Q4 2014 Earnings Call

Company Participants

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

Other Participants

- Brian Robert Meredith
- Doug Young
- Geoffrey Kwan
- John C. Aiken
- Mario C. Mendonca
- Paul Holden
- Tom MacKinnon

MANAGEMENT DISCUSSION SECTION

Operator

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

Dennis Westfall, Vice President-Investor Relations, you may begin your conference.

Dennis Westfall {BIO 15155973 <GO>}

Thanks, Courtney, 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 under the Investor Relations tab on our website at www.intactfc.com.

As a reminder, the slide presentation contains a disclaimer on forward-looking statements, which also applies on our discussions 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 of 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 today. So earlier this morning, we announced a strong finish to 2014. Our fourth quarter net operating income per share of $1.84 was well ahead of last year, benefiting from a benign cost environment, favorable weather conditions, as well as our initiatives to improve profitability.

From an underwriting perspective, we ended 2014 with a full-year combined ratio of 92.8% with good contributions from both Personal Lines at 92.7% and Commercial Lines at 92.9%. 2014 was a productive year and that our hard work and at times difficult decisions began to pay off. Clearly, we had some help with losses from catastrophes closer to our expected level at about half the level of 2013. In combination, these factors led to an operating ROE of 16.3%, much improved from the 11% we reported a year ago.

Turning to our two primary financial objectives, 2014 significant rebound and net operating income per share, put our trend back on track with a 13% annual average growth since 2011, above our target of 10% per year growth over time. 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. And based on the most recent industry data at September, we've outperformed by 900 basis points so far this year.

When I look at the results we generated in the fourth quarter, I'm pleased with the broad-based nature of the earnings contribution. Personal property's performance was outstanding with a combined ratio of 73.6%, clearly better than what is to be expected on an ongoing basis. For the full year, this line reported a combined ratio of 89%, slightly better than our expectation. Personal auto's 93.7% combined ratio was a solid performance for a fourth quarter, improved from 2013, reflective of less severe driving conditions and higher favorable prior year development.

In commercial P&C, we've now seen two consecutive quarters where the environment was favorable after a string of difficult quarters. For the full year at 94.2%, commercial P&C's combined ratio was closed to 10 points improved versus 2013. Across all lines of business of IFC, an 88.2% combined ratio in Q4 is 8 points better than a year ago.

In Ontario, our process of reducing automobile rates began in early last April and has been focused on existing customers. In the fourth quarter, we filed a 2% rate reduction to reflect the benefits we expect from Ontario's Bill 15, which was recently passed. It also reflects the comfort we have with our ability to protect margins in this business as the government has been proactive on this file. That being said, additional meaningful cost reduction measures will be necessary for the industry to achieve the government's rate reduction target. Overall, we're quite comfortable to grow in this market.

I mentioned last quarter that we expected to improve upon the 1.3% underlying pace of top line growth shown in Q3. Q4's growth did indeed accelerate to approximately 3% as mid single digit growth in commercial lines and personal property offset slower growth in personal auto. We've talked about being an early mover with our 10-point improvement initiative in personal property while the industry continues to move and as market conditions are firmed and our relative position has improved. Units were down less than a point in personal property during the quarter despite the headwind from our full product changes and rate actions.

When it comes to our outlook for the industry, we foresee low single digit growth in personal auto while we expect upper single digit growth in personal property from continued hard market conditions. Commercial P&C has firmed in the past year. Rate increases at renewal for IFC in this segment were close to 5% in the fourth quarter. The low interest rate environment and minimal profits at the industry level gave us comfort in projecting a mid single digit level of growth for the industry in 2015 in commercial lines.

Now I realized that this commercial lines outlook differ slightly from that of the U.S., where many are calling for the return to soft market conditions in 2015. Well, I believe it reflects the market reality here in Canada. As for Intact Financial, our growth ambitions have not changed. Our financial position at year-end was strong with $681 million of excess capital. Our objective is to leverage our underwriting outperformance by reinvesting our capital to expand our position right here in Canada.

Organically, I expect growth to improve for a couple reasons. One, the industry outlook is conducive to organic growth. And two, our multichannel distribution strategy is actually gaining momentum. I expect that we'll have a more focused branding approach by the end of the year, which should allow for a more impactful marketing spend.

We've also been very clear that our direct and distribution operations are key areas of focus for growth in the near term. At the same time, we expect further consolidation to take place in Canada and intend to lead on that front. 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 in conclusion, I'm proud of what was accomplished this past year, and I want to thank our thousands of employees from coast to coast for their tremendous efforts. I believe they've enabled our company to begin 2015 in an excellent position, a position that should lead to profitable growth in the period ahead.

We recently reached the 10-year mark of being a publicly traded company. And today, we announced a 10% dividend increase, our 10th consecutive annual increase. Our track record of value creation speaks for itself, I think, as we've generated a 274% total return for shareholders in the past 10 years, well above the TSX as well as our peers. So we look forward to many successful years to come as we strive to maintain this track record of value creation.

