Q3 2014 Earnings Call

Company Participants

- Alain Lessard
- Charles Brindamour
- Dennis Westfall
- Louis Marcotte
- Mathieu Lamy
- Patrick Barbeau

Other Participants

- Doug Young
- Geoffrey Kwan
- John C. Aiken
- Mario C. Mendonca
- Paul Holden
- Shubha Khan
- Tom MacKinnon

MANAGEMENT DISCUSSION SECTION

Operator

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

Thank you. Mr. Dennis Westfall, VP, Investor Relations, you may begin your conference.

Dennis Westfall {BIO 15155973 <GO>}

Thanks, Lisa, and good morning, everyone. Thank you for joining us on the call today. A link to our live webcast and background information for the call is posted on our website at www.intactfc.com under the Investor Relations tab. As a reminder, the slide presentation contains the disclaimer on forward-looking statements, which also applies on our discussion on the conference call.

Here with me today are Charles Brindamour, CEO; Louis Marcotte, CFO; Patrick Barbeau, SVP of Personal Lines; Alain Lessard, SVP of Commercial Lines; and Mathieu Lamy, SVP, Claims. We will start with formal remarks from Charles and Louis followed by a Q&A session. The others will also be available to answer your questions during the Q&A.

With that, I would like to ask Charles to begin his remarks.

Charles Brindamour {BIO 7012323 <GO>}

All right, thanks, Dennis. Good morning, everyone, and thank you for taking the time to join us on the call. Earlier today, we announced strong results for the third quarter. For me, the results illustrate the underlying strength of our operations. We've spoken before, probably more times than we would've liked, about elevated cat losses impacting our earnings.

This quarter was in some ways more of the same, but the net result was much improved as our actions are paying off. We announced a $125 million impact from catastrophes, but still reported net operating earnings of $185 million or $1.37 per share, more than three times the level from a year ago. The Q3 earnings helped generate our 14.3% operating ROE and 10% growth in book value per share over the past 12 months. So where does this put us in relation to our two primary financial objectives?

On a year-to-date basis, our net operating income per share is up obviously significantly versus 2013 given the elevated level of cat losses last year. Though if we look back three years, our first nine months net operating income per share represents an average yearly growth of close to 12% compared to our target of 10%.

From an ROE perspective, we target to outperform the industry by at least 500 basis points every year. We've done so by 710 basis points on average in the past three years. Based on the most recent industry data at June, we outperformed by 850 basis points so far this year.

The earnings contribution in Q3 was broad-based in nature. Personal property is showing its resilience with a combined ratio of 97.7% despite almost 17 points of cats. Year-to-date, this line generated a combined ratio of 94.4%, better than our 95% target.

Our underlying results have shown great progress, in my view, but only half of our 10 point improvement plan yet to be earned. Similarly, while personal auto was heavily impacted by storms in Alberta, its 95.8% combined ratio reflected an improvement in underlying results.

Commercial P&C rebounded from a string of difficult quarters with one of its best ever performances, an 84.7% combined ratio. Across all lines of business, our 93.2% combined ratio was close to 10 points better than a year ago. I think it's fair to say that the primary reason our results came in above expectations was due to the strong results in commercial P&C.

So the obvious question is how much of this improvement is actually sustainable. Clearly, you'll have quarters that are better than expected and others that are worse than expected. I'd say that several items lined up favorably in the quarter in this line of business. The year-to-date performance at 96.7% is how I think about this business, and this is just not good enough. As such, our actions to improve the commercial lines portfolio will continue.

In Ontario, the government's auto insurance cost and rate reduction strategy has so far led to a reduction in filed rates of 6% across the market as a whole. Our process of reducing rates by 5.3% on average began in early April and has been focused on existing customers. We're encouraged that Ontario Bill 15 is progressing well through the Legislative Assembly. This is consistent with our view that the government is very proactive on this file.

That being said, additional meaningful cost reduction measures are necessary for the industry to achieve the government's 15% rate reduction target. I think they get that. And in the current environment, due to the cost reduction measures already implemented and our own actions, we are comfortable with our margins in this market and we'll continue to pursue growth opportunities.

Turning to the top line, certain pressure points have dissipated in recent weeks. First, we've now completed our program to reduce the company's exposure to a large B.C. earthquake. We have in the past 18 months effectively reduced our exposure by 25%. This exercise obviously weighted on growth in past quarters.

Secondly, we've talked about being an early mover with our 10-point improvement initiative in property. The industry is clearly moving as market conditions have continued to firm and our relative position has improved. Units were down about 1.5 points in the quarter despite now reflecting our full product changes and rate actions.

Looking ahead for IFC, we expect our underlying growth to start improving from the 1.3% pace of Q3. When it comes to our outlook for the industry, we foresee low-single-digit growth in personal auto while we expect upper single digits in personal property from continued hard market conditions.

Commercial P&C has firmed in the past year. Rate increases at renewal in this segment were up by close to 5% in the third quarter. The low interest rate environment and elevated losses from catastrophes should support our growth outlook.

So, before turning the call over to Louis, let me close on where growth will come from in the coming 24 months to 36 months. In short, the message has not changed. At the end of September, our financial position was strong with close to $0.5 billion of excess capital.

Our objective is to leverage our outperformance by reinvesting our capital to expand our leadership here in Canada. Organically, I expect growth to improve for two reasons. One, the industry outlook is conducive to improvement given our leadership in implementing corrective measures. And two, our multi-channel distribution strategy is gaining momentum.

When it comes to expanding our franchise, we continue to view meaningful acquisition opportunities here in Canada in both manufacturing as well as in distribution. At the same time, we're continuing to pursue our strategy to expand beyond Canada in a prudent manner with the objective of building an organic pipeline with meaningful impact past 36 months. So I'm confident we have the right people and financial resources to make this plan a reality.

