from, I guess, better than expected frequency trends. Just in terms of what you would be modeling long term on either frequency or severity versus where those are coming in currently?

A - Charles Brindamour {BIO 7012323 <GO>}

No. You know, when you look at the US and number of the players in the automobile insurance space, there seems to have been a decline in frequency at least for those that are publicly traded that we're tracking. There has been no such equivalent decline and frequency. Here we've seen mild inflation when it comes to frequency, but no structural changes, as it's been observed for a few of the US players in the past couple of years.

Q - Christopher Campbell {BIO 20262752 <GO>}

Okay, great. Well, thanks for all the answers. Best of luck in the third quarter.

A - Charles Brindamour {BIO 7012323 <GO>}

Thank you.

Operator

Your next question comes from the line of Jaeme Gloyn from National Bank. Please go ahead.

Q - Jaeme Gloyn {BIO 19737597 <GO>}

Yeah. It was very quick, you talked about the 1.2 billion of capital and given that integration on OB, it sounds like it's complete now. What can you say in terms of your aggressiveness pursuing M&A transactions? And what type of businesses would you potentially be looking to?

A - Charles Brindamour {BIO 7012323 <GO>}

Well, let me just comment on your conclusion that the integration of OB is completed. I think that we're ahead of schedule on synergies. I think the investment team has done a great job faster than we thought to optimize and integrate the investment mix which has both income and expense benefits. We're not done. There's more work to be done in particular on synergies and a few areas, but when it comes to our underwriting and claims improvement plan, we don't think we're at the end of this.

In fact, we think we're right in the middle of the improvement plan there. We're pleased with the traction we're seeing. I mean our folks in the US are really good at executing on these plans and there's a lot of focus and I think it translates into a 93.8% combined ratio in Q2, but what we're looking for is sustainable top quartile low 90s combined ratio.

And I would say 93.8% is not that as far as I'm concerned, and sustainability will take some time. We're quite encouraged by what we're seeing, and gaining confidence that we will indeed deploy capital in the US, but the integration is not over. I think that we've got a few more months of work there before we reach that conclusion. Louis, anything you want to add?

A - Louis Marcotte {BIO 18040440 <GO>}

No, I think the capital position is strong. Something came up in Canada, of course, we deleverage our balance sheet to do it, or use our balance sheet to do it, that remains a priority, whether it's manufacturing or distribution. But I think you're right on, I think we have to be cautious and the integration is not yet completed, although we are seeing good progress.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah, I think where we are confident is that when you look at the US business, there's 14 different business segments. And some are there and sustainable and great performance in fact the majority of them. And would we do tuck-in acquisition to strengthen some of these segments? We might, because there we have the confidence. But I would say large or broad acquisitions at this stage, I would say it's too early.

Q - Jaeme Gloyn {BIO 19737597 <GO>}

Okay. So small tuck-in, in the US specialty line would be the focus there. And then in Canada, I mean, I see that post quarter there's been a couple of brokers picked up for broker link. Is that still more the focus and then potentially anything else on the M&A side?

A - Charles Brindamour {BIO 7012323 <GO>}

So, let me just come back. I think prior to number one in terms of meaningful capital deployment is Canada. And Canada manufacturing, Canada distribution no doubt and starting to think about tuck-ins in the US for the segments where we feel comfortable. Louis?

A - Louis Marcotte {BIO 18040440 <GO>}

On the distribution front. So it was a bit of a tame first half of the year, little activity picked up just after the end of the quarter as you've seen with the few acquisitions on the BrokerLink front. So of course this can be lumpy, we've said that in the past. There's still plenty of opportunities in the market, we're active on it and the proof is, we've concluded three year but just after quarter end, so we'll deploy capital there as the opportunities are available and I intend to continue on that front.

Operator

Your next question comes from the line of Brenna Phelan from Raymond James. Please go ahead.

Q - Brenna Phelan {BIO 20108118 <GO>}

Hi, good morning.

A - Charles Brindamour {BIO 7012323 <GO>}

Hello.

Q - Brenna Phelan {BIO 20108118 <GO>}

I just wanted to follow-up on Geoff's question on Metromile. And as you invest more capital in that business and spend some more time there. Do you think there is a sense for a pay-per-use Intact Insurance product in Canada? Are you any closer to that decision?

A - Charles Brindamour {BIO 7012323 <GO>}

Well. It's important to keep in mind that Metromile's approach to business is one that very much relies on telematics. And I would say that it's important to keep in mind that we have a huge telematics program in Canada that is focused on behavior first and foremost where Metromile's is focused on driving - on the amount of driving you're doing.

And we've got four billion kilometers driven leveraging artificial intelligence to find new ways to promote and so take risk with that product and are very much focused on that. But this is a platform that is evolving and I'll let Darren share with you where we are and some of the latest deployments we have made in telematics.

A - Louis Marcotte {BIO 18040440 <GO>}

No. That's exactly it, Charles, and to obviously, using that CAD4 billion - sorry, four billion kilometers of kilometers that we referred to, we're continuing to evolve the program. We're continuing to improve the sophistication of the program, not just from a behavior standpoint, but in fact, actually from a kilometer standpoint as well too.

So I think, that as we look at our telematics program, where we're soon launching a new iteration of the program. We're in research for the next iteration of the program as well too. So we're quickly continually, I would say evolving the program and assessing both from a segmentation standpoint, but also from a product position standpoint as well.

Q - Brenna Phelan {BIO 20108118 <GO>}

Okay, great. That's helpful. And then, just last one. The accident benefits related prior development in Ontario, give us sense, is this an industry wide phenomenon or your competitors feeling the pain here? And do you think there's a chance that as we near the end of one, these claims can actually be filed do you think there's a chance that there is maybe one more last surge over the next year?

A - Charles Brindamour {BIO 7012323 <GO>}

I think the risk of surging is diminishing given the reforms were introduced two years ago. And I do think it is an industry wide issue absolutely.

Q - Brenna Phelan {BIO 20108118 <GO>}

Okay. Thanks very much.

Operator

And there are no further questions at this time. I will now turn the call back over to the presenters for closing remarks.

A - Charles Brindamour {BIO 7012323 <GO>}

Great. Thank you all for joining us today. Following this call, a telephone replay will be available for one week and the webcast will be archived on our website for one year. Transcript will also be available on our website in the financial reports and filings archive. Our third quarter 2018 results are scheduled to be released after market close on Tuesday, November 6th. Thank you again. And this concludes the call for today.

Operator

This concludes today's conference call. You may now disconnect.