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 focus on three topics this morning: our operating results, our lines of business, and our balance sheet. As Charles mentioned earlier, we delivered exceptional fourth quarter net operating earnings of $247 million or $1.84 per share on a combined ratio of 88.2% compared to 96.3% in the same quarter last year.

Weather was clearly a factor. Warmer temperatures were observed across the country. We incurred lower cat losses and we've seen lower frequency in all our businesses. But our own profitability initiatives, particularly in property lines, paid off as well as rate and product changes helped drive our overall underlying current year loss ratio to 62%. This is the best fourth quarter showing in the past five years.

On a full year basis, we reported a 92.8% combined ratio despite having experienced a challenging first half of the year and a fair level of cat losses. Strong underwriting results in the quarter were further complemented by healthy investment income of $111 million. This income reflects a higher level of invested assets on the back of strong operating cash flows. We expect the continued low yield environment to pressure our investment income in 2015, making it difficult to match the level recorded in 2014. Net distribution income in the year was $75 million, unchanged from 2013. We maintain our $100 million target of distribution income in 2015 as we continue to grow and support our broker channel.

On the expense side, better underwriting results in the quarter drove variable commissions higher, offset by savings in general expenses resulting in a slightly higher expense ratio compared to last year. For the full year, the expense ratio improved close to 1 point to 30.1%, driven primarily by savings in general expenses.

Moving on to lines of business, personal auto premiums increased 1% in the quarter, including the mandatory rate reductions taken in Ontario, which impacted both premium and units. The combined ratio improved 4.7 points from Q4 last year despite $13 million lower profits from pools. Favorable prior year development was higher in Q4, but comparable to historical levels on a full year basis. The underlying current year loss ratio of 73.5% improved 3 points year-over-year, driven largely by lower frequency. As Charles mentioned, we recently filed an additional 2% rate reduction in Ontario in anticipation of savings from the recently passed Bill 15 as we pursue growth in this market.

Personal property premiums grew 4% in the quarter as rate increases initiated in November 2013 under our Home Improvement Plan more than offset a small decline in units. Now that we have completed one renewal cycle, we expect rate increases to moderate going forward. All initiatives under our improvement plan have been rolled out and we estimate that the benefits were roughly 70% earned in the fourth quarter. Our combined ratio for the latest quarter was a remarkable 73.6% and led to a full year combined ratio of 89%, both significantly improved from 2013.

On the commercial side, auto premiums were up 9% year-over-year as we successfully acquired a number of large accounts. The commercial P&C business saw a good top line growth as well, thanks to firming market conditions and the completion of our efforts to reduce earthquake exposure in BC. In terms of profits, we experienced some quarterly volatility in commercial auto leading to a combined ratio of 99.5% in Q4, 1 point better than last year. On a full year basis, the combined ratio improved 4 points to 89.6%.

In commercial P&C, lower frequency of claims and our actions to improve profitability paid off as we've reported a strong combined ratio of 87.1%. Our actions, which were initiated in mid-2014 after reporting five unprofitable quarters, are too recent to be considered fully responsible for this quarter's strong combined ratio. Like commercial auto, the full year combined ratio of 94.2% is more reflective of the true performance of this line of business. We will continue with our commercial P&C action plan with the goal of running this business in the low-90%s on a sustainable basis.

Finally, a few comments on our financial strength. Our investment portfolio was of high quality and well diversified. The asset mix includes recently added U.S. exposure being 12% of our bond portfolio and 17% of our net common share portfolio. We believe that the benefits of geographic and sector diversification, as well as maintaining currency exposure on the U.S. common shares, outweigh the slightly lower yields on U.S. securities.

The portfolio generated net investment gains of $48 million in Q4 before recording $51 million of impairment losses. Such impairments do not impact our operating earnings nor book value as the assets are mark-to-markets. Of the impairments, approximately two-thirds were related to the energy sector. And as a reminder, only 6% of our total portfolio, net of hedges, is investment in energy securities.

We maintained our strong financial position at quarter end with an estimated MCT OF 209%, $681 million in excess capital, and debt-to-capital ratio below our target. Our book value per share increased 11% in 2014, primarily on growth of operating earnings. Our adjusted ROE reached 16.8% for the year, including the impact of carrying substantial excess capital.

We are clearly in an enviable position to pursue growth opportunities. On the basis of our balance sheet strength and earnings power, we are increasing our dividends by 10% to $0.53 per quarter, which represents a 12.5% annual growth rate when considering every dividend increase since the IPO in 2014.

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

Dennis Westfall {BIO 15155973 <GO>}

Thanks, Louis. Courtney, we're now ready to take questions.

Q&A

Operator

Certainly. We'll pause momentarily to compile the Q&A roster. Your first question comes from the line of Geoff Kwan with RBC Capital Markets. Your line is open.

Q - Geoffrey Kwan {BIO 7413168 <GO>}

Hi. Good morning.