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

Louis Marcotte {BIO 18040440 <GO>}

Thanks, Charles. Good morning, everyone. I will cover three topics this morning. First, a brief discussion of the overall results, followed by more details on our lines of business and, finally, I will comment on the strength of our balance sheet.

As Charles mentioned earlier, our third quarter results were driven by our strong underwriting performance, which generated a 93.2% combined ratio, including 7 points of catastrophe losses. The vast majority of these losses were incurred by the time our press release of August 27 was issued and we were fortunate not to suffer any substantial weather events thereafter.

Our Q3 results also include improved underlying claims ratios, as well as a healthy level of favorable prior year development, albeit less than last year. Clearly, this quarter's results compare favorably to last year when we were hit by the Toronto rainstorm, the Lac-Mégantic tragedy and multiple other cat losses.

Let me now take you through our results in detail starting with our lines of business. Personal property was hit especially hard by this quarter's cats, close to 17 combined ratio points in total, mostly from the hailstorm that hit the city of Airdrie, Alberta, in August.

In terms of underlying results, excluding cats and prior year development, we saw a 5-point improvement year-over-year. Although we benefited from relatively good weather beyond the cats, the actions we've taken in this line of business over the past few quarters are clearly bearing fruit.

With a year-to-date combined ratio of 94.4%, including 11 points of cats, we remain committed to operating our property business at or below 95% combined ratio, cats included. On the growth side, the continued severe weather has been supportive of hard market conditions. Despite our rate and product changes, retention to date was better than expected helping drive Q3 underlying growth to 5% in this line of business.

The Alberta hailstorm also led to elevated cat losses in personal auto resulting in a combined ratio of 95.8%, almost 3 points worse than a year ago. Favorable prior year claims development was weaker than last year but remains within our expectations. Our underlying results were negatively impacted by the risk-sharing pools, whose results tend to fluctuate on a quarterly basis. Excluding this impact, underlying results in auto are about 1 point better than last year.

From a top line point of view, the personal auto business remains under pressure from government-mandated rate reductions in Ontario.

Moving to commercial lines, our P&C business generated strong results as several drivers of the business impacted it positively this quarter. The underlying current year loss ratio was low at 53.4%, a nice change from recent quarters. While we are pleased with the mid-80s combined ratio in Q3, we will continue our current plan to ensure a low-90s performance is achieved on a sustainable basis.

Premiums in commercial P&C grew 3% in the quarter despite our actions to reduce earthquake exposure and to improve profitability in specific segments of our portfolio. The commercial auto line of business continues to deliver solid underwriting results with a combined ratio of 89.4%.

A small amount of unfavorable prior year development was recorded in the quarter, but this is not indicative of any underlying problems or new trends. Premiums were up 3% from a year ago despite competitive market conditions.

Before moving to our balance sheet, I'd like to comment on three other areas of our results. Our expense ratio of 29.6% was nearly 2 points better than Q3 2013 on lower commissions and lower general expenses. The net investment income of $106 million in the third quarter of 2014 was up 2% from a year ago as higher investments more than offset the decline in yields.

Net investment income is not expected to grow from the current quarterly level in 2015 as the low yield environment should offset the growth in our investments. Our distribution business continues to grow at a good pace. So far this year, we recorded income from distribution of $61 million, up 9% from 2013. Keep in mind the distribution business tends to be seasonal.

Finally, allow me to comment on our financial strength. We maintained our strong financial position at quarter-end with an estimated MCT of 203%, $497 million in excess capital and debt-to-capital ratio of 17.8%. Three items explain most of the reduction in excess capital from Q2. Firstly, a higher level of invested assets, assets led to a higher capital charge; the stock market drop in September reduced our unrealized gains; and the lower discount rate negatively impacted our pension plans.

Book value per share was $36.44 at the end of September, up only slightly versus Q2 as the unrealized gains in pension plans negatively impacted our book value.

On the investment side, our asset mix remains fairly stable. We now have 11% of our fixed income portfolio and 9% of our common share portfolio comprised of U.S. securities, both of which provide geographic and sector diversification.

In closing, I believe our strong profitability, our financial strength and our people enhance our ability to pursue growth prospects whether in manufacturing, distribution in Canada or abroad.

With that, I'll turn the call back to Dennis.

Dennis Westfall {BIO 15155973 <GO>}

Thanks, Louis. Lisa, we are now ready to take questions.

Q&A

Operator

[Operator Instruction] And our first question comes from John Aiken from Barclays. Your line is open.

Q - John C. Aiken {BIO 21267604 <GO>}

Good morning. Hi. When we look at the property lines, both personal and commercial, you talk about all of the pricing impact and the claims mitigation strategies that you have in place. On personal property, you're talking about half being baked in, so looking for another 5 points improvement. But when do we expect this to get fully baked into the results with obviously taking into consideration the ongoing volatility?

A - Charles Brindamour {BIO 7012323 <GO>}

I'll let Patrick Barbeau take care of the impact of home insurance, which indeed have run its course to a greater extent than in commercial lines, where we've had good actions in the past year, but there's still much in the pipeline, and Alain will comment on that. So why don't you start, Patrick?

A - Patrick Barbeau {BIO 18476397 <GO>}

So maybe, first, to come back on a few reminder, the 10-point improvement that we implemented starting last November was about two-thirds coming from rates and one-third coming from product and other actions in underwriting. Most of the rates have started to take in place on renewals last November. So, in fact, we're almost done.

So starting in November of this year, the coming months will fully reflect the rate increase. But most of our underwriting actions were started in April and May of 2014. So it's only at that time in 2015 that our results will fully reflect it. However, there is inflation in the system, so there are further rate increases that are coming through at the next cycle to cover that part. But I would say that, starting at the end of Q1 next year, our results will pretty much fully reflect our 10-point improvement plan.