A - Charles Brindamour {BIO 7012323 <GO>}

Morning, Geoff.

Q - Geoffrey Kwan {BIO 7413168 <GO>}

Just had a couple of questions. First off, in terms of your investment portfolio and the investments in the energy space, I believe you do some kind of total return swaps and the like. But I just wanted to get a sense as to the variability that we're seeing in the energy markets and what that impact might be on the investment book?

A - Charles Brindamour {BIO 7012323 <GO>}

So on that first question, as we mentioned, 6% of the overall portfolio is in the energy sector. So that includes bonds, spreads, commons, and what we call energy includes pipeline infrastructure, oil and gas producers, as well as integrated. Maybe, Louis, you want to add some color there.

A - Louis Marcotte {BIO 18040440 <GO>}

No, that's exactly right. So it's important to notice that we're not that heavily invested into producers, which are more likely hit. Important as well when we talk about the total return swaps that you net out the growth exposure. So we consider 22% of our net equity portfolio to be invested in energy and that represents a bit north of $350 million a year.

And because they're invested in high quality companies, not so much in the producers, varied between pipelines infrastructures as well, the volatility is not as important as we see. There is no high yield securities in the portfolio. That also limits the impact for us.

Q - Geoffrey Kwan {BIO 7413168 <GO>}

Okay. And just the other question I had was with the kind of expansion with Berkshire and CNA from what they've already got in Canada, just wanted to get your sense or your thoughts on what that might mean and whether or not they may also look to go further into Canada and how that impacts how you run your business.

A - Charles Brindamour {BIO 7012323 <GO>}

I'll let – both Berkshire and CNA are operating in upper-end commercial lines as well as specialty lines. I'll let Alain comment on their presence.

A - Alain Lessard {BIO 17592535 <GO>}

Well, I think you hit the first point, which is if you look at their license in Berkshire Hathaway, they look for licenses not only in Canada but in other countries. And their target is international and very large accounts, which is not necessarily the space where we operate mainly, since we – focus is more on small and mid size account.

That being said, we live currently in a very competitive environment. Adding another competitor and they're, in general, disciplined competitors, well, we think we have sufficient and we have the competitive advantage to face that competition. We have like the largest database in Canada, and we have all the expertise and the capacity to exploit that database.

We have a very good service both in terms of clients, customer and broker. We have a very good support of our broker going forwards. Our supply chains is well managed, and all of those advantage are not easily replicated – easily to replicate. So we think we have the competitive advantage to face any of those competition coming in. But as I said, they're moving in a space where we're not really present.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. And I think the bottom line is that if Berkshire Hathaway sees value in Canada, I'm glad with that perspective.

Q - Geoffrey Kwan {BIO 7413168 <GO>}

Okay. Thank you.

Operator

Your next question comes from the line of John Aiken with Barclays. Your line is open.

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

Good morning. I guess, just a follow-on question to that. Charles, what are you seeing about the distribution landscape, about the potential entrants and possible disruption along those lines?

A - Charles Brindamour {BIO 7012323 <GO>}

Well, I think there are important changes in distribution taking place in the near term and we think there will be even more important distribution changes taking place in the mid to longer term and we're clearly focused on managing the business with the mid and longer term in mind. And that's why, as I've mentioned in my remarks and as I've mentioned at the Investors Day, you can expect our brand architecture to become more streamlined and stronger. And you can expect our distribution platform to become more diversified precisely to prepare against these threats.

The other thing that we're putting a lot of emphasis on is digital leadership. We want to make sure that the interactions with our various business units, be it BrokerLink, Intact Insurance or belairdirect is leading when it comes to digital experience. So that being said, I mean, there are – we're seeing, in the near term, certainly different patterns and different regions, but companies tend to reach out in other channels.

You can think about the acquisition that was announced last year by one of our competitor in Québec that's actually extending its reach in the tight agency distribution. They're involved in broad distribution and in pure distribution like we are in the west of the country. For us, that's a very concrete example of branching out other than your core distribution network.

Because at the end of the day, I think consumers – you want to make sure your product is available to consumers regardless of how they want to do business with you, and we think that many of our competitors are headed towards that direction. So I think this though is just people branching out in existing modes of distribution today. So that's the short term. And I think we're well ahead of the parade there given our multichannel distribution platform.

I think the bigger play is what happens three years, four years, or five years from now or maybe less than that when you have big technology players who are not in the market today, who have strong brands, who have a very good understanding of consumer behavior, who have agile technology come in and start disrupting how the business is distributed.

We're not overly concerned about disruption in manufacturing per se, given our position, but certainly when it comes to distribution, it's fair to expect a disruption. We've seen that in other markets. And while there are a number of barriers in our market, I think, overall, we're getting prepared for some disruption. And I would say I would put at the top of the list big technology players here.

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

Great. Thanks, Charles. And if I can just tag in quickly for Louis. The distribution contribution, which is a net number within your sub-pack, dropped, I understand from the commentary it was related to some accruals. Can you us some additional color around what was driving that?

A - Louis Marcotte {BIO 18040440 <GO>}

Yeah. I would say the quarter four is the one where distributors accrued their respective CPC. So, in 2015...

A - Charles Brindamour {BIO 7012323 <GO>}

That's profit sharing.

A - Louis Marcotte {BIO 18040440 <GO>}

Profit sharing; variable commissions, I mean. And so in 2013, they had more and a bit less in 2014. So there's a gap that actually looks like the reduction. But it's really, I would say, conservatism on the part of how they accrue for the expected profit share or variable commissions during the year.

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

(23:50).

A - Louis Marcotte {BIO 18040440 <GO>}

So that is, in our view, sustainable. It's a bit seasonal in the distribution sector. So it's nothing that we think is sustainable. It's just the quarterly volatility.

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

Great. Thanks, Louis.

Operator

Your next question comes from the line of Brian Meredith with UBS. Your line is open.

Q - Brian Robert Meredith {BIO 3108204 <GO>}

Yeah. Good morning, everybody. A couple of questions here. First one, Charles and Louis, I wonder if you could kind of dive in a little bit more into what's going on with kind of the underlying loss trends here. What should we expect here going forward? I know you said in commercial kind of think the annualized number is a better one than kind of we're looking on a quarterly basis. Is that the same for property and auto lines given the favorable weather we had in the quarter?

A - Charles Brindamour {BIO 7012323 <GO>}

I think if I just take an aggregate picture of the results, all line combined, you see the combined ratio improved by 8 points. There's about 4 points of cat. And that is purely biased towards the property line. So a portion of the improvement in personal prop and commercial P&C is cat driven and as such, one has to take that into account as you think forward.

If you leave that aside and you look at the current excellent year performance, which improved by about 5 points, I think about that in three ways. The first way and probably the most important one is the fact that our corrective measures have brought in aggregate close to 3 points of rate increases, if you take all lines combined. And you know roughly what these numbers are by line of business.

But a big portion of the current excellent year performance is actually driven by corrective measures. This has been helped, from our perspective, pretty much across all lines by a stable cost environment. And by that I mean you see frequencies dropping in all lines of business; some lines more than other, but all lines of business.

And I think beyond frequency, we're operating in a fairly stable cost environment. There are many things that we do in particular in claims and underwriting that are not part of the corrective actions that we're talking about that are aimed at improving severity and cost inflation. And if I look across the business in Q4, I mean, there's been – even though frequencies have dropped, there's been no inflation in the system. Normally, when you see a drop in frequency, it often comes with a pickup in severity. This time around, we're seeing zero increase in severity across the book.

So I think that beyond cats, it's not all about weather. I mean, corrective measures are an important portion of the equation and then stable cost environment in part influenced by what we're doing is there. But the fact that we're seeing frequencies drop across all lines of business certainly add weight to the fact that we've had a milder Q4 with less precipitations.

Q - Brian Robert Meredith {BIO 3108204 <GO>}

Got you. So it sounds like a better point or two is maybe due to just the favorable weather, if I add up what you're saying?

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. As you know, this is hard to put your finger on it, but it makes sense.

Q - Brian Robert Meredith {BIO 3108204 <GO>}

Right. On the severity, you did mention that you had some severity issues in the quarter in the commercial auto. Can you dive into what exactly that was? As I recall, there were some issues in the fourth quarter of 2013 as well.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. So I'll let Alain Lessard, SVP Commercial Lines, talk about the commercial auto severity.

A - Alain Lessard {BIO 17592535 <GO>}

Yeah. Well, if you look at the commercial auto combined ratio in the quarter at 99.7%, there's a lot of volatility quarter to quarter. In this quarter, there was, as we review our reserve on a quarterly basis, there was an adjustment that related and generated about 6-point adjustment in the quarter...

Q - Brian Robert Meredith {BIO 3108204 <GO>}

(28:01)

A - Alain Lessard {BIO 17592535 <GO>}

...adjustment was booked in the quarter, but relates to the full year, and this is what has driven the severity up. If we eliminate that adjustment, the severity is about 2.5% increase. The current year loss ratio would have been 6 points better than last year reflecting better weather in current situation.

So we go back saying that the way we look at the profitability of this line is very much on the basis of the annual result of 89.6% and basically the 99.7% it's just kind of a blip related to adjustments.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. And for the sake of clarity, Brian, when you do an IBNR adjustment on the current excellent year, it shows up...

Q - Brian Robert Meredith {BIO 3108204 <GO>}

Yeah.

A - Charles Brindamour {BIO 7012323 <GO>}

...as severity.

Q - Brian Robert Meredith {BIO 3108204 <GO>}

Yeah. That makes a lot of sense. And then just lastly, quickly, we had a bunch of snow down here recently, I'm wondering if you guys experienced the same up there and any thoughts on kind of weather activity so far in the first quarter on losses?