A - Charles Brindamour {BIO 7012323 <GO>}

Thanks, Patrick. How about you, Alain?

A - Alain Lessard {BIO 17592535 <GO>}

Well, I think, at this point, it's difficult to call as to when everything will be earned because not all actions are being taken place at the same time and still are, like you said, Charles, some are still in the pipeline. But a good example of that is, let's say, on the rate increase side, we've always been pushing rate increase quarter-by-quarter to the tone of 1% or 2% in the past, but we've increased that gradually in 2013 to reach a rate increase close to 5% in 2014. So that's still going on.

We've also introduced a minimum deductible on flood that hit most of our book starting in June this year. We've introduced in September a new rating algorithm for flood and sewer backup. Again, that will take another year to go through and we are tweaking continuously our segmentation on rate increase at renewal. And in fact, without changing our plan, we've always focused our rate increase on the worst 25%, but we are now introducing an even enhanced focus on the worst 3% to 5%, okay, where we're going to see a substantial rate increase because this book is really completely underpriced. We're talking a rate increase that could hit doubling the premium. That...

A - Charles Brindamour {BIO 7012323 <GO>}

You're talking about the worst 3% to 5%.

A - Alain Lessard {BIO 17592535 <GO>}

The worst 3% to 5%, exactly, just to make sure, yes, the worst 3% to 5% will basically see substantial rate increase. Considering the disruption that create with our broker, we've given them more lead time to deal with that situation, and that will gradually hit our book starting January 2015.

So some of those actions are all piling up among themselves, so it's difficult to see when we can say everything will be earned considering also in fact that there is inflation towards – (19:25) in the system.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. So I think maybe to sum up commercial lines, as far as I'm concerned, we've been working on the worst 25% of the book for a full year. And starting in 2014, that started to generate close to 5%. So as far as I'm concerned, when you hit the first quarter of 2015, you should have the full effect of that sort of 5% movement that we're seeing throughout 2014. But I think that we are trying to find areas of underperformance constantly in general, but in particular, in our commercial lines portfolio at the moment, then you can certainly see us continuing to work on that on an ongoing basis and certainly for as long as the market will allow it.

And I think the main point is that the market seems to offer up opportunities because we're seeing capacity shrinking in certain segment. We're starting rates firm up in certain segments and we're going as far as we can in that context. But my expectation, if you look at the first half of 2015, I'm hoping to see the impact of what we've been doing in the past 18 months in commercial lines.

Q - John C. Aiken {BIO 21267604 <GO>}

And then, Charles, just as a follow-on within the commercial lines, given the fact that the renewals have been stronger than what you had originally anticipated, should we expect that this pricing increase policy to carry on through 2015 and maybe even into 2016?

A - Charles Brindamour {BIO 7012323 <GO>}

Yes, I think that's the way to think about it, John.

Q - John C. Aiken {BIO 21267604 <GO>}

Great, thank you very much. I'll re-queue.

A - Charles Brindamour {BIO 7012323 <GO>}

Thank you.

Operator

And our next question comes from the line of Geoff Kwan from RBC Capital Markets. Your line is open.

Q - Geoffrey Kwan {BIO 7413168 <GO>}

Hi there, good morning. First question I had was just looking at the expense ratio on your various business segments. I mean, they had pretty good improvements quarter-over-quarter and year-over-year. Just wondering if you can talk about the sustainability of it and maybe provide some additional color around some of the things that were driving the improvements.

A - Louis Marcotte {BIO 18040440 <GO>}

Sure. So let me do it overall by line of business, the allocations are a bit tricky. But on an overall basis, I would say three drivers here. First, on the commissions, a bit of an improvement there. Part of it a catch-up from prior years on the results of the first half and a bit of structural impact as well that reduced the impact this quarter.

Secondly, on comp, on some compensation, there were some adjustments to our bonuses due to our – as compared to last year, we're accruing a bit less than last year and mostly due to growth in this year compared to last year. The third element is really savings initiatives we've taken on from the first half of the year to reduce costs. I think they've come together in this quarter and we expect that it will revert back to a bit higher levels going forward. So this is, I would say, a strong quarter from an expense point of view, but I would expect next quarters to go back to a bit more past levels basically.

Q - Geoffrey Kwan {BIO 7413168 <GO>}

Okay, thanks. And then the second question I had was just looking at the personal property side of the business, you talk about a combined ratio of 95% or less, and if – just for easy math, if you kind of say 95% and let's just assume a 33% expense ratio, that would imply a 62% claims ratio. Now, in terms of how you look at the underwriting to that 62% claims ratio, do you kind of model in how much of that might come from cat losses, and if so, like, how much might that be?

A - Charles Brindamour {BIO 7012323 <GO>}

Do you want to take it, Patrick?

A - Patrick Barbeau {BIO 18476397 <GO>}

Yeah. We – overall, if we take a long-term average, we've talked about in the past I think the $50 million per quarter that we were expecting in cat losses, that was all lines combined. When we factor in the property, it's between – around close to 15 points now of premium, so 15 points of loss ratio that could come from cats in coming years.

Q - Geoffrey Kwan {BIO 7413168 <GO>}

Okay.

A - Charles Brindamour {BIO 7012323 <GO>}

And, Geoff, just so we're clear, we say that we want to operate that business sub-95% in good times and in bad times, maybe not in extreme times, but certainly in bad times. We're pricing the business to do better than 95%, just so we're clear.

Q - Geoffrey Kwan {BIO 7413168 <GO>}

Sure. Absolutely. I was just trying to use round numbers, so, okay. Thank you.

Operator

And our next question comes from Shubha Khan from National Bank Financial. Your line is open.