A - Charles Brindamour {BIO 7012323 <GO>}

So Canada tends to experience snow, Brian. That's part of how we live. I haven't looked at the weather stats compared to last year and the year before. If we look at claims activity, Mathieu, just at the operating level, anything abnormal that you want to report?

A - Mathieu Lamy {BIO 15207469 <GO>}

No. I'd say we have a normal January, yes. It's a winter month, but (29:25)

A - Charles Brindamour {BIO 7012323 <GO>}

Clearly, there's seasonality, but we're not coming to the office with our shovels.

Q - Brian Robert Meredith {BIO 3108204 <GO>}

Understood. Thank you.

Operator

Your next question comes from the line of Tom MacKinnon with BMO Capital. Your line is open.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Yeah. Thanks very much for that, the comments there. I guess it wouldn't be an Intact conference call if we didn't ask what your thoughts were on the potential acquisition environment and maybe some global observation platforms as well if you can just elaborate on that, please, Charles. And then I have a follow-up.

A - Charles Brindamour {BIO 7012323 <GO>}

So with regards to the Ontario automobile market, when you said it wouldn't be an Intact call, no, I think that our view has not changed one bit there, Tom. I think we're still pretty clear that we'll see 15 points to 20 points of market share change hands. I think the combined ratio at the industry level certainly points in that direction, in particular with further compression on investment income.

I think that the changes we're seeing in distribution as well and at the distributor level and the repositioning that is taking place, from my perspective, is another indication that at the manufacturing level you'll see further consolidation. So I think everything points in that direction as well.

I think capital requirements are still shifting. I mean, there are capital requirements taking place in our industry. It happens to be very good for us. There are capital requirements shifting for banks, capital requirements shifting globally as well, and I think this adds to our view that there will be consolidation.

Q - Tom MacKinnon {BIO 2430137 <GO>}

And as a follow-up on the commercial lines, you said to be looking at – working towards your goal of low 90%s. And I think you had said in your – look maybe more at the annual 94% something and so there's still some room to go. I think you had said at the Investor Day that you're looking at an 8-point combined ratio improvement by 2016 in commercial lines. I think you were going to get 40% of that improvement in 2014, 40% in 2015, and the rest in 2016.

So should we really look at a continuation of a trend of probably in the area of a few point combined ratio underlying – underlying combined ratio improvement in the commercial lines in 2015 and maybe a little bit more in 2016 if – in order to kind of hit that forecast that you had indicated at the Investor Day? Do you still kind of stand by that?

A - Louis Marcotte {BIO 18040440 <GO>}

Yes. I think the number you quoted were pretty much in line with where we see it right now. We have about so far earned a little bit of about 3 points, and we still have something like about 4 points to go. So, basically, we're still aiming at low 90%s. We don't consider 94.2% as being low 90%s, but we still have a few point to go in 2015. And probably some little things left also to be earned in 2016. So I think we'd pretty much stand with what you quoted.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Obviously, that's not on – that's on the entire reported basis. Is that the way we should be looking that with normalized cats? Is that how we should be looking at that number then?

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah, I think that's right.

A - Louis Marcotte {BIO 18040440 <GO>}

Yeah.

Q - Tom MacKinnon {BIO 2430137 <GO>}

And then would that be – then the question actually becomes whether it would be normalized cats and that kind of thing in that kind of business. But I assume they've got to be somewhere around 2 points on the combined ratio would be more normalized cats for the commercial lines? Is that the way to think of that?

A - Charles Brindamour {BIO 7012323 <GO>}

I think we might have to come back on this one. I don't want to venture...

Q - Tom MacKinnon {BIO 2430137 <GO>}

Yeah.

A - Charles Brindamour {BIO 7012323 <GO>}

...into a cat normalization for one of four lines. I think, Tom, 94% is getting close to the zone as far as I'm concerned. But I mean if you look at the performance of that line of business, 94% is made up of 106% in Q1, 101% in Q2, 85% and 87%. So if I look at the work that the guys in commercial lines have done, what we've seen in the past six months, I feel pretty good about our ability to be in the low 90%s next year. It might be worth spending 30 seconds, Alain, on what is in the pipeline in terms of corrective measures at this time.

A - Alain Lessard {BIO 17592535 <GO>}

Yeah. Well, basically, our plan aims on four elements. The first one is rate increase at renewal, and we've been pushing rate increase to the tone of about 5% this year and that's on top of something close to 2.5%, 3% last year. That's about 7.5% cumulated since two year. Those rate increase at renewal are pretty much segmented.

And to give you an idea of the segmentation like the worst 3%, 5% is getting high double digit increase. The next 20% is getting pretty much 10%, 15% increase, and the rest of the book is getting minimal increase. So it's very much segmented approach. We spend a lot of time on managing, I would say, tail exposure. So we've reduced our earthquake exposure and the cost associated with that. That is behind us. It's pretty much done by the end of the fourth quarter this year.

We've also invested a lot in managing flood exposure through geo mapping, so I think we now have – and we presented that at the Investors Day, but we have now very good maps that give us the elevation of the risk compared to the body of water. So we can look at not only the distance to water but also elevation. We've adjusted the price according to it.