Q - Shubha Khan {BIO 16255963 <GO>}

Thanks. Good morning. Just the one question with respect to Ontario auto. So, again, I guess, you reiterated the view that you can protect the combined ratio there. And just so I'm clear about how you're thinking about this, would it be appropriate to assume that the 6% in average rate reductions announced by the industry so far can be offset by cost reduction measures already announced? And so, the further – and so further government action is required for the remaining 8% or 9% in rate reductions?

A - Charles Brindamour {BIO 7012323 <GO>}

So, I think there are differing views about what's been announced already and how much that's worth because, depending on how you run your business, these measures will have an impact that will differ from one company to the other. In aggregate, we're not that far from the measures that have been already announced is what I will say.

If you look ahead, the government still has in mind to reduce rates by 15%, so there's 8 points to 9 points missing. There's Bill 15 on the table at the moment, that is moving nicely through the Legislative Assembly. That will be worth a few points. And the government is considering a range of additional measures to get closer to 15%. And therefore, our expectation is that we will see momentum on the cost reduction front going forward.

If you look at where we are today, there have been a number of measures that have been implemented either through the budget in August last year, earlier in February this year. There has been an election in June, as you know, and yet, despite all of that, now there's a bill on the table, that is Bill 15, progressing well. So there is a fair bit of momentum, especially when you take into account the fact that there's been an election halfway this year. And I mean these guys get it. They're smart, they're focused on Ontario drivers. And so far, we're comfortable that we're very much in line with what we see as the base scenario, which is symmetry between cost and premiums.

Q - Shubha Khan {BIO 16255963 <GO>}

Okay. But clearly, more is required at least by the industry in order to make up the remaining 8% or 9% in rate reductions. And so, I'm curious as to whether you have a sense on the timing of further sort of cost reduction measures and what, in particular, you might be looking forward to?

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. Why don't I ask Mathieu, our SVP, Claims, to talk about some of the elements in Bill 15 and then some of the areas where you expect or would like to see more cost reduction measures to get closer to 15% in the near term.

A - Mathieu Lamy {BIO 15207469 <GO>}

Sure. So, in Bill 15, there's three elements on the claims side that we expect is going to help us. First, fixing the dispute resolution system as recommended by the Justice Cunningham Report in last February, lowering the prejudgment interest rate on non-economic damage, that's going to help us, and the measures on the towing and storage costs. That's going to help us control the worst operator in the business. So those are three important elements of Bill 15 that should help us control costs.

In our discussion with government, in terms of further measure to help us control costs, we're discussing a new cat definition, shortening the med, rehab benefit period from 10 years to four years, discussing the disappearing deductible on the torts line and eliminating some of the fees on the tort side, too. So those are in discussion. Hopefully, we're successful influencing the direction there.

A - Charles Brindamour {BIO 7012323 <GO>}

Thank you, Mathieu. I think it's fair to say indeed that Bill 15 will certainly move the needle, but then if you want to really get closer to 15%, you have to focus on catastrophic injuries on AB and on the tort-related side of things. And I think the government has a number of good ideas on that front. It might be worthwhile to spend just a few seconds on clinic regulation and what's happened on that front in the past six months.

A - Mathieu Lamy {BIO 15207469 <GO>}

Yes, the intent of Bill 65 was to regulate clinic and mainly to license them and restrict payments from insurers to only licensed clinic in the industry. This is taking place this year. Clinics are getting licensed right now. It is to be effective December 1 this year. It's positive. The jury is still out, though, how effective it will be.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. My understanding is that 82% of clinics have been registered so far, which is quite good. I think the question for us as a firm here in terms of how much that's worth is that you will recall that in 2010, we basically revamped our claims operation to tackle fraudsters, and that really moved the needle for us. And for those who've followed our story back then, we said the reforms will be worth 6 (30:20), our own actions will be worth 6 (30:22). A big chunk of that 6 (30:23) was actually around fraud monitoring and mitigating fraud.

So, we'll see how much that's worth to us, but I think if we take a broad perspective at the industry level, clinic regulation is actually a very good move and they're making really good progress.

Q - Shubha Khan {BIO 16255963 <GO>}

That's great color. Thank you.

Operator

And our next question comes from Tom MacKinnon from BMO. Your line is open.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Yeah. Thanks very much. Good morning and congratulations on a good quarter.

A - Charles Brindamour {BIO 7012323 <GO>}

Thanks, Tom.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Charles, if you can maybe update – your thoughts with respect to the M&A environment in terms of – how much in terms of market share points you see moving, when you see it moving and how Intact is positioned in this?

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. I think, from our perspective, if you take a 36 to 60-month perspective starting now, we think there'll be 15 points to 20 points of market share that will change hands. We used to say 25-ish points, and there's been more than 10 points in the past three years actually that have changed hands. Half of that we've done through AXA and Jevco.

So I think we've demonstrated then that when market share change hands, we have an ability to act on that. That hasn't changed. And in fact, the fact that our integrations are finished at this stage means that, operationally speaking, we're ready to grow inorganically, so to speak. When we look at the environment today, there's nothing that points to any reason to change our view that there will be 15 points to 20 points of market share that will change hands over the coming, say, five years. But as I've mentioned before, we don't think it'll be back-ended necessarily. We think it'll happen throughout just as we've seen in the past three years.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay. And maybe just as a follow-up, I think you used to give total guidance with respect to cat losses of $200 million a year, and it used to look – it looks to be around 2.5 points to 3 points on the combined. If I look, it was a great call in 2008 through maybe 2010 or maybe part of 2011, but of late it hasn't been.

A - Charles Brindamour {BIO 7012323 <GO>}

Right.

Q - Tom MacKinnon {BIO 2430137 <GO>}

I know you're not in the business of predicting weather, but how should we be looking at that going forward? Obviously, 2013 was a tough year and so far in 2014, it's probably running higher than that. So how should we be thinking about a cat load?

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. I think your observation is correct, Tom. I think you're right on. I mean, if you look at the past three years, it certainly has been above the sort of average cat that one should expect. I would say that, sitting here today, our perspective is pretty much still around that level because we've introduced a bunch of measures aimed at curbing the cost of these catastrophes. I think the impact in 2013 was 7.7 points, so that's a lot of points, 7.7 points related to cat.

For us, that was one outside the curve, and so I think if you look at the average, excluding that, you're not too far from 3%. And then we've put a bunch of cost reduction measures in place, and that's the number we're still keeping in mind. In other words, a run rate of about 50 (34:47) knowing there's seasonality obviously for quarter to quarter. But that's still the number we have in mind. And I think when we change our perspective on that, we'll make sure that it's made very clear to you, guys.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay. Thank you very much.

Operator

And our next question comes from the line of Doug Young from Desjardins Capital. Your line is open.

Q - Doug Young {BIO 5640851 <GO>}

Hi. Good morning.

A - Charles Brindamour {BIO 7012323 <GO>}

Good morning.

Q - Doug Young {BIO 5640851 <GO>}

So just wanted, Charles, to go back to the commercial P&C business because, in your prepared remarks, you kind of talked a bit about sustainability and you said there were several positives that came through. Just wondering, can you kind of go through what those positives were, what the unusual items are? Because, I mean, an 84.7% combined ratio in the quarter, I would imagine you would guide me not to punch that into my model. And I know you're targeting around 90% over the year or bringing for the year down towards 90%. So I'm just trying to get a sense of what the outsized return was this quarter and what we should be expecting in that business.

A - Charles Brindamour {BIO 7012323 <GO>}

Okay. So I think that my comments, Doug, were basically that I look at this business after nine months and I'm assuming that's about the run rate in that business and that's about 97% combined ratio. We're working hard at corrective measures that have been described earlier, and Alain touched on that, and we're pricing that business to be in the low 90s. I don't think we said 90%, but certainly low 90s. So 97% just doesn't cut it; it's not good enough. So, that's the first sort of point in terms of direction that we expect.

If you look at what happened in the quarter, prior year development was slightly better than before. Large losses were slightly lower than what we've experienced historically and cat losses were also slightly lower than what we have experienced historically. And it's on the basis of those three elements that we're seeing that many elements were slightly better than what they've been historically.

Q - Doug Young {BIO 5640851 <GO>}

Yeah. I guess where I'm confused is, I mean, the underwriting results in the quarter were $62 million. If I look at the last 10 quarters, I mean, on average, it's been $4 million, and so the delta is huge. And I know there has been some big losses in those past quarters and some big gains. And I'm trying to get a sense as kind of the right number kind of in between those, trying to get this because I know the last 10 quarters have been obviously some difficult times, too. So that's where I'm trying to go with it.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. Doug, I think, if you look at the slides that we've produced for the call, I would – I think there's a slide that talks about the commercial P&C action plan. And what we do in there is we actually break the performance by components. You'll see clearly the cats, you'll clearly see the favorable development and the underlying performance. The only thing you don't see in there is the large loss weight, and (38:11) maybe, Alain, can you comment on large losses for the quarter?

A - Alain Lessard {BIO 17592535 <GO>}

Yes. In general, you don't see that, but our historical level of large losses is in around about 16 points, but it has varied from quarter-to-quarter anywhere between, let's say, 9.5 points to about 22 points. So there's interim volatility in the result there that are effective (38:35). And this quarter, our large losses came in at about 12 points, where (38:38) there's about 4 points below historical average, okay, which affected and influenced, I would say, favorably our result in the quarter.

Q - Doug Young {BIO 5640851 <GO>}

Okay. Well, that gives me a little bit of color. And then just wanted to go back thinking about Ontario auto, and it's a market I've struggled with trying to kind of figure out – and I understand everything that you're saying, I guess. Some of the – one of the kind of things I wanted to kind of get a sense of was – well, the (39:10) two items. We've had some rulings, I would imagine, coming through an arbitration. I'm just interested if there's been any rulings in the arbitration that have come through that are concerning to you.

And then the auto pool or the risk-sharing pools, I know that you showed the delta in the auto pools. What are – are the auto pools generating a loss, or the allocation, is that a loss for you? Can you quantify how much that is? And are you starting to see, because of some of the changes happening, the auto pool starting to grow here again?

A - Charles Brindamour {BIO 7012323 <GO>}

Doug, I think the best way to tackle this is I'll ask Mathieu to talk about mediation and arbitration decision and how that shapes our view of the world. And then I'll ask Patrick to talk about pools and we'll see if we can tackle your question this way. Why don't you go, Mathieu?

A - Mathieu Lamy {BIO 15207469 <GO>}

In terms of arbitration, the outcome of those decisions are – there's no really adverse decision in the last quarter and in the – even though in the last few years actually, the decisions that have been rendered are maintaining the spirit or the intention of the reform. So I'd say there it's positive. And when there was a bit of doubt, the government has reacted swiftly. So that leads us to believe that the intent of the reforms are going to be maintained.

A - Charles Brindamour {BIO 7012323 <GO>}

Mediation, same sort of story, I think.

A - Mathieu Lamy {BIO 15207469 <GO>}

Yes. Mediations are not binding by nature, so the only downside there, there's a huge backlog and there's very few decisions rendered on post-reform cases at this point.

A - Charles Brindamour {BIO 7012323 <GO>}

Right.

A - Mathieu Lamy {BIO 15207469 <GO>}

I'd say that's why there's still uncertainty in the system, but those that have been rendered are maintaining the spirit of the reform.

A - Charles Brindamour {BIO 7012323 <GO>}

I think, Mathieu, for Doug's benefit, if you go back to 2012, there have been a few meaningful decision, which we actually talked about on the call such as (41:13) and all of that having an impact on cats.