And we've invested a lot in segmenting our new business pricing to new algorithm. The GLM algorithm was implemented in July last year and the property algorithm will be implemented by the end of Q1 this year. So we think that those four factor combined together are really generating the plan and the necessary actions to get back to the low-90%s.

A - Charles Brindamour {BIO 7012323 <GO>}

Thanks, Alain. And I think that maybe to add to the context here, Tom, when you speak with operators in the insurance business and you talk about the state of the market, often you'll hear about the last bad tough market example, the last anecdote. And while anecdote are interesting, we try to look at broader basis of data.

And for me there's two data points that I track to assess the state of the market. The first one is our closing ratio. Our closing ratio is basically the number of times in commercial lines that we sell in relationship with how often we quote. And to put things in perspective, at the start of the year in Q1, we sold one policy for every three quotes basically, a little less than that. At the end of the year, we're closer to selling four policies for every 10 quotes. In other words, all that while we're doing what Alain has just described. So for me that's a clear sign that there is something happening in the market in the right direction.

The second key metric that I'd like to keep an eye on to put in perspective the anecdote is how much of the business will retain. So Alain is talking about rate increases close to 5%. Our retention between the start and the end of the year is up a couple of points, which sort of adds to the closing ratio picture for us to see, you know what, we're doing what we think is right in terms of getting towards the low 90%s and the market seems to be absorbing that positively. So I think we will keep plowing in 2015 and hopefully get into low 90%s.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay. Thanks for the color.

Operator

Your next question comes from the line of Paul Holden with 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>}

So your 2014 results with a 16% ROE and a 93% combined plus a lot of what you're messaging signals that we should expect the growth and the number of insured risks to start accelerating from here. So I want to ask two specific questions on that. I guess, first is, how do you feel about rate adequacy and growth prospects in personal auto outside of Ontario? And then secondly, sort of same question on personal property, but then inclusive Ontario.

A - Charles Brindamour {BIO 7012323 <GO>}

I'll ask Patrick Barbeau, SVP – Personal Lines, to give you some color on that.

A - Patrick Barbeau {BIO 18476397 <GO>}

So if I start with the auto piece outside of Ontario starting from the west, we've seen, in the past couple of years, more activity on the BI side. We recognized it early and we're at ease with where it's going on the bottom line, but that put some pressures up on rate. Hailstorm in Alberta also is putting some pressure upward on rates. So we expect upward rates to continue for a while in the west.

If I look at the Quebec situation, the rates have been stable and results as well for many years. So that's probably more flat outlook. And in the Atlantic, although it's small in terms of rate volume, this is also somewhat upward from a rate perspective. Units, though, overall, in all of those regions are fairly stable, but we believe we're in a good position to grow.

On the property side, the hard market conditions are likely to continue for another 12 months or 18 months. We've had outperformed the industry at the end of September by more than 8 points in that line of business. So it's clear that some of our competitors still need corrective actions. Our own rates will continue to go up, because of the unwinding of the capping, but to a lower extent than what we've observed in the last 12 months. And that situation on property is pretty much the same across the land.

A - Charles Brindamour {BIO 7012323 <GO>}

Good. Thank you. I think, Paul, I don't want people to think that growth will explode here, but there's clearly a change in trajectory the way I've sort of put on the call in Q3. And again, if we go back to data and just look at insured risks growth this year, we started Q1 with a unit shrinkage of 1.2% move to Q2 with a unit shrinkage of 1.1%, Q3 we shrunk by 0.9%, and Q4 we're growing by 0.4%. So I think you see that there is a trajectory there. We're not talking about double digit growth here, but certainly operating in an environment that's more conducive to some of the things that we're doing on an organic basis.

Q - Paul Holden {BIO 6328596 <GO>}

So right. So I wouldn't be expecting double digit growth, but how is sort of mid single digit type growth, which would be a big change from what we've seen over the last 12 months.

A - Charles Brindamour {BIO 7012323 <GO>}

That would be a big change from what we've seen...

Q - Paul Holden {BIO 6328596 <GO>}

Okay.

A - Charles Brindamour {BIO 7012323 <GO>}

...in the last 12 months.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. Fair enough. With respect to investment income, you provided some guidance at the Investor Day, which suggests that it should be relatively flat in 2015 versus 2014. Yields have come down surprisingly a large amount since then. So should we expecting now probably lower investment income year-over-year?

A - Louis Marcotte {BIO 18040440 <GO>}

I would say so compared to what we had in 2014, slightly below.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. Okay. Good.

A - Louis Marcotte {BIO 18040440 <GO>}

So just a notch below, but potentially (42:44) we won't reach the levels of 2014 as we see it now.