A - Mathieu Lamy {BIO 15207469 <GO>}

Yes, case law, not mediation, arbitration.

A - Charles Brindamour {BIO 7012323 <GO>}

That's right. It's case law, but...

A - Mathieu Lamy {BIO 15207469 <GO>}

Yes. And so – and that's why we're recommending reform on the cats line.

A - Charles Brindamour {BIO 7012323 <GO>}

Right.

A - Mathieu Lamy {BIO 15207469 <GO>}

So those decisions are still standing, but hopefully, in the future, after Bill 15, that's why we're discussing with government to get a new cat definition...

A - Charles Brindamour {BIO 7012323 <GO>}

Yes, exactly.

A - Mathieu Lamy {BIO 15207469 <GO>}

...to enable (41:41) have more certainty on the cats.

A - Charles Brindamour {BIO 7012323 <GO>}

Exactly. And I think when these decisions came out in 2012; we have made a number of reserving adjustments as a result, talked about that with the Street and integrated that in our pricing model. But if you go back one year, there's nothing that we see that is concerning. One decision, I think it was in 2013, weakened the minor injury definition, and very soon thereafter, through the budget and the February regulation, they've actually tightened the interpretation of the minor injury definition. Is that correct?

A - Mathieu Lamy {BIO 15207469 <GO>}

It is correct. And since then, there's another arbitration decision that reinforced that the minor injury guidelines are in fact binding. That was...

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. It was quite big actually.

A - Mathieu Lamy {BIO 15207469 <GO>}

Yes.

Yeah. All right. So let's move on to pools.

A - Patrick Barbeau {BIO 18476397 <GO>}

Well, the pool results are made up of two main things, so it's premiums and losses that we cede to the pools and those premiums and losses that we assume because of our market share and usage of the pools. So when we look at the quarter, Q3 of 2014, if we look at it from a year-on-year perspective, it increases a bit the gap because 2013 was actually a very good – Q3 2013 was a very good quarter.

But when we look at specifically the Q3 of this year, it is a loss of close to 1 point caused by both sides. So the assumed that has been worse than the average quarter and also the profit we get from decession (43:29) that has been slightly worse. Overall, over the years, quarter-to-quarter, it fluctuates a lot, but it generates in general a slight profit because we are performing slightly better than the average of the pool in the risk we select to cede. It's just this quarter, it's a small loss of close to 1 point.

A - Charles Brindamour {BIO 7012323 <GO>}

To Doug's question, I think the more interesting thing to look at to understand the state of the market is the size and the growth in the Facility Association, which is a direct reflection of how much capacity is available in the market. So maybe you can comment on...

A - Patrick Barbeau {BIO 18476397 <GO>}

Yes, that's right. From that perspective, both the Facility Association and the risk-sharing pools of the industry, the volumes have been stable over the past many years.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah.

A - Patrick Barbeau {BIO 18476397 <GO>}

I would say four years or five years. In fact, we've seen a slight decrease in the Facility Association, which is really the final stage. So after the pools, there's the Facility Association in the regulated markets and the volumes there have slightly decreased in 2014 compared to prior year.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. Just so we're clear, the Facility Association, for those who wouldn't be familiar with that, is essentially if you cannot find an offer from a private carrier, there is an industry mechanism called the Facility where you can get insured. And we haven't seen much movement there for the past few years. We manage the facility – one of the big facility carriers on behalf of the industry. So we have good sense of what's going on there and there's no signs of capacity shortages based on what we see in the FA.

Q - Doug Young {BIO 5640851 <GO>}

All right. Just one quick one hopefully. I know the biggest item here to get the full 15% cost benefit or to offset the rate reductions in Ontario auto is going to be the new cat definition. We've had a new cat definition out there that has been proposed, but never kind of adopted. What probability would you put on it, Charles, that you actually get a new cat definition here? Thanks.

A - Charles Brindamour {BIO 7012323 <GO>}

Oh, I would say that there's a lot of efforts right now invested in looking at ways to tighten and make the definition of what is a catastrophically injured driver, to make that definition as tight as possible, in other words, to reduce the likelihood of leakage over time. It's not many cases, but it represents a meaningful portion of the incurred losses.

I'd go so far as to say close to one-third of incurred losses are cat-related. So there's work being done at the government level considering various options at this stage and I do think that the makeup of the government will be conducive to see a change on the definition of accident benefit catastrophes. So, to your question, I would say north of 50%, which, in this world, is pretty good.

Q - Doug Young {BIO 5640851 <GO>}

I'll take that. Thank you.

Operator

And our next question comes from the line of Paul Holden from CIBC. Your line is open.

Q - Paul Holden {BIO 6328596 <GO>}

Thank you. Good morning.

A - Charles Brindamour {BIO 7012323 <GO>}

Good morning, Paul.

Q - Paul Holden {BIO 6328596 <GO>}

First question I wanted to ask you is on Alberta auto. We've talked about some potential cost pressure coming through on the BI side. When I look at the overall personal auto results this quarter, it doesn't seem to have had any impact, but wondering if you can provide us with an update there.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. I think I'll ask Mathieu to comment on some of the things that we have in the pipeline to curtail inflation and bodily injury in Alberta, which I'm very pleased with where we are now. I think what happened in the quarter is that the catastrophe in Alberta, the hailstorm in Alberta was 60% automobile-driven. And that's certainly an area of focus for us, but I'll let Mathieu comment on the work we're doing in bodily injury to a little bit like we did in Ontario five years back, really create outperformance as a result of claims management.

A - Mathieu Lamy {BIO 15207469 <GO>}

So this increased activity in the bodily injury files in Alberta is stemming from a decision that happened early 2012, the Sparrowhawk decision that kind of excluded the TMJ out of the minor injury cap and opened the door for chronic pain to be outside of the cap. Since then, we have I think a vigorous action plan to make sure that the intent of the minor injury cap is maintained in Alberta. So we've increased staff. We have created a special handling unit handling those cases where, with certain plaintiff lawyers and when TMJ and chronic pain is alleged, we have a special protocol to handle those cases and make sure that the intent of the reform is maintained.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. And the claims organization has been essentially broken into teams to work on different degrees of pressure, so to speak, coming from the trial lawyers.

A - Mathieu Lamy {BIO 15207469 <GO>}

Yes, triaging the more difficult file and a special unit to handle that.

A - Charles Brindamour {BIO 7012323 <GO>}

Exactly. And changing protocols as a result of this common law decision. And I think so far, so good, like...

A - Mathieu Lamy {BIO 15207469 <GO>}

Yes.

A - Charles Brindamour {BIO 7012323 <GO>}

...making really good progress on that point.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. So I understand the answer correctly. Then the measures you're taking are effectively offsetting cost pressures that others in the industry might be feeling.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes, yeah, exactly. And when we talk about underlying performance in automobile insurance in the quarter, if you put cats aside, you see that the severity is well within check and the frequency is actually down a bit. And that's an observation that holds pretty much across the land.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. Next question, when I look at your direct premiums written that are done through the direct channel, it's up 12% year-over-year. So obviously quite healthy growth there. Can you give us a sense of where that's coming from? Is it primarily Ontario auto?

A - Charles Brindamour {BIO 7012323 <GO>}

There are two areas. The area where our direct operations are growing the fastest is in home insurance. And we've run – our combined ratio in home insurance in the direct channel has actually been in the 80s for a long period of time. So that's a place that's working well for us. Because it is a hard market, people are shopping and our direct operations have benefited from that.

The second area of good growth, as far as I'm concerned, in the direct channel, is indeed automobile Ontario. I would say that we're very comfortable with our pricing position there. We're very comfortable with our selection mechanism, as well as how we manage claims. So I would say home insurance, one, and then Ontario auto, two.

Q - Paul Holden {BIO 6328596 <GO>}

Good. And then, Charles, earlier, you mentioned that there continues to be cost inflation in personal property, no surprise there. But wondering if you can give us a sense of what kind of cost inflation you're seeing outside of cats and, therefore, what kind of rate increases we might see in 2015?

A - Charles Brindamour {BIO 7012323 <GO>}

I'm not sure I talked about cost inflation much in personal property outside of cats at this stage, but I'll let Patrick comment on your question.

A - Patrick Barbeau {BIO 18476397 <GO>}

I agree. I think, beside cats, I would say just the normal inflation in the cost of material and labor, but not more – not inflation in frequency, for example, outside of cats, more the normal (52:21).

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. No. Exactly right. I would say, Paul, if I look at how personal prop – let's take nine months, for instance – is shaping up on a current accident year basis. Frequency is down 1 point, severity is up 2 points, but then, as you know, our sum (52:40) insured is up 3 points. So net-net, the cost equation is actually improving, so to speak. And then on top of that, you add the rates, and that's why we feel pretty confident that our results in personal property are headed in the right direction.

As Patrick has mentioned, two-thirds of our action plan was rates, the rest was basically either product changes or cost reduction measures. And Mathieu, in claims, is working really hard at reducing the cost equation and we think that's working. So maybe, Mathieu, you want to give a few examples of what you're doing on the property side of things to keep the cost equation in check?

A - Mathieu Lamy {BIO 15207469 <GO>}

Well, first, we're working hard to internalize most of our adjusting, so we have reduced our alliance on external adjuster. And we think, given process and technology, we do a better job on scope and controlling costs when we do those losses internally. We've worked hard also on securing capacity ahead of events to help us respond to – to respond to big events or cat losses. And we're working ahead of events on protocol on how we're going to handle water losses and restoration with different vendors to enable us again to contain the scope of the work we have to do and ultimately the indemnity overall.

A - Charles Brindamour {BIO 7012323 <GO>}

And that, Paul, is not just in the case of cats.

A - Mathieu Lamy {BIO 15207469 <GO>}

No.

A - Charles Brindamour {BIO 7012323 <GO>}

It's in all cases. So we really cranked up control around appraisal, on-site reviews and things of that nature.

Q - Paul Holden {BIO 6328596 <GO>}

Got it. All right. So water losses were a pressure in the past on the cost side, but given the action you're taking, that's no longer the case. Okay.

A - Charles Brindamour {BIO 7012323 <GO>}

Well, no.

Q - Paul Holden {BIO 6328596 <GO>}

No?

A - Charles Brindamour {BIO 7012323 <GO>}

I wouldn't put it like that. I think that we're certainly correcting the pressure there, but we're not done and we're seeing momentum in the right direction, but I wouldn't want anyone to feel comfortable about us having tamed water damage at this stage.

Q - Paul Holden {BIO 6328596 <GO>}

Okay, okay. Next question, on the commercial P&C side, you said the average rate increase year-to-date is 5%. I think the average last quarter was 5%. So I'll take away that the average this quarter was also 5%?

A - Alain Lessard {BIO 17592535 <GO>}

Just short of being 5% rate increase on renewal on the quarter.

Q - Paul Holden {BIO 6328596 <GO>}

Okay, so roughly 5%. Okay.

A - Charles Brindamour {BIO 7012323 <GO>}

I think, Paul, what I liked about the quarter in commercial lines, of course, other than the 85% combined ratio, is the fact that our ability to sell has improved despite what we've done. And I think our retention has been fairly strong. So it's one thing to get rate increases; it's something else to grow in the market. And I feel we're in a better spot in Q3 than we were in the first part of the year. And I think it's the combination of both that we're positive about.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. A final question, there were some mark-to-market losses on the common equity portfolio in Q3. Looking at what the market did in October and some of your exposure to the energy sector, wondering if you're taking any response or change in security allocation post quarter-end.