Q - Paul Holden {BIO 6328596 <GO>}

Got it. And then in terms of commercial P&C, if you look back at that string of, I think it was five consecutive quarters of unfavorable results and at that time or at least for the first few, you're sort of saying it looked like it was bad luck. There's no common factors that cut across all of the quarters. If you look back at those quarters now, would you still have the same conclusion that it looked like it really was just bad luck?

A - Charles Brindamour {BIO 7012323 <GO>}

I think, Paul, there were a couple of factors that showed up to influence these full results. One was cat and the other one was an abnormal level of large losses. I think our point was that it was difficult to establish a root cause for these large losses to a certain extent. So just providing some color on that basis and I'll ask Alain to give his perspective, because I suspect he thinks about that a lot.

A - Alain Lessard {BIO 17592535 <GO>}

Yeah. Well, I think what historical patterns have shown is that we're subject to higher level of volatility than some other line in commercial lines. And in fact, when you look at commercial P&C, it's made up of all sorts of lines. You've got surety losses there, you've got basically marine business, you've got E&L business as you've got your commercial property and liability regular business, and that's what we saw in the last quarter.

The sources of the variation was coming from all sorts of different line. So I think that when – that's why I said, when we look at the overall perspective and we look establishing the profitability of that line of business, we never focus on a single quarter but looks at normally even more than one year and adjust for trend and things like these.

So I think when we look at the string, our view that we were operating slightly higher than our, I would say, expected target of low 90%s and we needed an action plan, that for me is still the case, and we're continuing on the action plan, but I see that we were subject to, what I would call, normal volatility in the results. You may call that luck, but I would call it that's normal volatility from quarter-to-quarter of the results.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. It's just that when you have normal volatility five times in a row in the wrong direction, you start doubting and you put some action in place. But the view has not changed. And I go back to my perspective on our ability to carry on with our action plan and what it does to the top line closing and retention and new business production. The market can absorb it. So, in my mind, we're at 94%. Interest rates are coming down. The industry is losing money. We keep doing what we're doing.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. Good. And then finally, it's been just over a year now since you've launched your telematics offering. So I think it's probably fair to start asking some questions on that. What have you learned over the last year? Is the analytical predictability that comes at the telematics as powerful as you would have thought? Is it less powerful? And what kind of penetration are you getting through the broker channel versus the direct channel?

A - Charles Brindamour {BIO 7012323 <GO>}

All questions are good. I'll ask Patrick to comment on our perspective today.

A - Patrick Barbeau {BIO 18476397 <GO>}

Yeah. So we're now offering our UBI program in Ontario and Quebec, both channels, as well as in the New Brunswick in the broker distribution. The plan is still to launch in Alberta and Nova Scotia later this year. So far, both channels together, we have more than 60,000 clients enrolled in the program. That represents more than 250 million kilometers driven by those clients.

So we'll start to have a good database to analyze and confirm as you said how predictive it is. And we're very happy with the way it's going. The predictiveness of those new information that we gather are in line with our expectation. Of course, there will be adjustments down the road as we dig into that data.

From a take-up rate, it has picked up more quickly in the direct channel. When offered, the take-up is in the above 80%. But if you look globally on our new business, it's around 50% of our new business in the direct channel that go for it. In the broker, it's a bit lower, because not all brokers are as proactive as some others in offering it, but it's accelerating right now and we're close to 20% in the broker channel as well.

A - Charles Brindamour {BIO 7012323 <GO>}

So, Paul, I mean, this is a higher take-up than I originally anticipated in your number one, first point I'll say. The reason why we haven't launched in Alberta is because the regulator is not ready to see UBI in Alberta just yet. We're looking forward to do it, because consumers benefit from it and ultimately that's why we're doing it.

And then I think we're learning to deal with the massive amount of new data coming our way. I would say that it's one thing to work on predictability, it's another thing to create agility with such a new source of information and I would say that's focus number one right now. But that being said, so far, so good.

Q - Paul Holden {BIO 6328596 <GO>}

Thank you very much for your answers and your time.

A - Charles Brindamour {BIO 7012323 <GO>}

Thank you.

Operator

Your next question comes from the line of Doug Young with Desjardins. Your line is open.

Q - Doug Young {BIO 5640851 <GO>}

Hi. Good morning. And I'll be the guy with Ontario auto questions, Charles.

A - Charles Brindamour {BIO 7012323 <GO>}

I would have been disappointed if you wouldn't.

Q - Doug Young {BIO 5640851 <GO>}

I didn't want to let you down. So, Ontario auto, you've stated you've cut the rate 7.3%. You've mentioned further rate cuts have to be accompanied by further cost reductions by the government. So what I'm trying to understand is what are those additional cost adjustments are you anticipating? And I guess I'm kind of taking aback a big picture here. So if there is no further cost reductions that are implemented, can you just not reduce rates by the full 15%? Just trying to get a sense of how to think about that.

A - Charles Brindamour {BIO 7012323 <GO>}

Let me start with the last part of your question. I'll ask Mathieu to talk about some of the cost reduction measures in the pipeline and some of the cost reduction measures that we think will come. The industry is running at a combined ratio of 100% in Ontario auto, nine months into the year with the reforms that have yet to take hold.