A - Louis Marcotte {BIO 18040440 <GO>}

Nothing specific, Paul. The mix is staying fairly stable. We're monitoring it obviously, but there is no change in direction specifically on the allegations here.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. Got it.

A - Louis Marcotte {BIO 18040440 <GO>}

We are monitoring obviously the energy sector carefully.

A - Charles Brindamour {BIO 7012323 <GO>}

Oh, yeah. No. Absolutely. At the same time, I mean, if you look across all securities, our unrealized gain is pretty solid across the board. But obviously, we're looking at the market, as most of you are, with intensity, but it's really not something that's keeping us up at night at this stage.

Q - Paul Holden {BIO 6328596 <GO>}

Thank you very much for your time.

A - Charles Brindamour {BIO 7012323 <GO>}

Okay.

Operator

And our next question comes from Mario Mendonca from TD Securities. Your line is open.

Q - Mario C. Mendonca {BIO 2450557 <GO>}

Perhaps an all-encompassing question that would capture a lot of the things you've discussed on the call so far. In your opening remarks, you referred to the company's ability to outpace the market or the industry in terms of ROE. But I didn't get a good sense of what you think on an absolute basis your company's ROE capacity is. And if you could talk about that sort of in the context of what we've seen so far, like over the last 12 months, about a 15% GAAP ROE, but there was some elevated cats in there. So, could you help us think through, on an absolute basis, what you think this company's ROE capacity is?

A - Charles Brindamour {BIO 7012323 <GO>}

So, the industry has generated 10% over time. And if you look at 30 years or within cycles of seven years, you always tend to revert back to about 10%. We've said as a firm that we want to beat the industry by 500 basis points every year, which we have a pretty good track record of doing.

We also said that we're actually gearing the machine to generate more than 500 basis points because there are moments in time when the industry's performance is just not acceptable to only beat it by 500 basis points. And if you look at the industry performance in the past five years, six years, it hasn't been really good, quite frankly. And that's why we've outperformed by 700 basis points, as I've mentioned in my remark, which is not too far from how we're planning our actions.

We're asking Mathieu in claims to generate 300 basis points of ROE outperformance. We're asking the folks on pricing and risk segmentation to generate 200 basis points of ROE outperformance. Then from investment management and capital management, we're hoping to generate another 200 basis points ROE outperformance.

Now, I'm not saying that you should expect the machine to generate 700 basis points of ROE outperformance because we think that there are points in the cycle where you ought to reinvest to grow faster at high ROE. We think that's the best way to calibrate the economic levers in the business. We're planning for more. We're saying the objective is

500 basis points. The ROE of the industry is about 10%. So, in theory, you should expect north of 15% performance in the long run and we're planning for a little more than that; however, we keep room to reinvest. That's how I think about this.

Q - Mario C. Mendonca {BIO 2450557 <GO>}

That's helpful. And so when you said there are times when it's appropriate to reinvest in the business for better top line growth, and you said when the ROE is high, so what is a high ROE that would encourage you to reinvest for growth?

A - Charles Brindamour {BIO 7012323 <GO>}

When you get in the upper teens, Mario, when you get close to 18%, 19%, 20% type ROE, you really ought to ask yourself what one additional point of growth is worth and whether there's an economic logic to reinvest. And that's in that context that I talk about that.

Q - Mario C. Mendonca {BIO 2450557 <GO>}

And then, finally, excluding anything to do with cats, like, if you just consider the previous 12 months have been a normal cat period, do you think there's momentum in ROE at this point on an absolute basis for your company, not in relation to the industry? Would you expect ROEs to be improving because of all the actions you're taking?

A - Charles Brindamour {BIO 7012323 <GO>}

So let me first say, Mario, that 2013 was a real bad year. I mean, we got hit on all fronts. And that's certainly reflected in the industry's ROE, and our own operating ROE was about 11% in what was a real bad year. I think that's a point that's important to understand. To get back to your question, is there momentum in the ROE?

Well, first point that I will make is that, if you look at the underwriting performance, automobile insurance, we think, if you leave cats aside, we think we're in a largely neutral territory there. I say that not just because of Ontario, but I see pluses and minuses from coast to coast. We see rates up in Alberta; we see rates fairly flat across the land. We see a decent stability in costs in automobile insurance. And I would say this is an area where we don't necessarily see or expect much margin expansion.

I think, though, if you look at home insurance, there's clearly momentum on that front. And the actions that we're taking are bound to have an impact, and they have so far this year. And I would say same thing in commercial lines. If you look 12 months, the performance in commercial lines is completely unacceptable. And I think everybody feels that here. And that's why we've been taking action for a year or over a year. And to me, that should bring an improvement to the performance in that line of business because what we've done in the past year is just not good.

I'll let you judge on the interest and capital investment income and capital markets side of things. You're probably better equipped than I on that front. And then it's a question of using our capital effectively. And that's clearly an area where there's a lot of focus for my team in terms of expanding the business in economically very attractive ways. That's another lever in my mind.

Q - Mario C. Mendonca {BIO 2450557 <GO>}

That's helpful. Thank you.

A - Charles Brindamour {BIO 7012323 <GO>}

Thanks.

Operator

And we have no further questions in queue. I'd like to turn the call back over to Dennis Westfall for closing remarks.

A - Dennis Westfall {BIO 15155973 <GO>}

Thank you, everyone, for participating today. The webcast will be archived on our website for one year. The telephone replay will be available at 2:00 PM today until Wednesday, November 12. A transcript will be made available on our website. Please note we'll be hosting our annual Investor Day in Toronto on the afternoon of Wednesday, December 3, and our fourth quarter and year-end results for 2014 will be released on February 4, 2015.

That concludes our conference call for today. Thank you, and have a great day.