So it's pretty clear, especially as interest rates decrease, that you won't get to 15% if there are not more cost reduction measures. I think it's clear at the macro level and I think the government gets that. That's why we feel there is momentum and a certain amount of productivity in terms of coming up with more meaningful cost reduction measures.

On that, I'll ask Mathieu to comment on what these could be.

A - Mathieu Lamy {BIO 15207469 <GO>}

So, first, Bill 15 introduces mainly three things that could help us control the cost. The prejudgment interest is lowered as of January 1, and we're expecting a reform of the DRS, the Dispute Resolution System, and regulation on the tow and storage costs. So those three things should help us reduce the cost. This is in the pipeline.

Pre-adjustment interest is effective right now. But the last two, we expect throughout the regulation toward the year-end this year. That should help us. We're also discussing in conjunction with IBC and government what could help us going forward on the accident benefit and on the bodily injury coverage reduce the cost.

And accident benefit, we're talking about a new definition of the cat impairment. What could that be? Could we go back to what it was before the case load that weakened that definition. We're talking about shortening the med rehab benefits from a 10-year period to a 4-year period, which is the case in most jurisdiction in Canada, introducing a psychological component in the minor injury guideline. That's on the AB side.

And on the BI side, we're talking about removing the fact that the deductible disappears. So keeping the deductible in our case at $30,000 on the general damages. And reducing the fees that are allowed to be recovered on the BI side. Those are some of the measure we're discussing right now to provide further relief on the rate side.

Q - Doug Young {BIO 5640851 <GO>}

And there's a sense that the government understands as more needs to be done for you to get to the full 15%. So the reality in the situation I portrayed where the government doesn't do anything and you still reduced the rates only 7.3%, that's a very low profitability would you say?

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah.

A - Mathieu Lamy {BIO 15207469 <GO>}

Yeah. We get a sense that they understand that they need symmetry on the cost side to have on the premium side.

A - Charles Brindamour {BIO 7012323 <GO>}

I think they get that.

Q - Doug Young {BIO 5640851 <GO>}

Okay. Okay. And then just – I know getting to the end of the hour here, but the other question that I wanted to ask, Charles, and again bigger picture, your positive reserve development has been running consistently about 4% to 5%, sometimes a little bit higher than that over the last while. And obviously, since you did the AXA transaction, should we be thinking about reserve developments now in the 4% to 5% range versus your historical 3% to 4%, and if not, why not?

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. I think there's no structural reason to start thinking about reserve development above the 4% range. I think that we stick by our perspective of historical or pattern of 3% to 4% in part driven by the fact that we use provision for adverse deviation in reserving in line with the Canadian Institute of Actuaries guidelines. And we try to be cautious in how we reserve. But there is no structural reason to think about a higher favorable development pattern.

Clearly, there have been contributing factors to a higher pattern in the past few years. Obviously, when reforms pan out to be better than what we anticipated, as you settle claims, your caution flows through favorable development. You've seen that for a few years here. So that would push us above historical pattern.

Clearly, the acquisition of AXA was an outstanding acquisition. And as I've mentioned, early in the process, the balance sheet was stronger than what we thought. And what that means in practice is that the reserves were stronger than what we thought. And that certainly helped go above the historical pattern of favorable development and a few other factors of that nature. But overall, one shouldn't plan for necessarily much more than what we've been guiding to in the past. When it's above that, that's good. We're happy. But that's not our plan.

Q - Doug Young {BIO 5640851 <GO>}

And sorry, I lied. I want to just kind of go back Ontario auto for one additional thing. Just the definition of what constitutes a cat accident, I mean, that's been going on for a long time. And do you feel that we're – because we've gone through iterations where FSCO and the government and you've created a new definition, it doesn't seem like that file has moved forward. Are we to a point where you think we could be breaking through on that particular issue?

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. I think that – it's one-third of incurred losses an accident benefit. So if you want to move the needle, you'll have to get down to business on these things, and I think they do want to move the needle. They realize that there's a lot of excesses. There have been leakage in terms of what is deemed catastrophically injured.

The objective is to protect the victims that need it the most, but to make sure that this definition indeed sends the money and the indemnity towards the victims that need it the most, not those that don't. And I think that the government clearly understands that. I think that they're thinking through how – I suspect they're thinking through how they can do that in a way that'll protect the victims properly, which is clearly our objective as well.

Q - Doug Young {BIO 5640851 <GO>}

Okay. Thank you very much.

Operator

Your last question comes from the line of Mario Mendonca with TD Securities. Your line is open.

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

Everything was covered there. Thank you very much.

A - Charles Brindamour {BIO 7012323 <GO>}

Thanks, Mario.

Operator

There are no further questions at this time. I will turn the call back over to the presenters.

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, February 11. A transcript will also be made available on our website. Please note that we'll be hosting our annual meeting of shareholders and releasing our first quarter results for 2015 on May 6.

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