Q2 2014 Earnings Call

Company Participants

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

Other Participants

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

MANAGEMENT DISCUSSION SECTION

Operator

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

I would now like to turn the call over to the VP of Investor Relations, Mr. Dennis Westfall. You may begin your conference.

Dennis Westfall {BIO 15155973 <GO>}

Thanks, Jeremy, 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 a 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; and Alain Lessard, SVP of Commercial Lines; and Mathieu Lamy, Senior VP 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, and good morning, everyone. Earlier today, we announced the second quarter net operating income of $206 million or $1.53 per share, much improved from the levels we've recorded in recent quarters. Improvement was driven by our underwriting performance with particular strength in personal lines and commercial auto. Overall, our 92.9% combined ratio was closed to 5 points better than a year ago.

Our solid underwriting performance was complemented by strong investment returns leading to growth in book value per share of almost 10% from a year ago. We reported an operating ROE of 11.6% despite the heavy cat burden in the second half of 2013. More recently, the annualized operating ROE for the first half of the year is closed to 15% aided by our property improvement initiatives, which helped deliver a year-to-date combined ratio of 92.6% in that line of business.

In property, we've talked about being an early mover with our 10-point improvement initiative. I'd say that the industry is catching up as market conditions have continued to firm and our relative position has improved. Units were down 1% in the quarter in that line of business, improved from being down 2% in recent quarters despite now reflecting our full product changes and rate actions. Though more time is required for our results to fully reflect our corrective actions, year-to-date, we've shown a 2-point improvement in our underlying loss ratio in our property business.

We maintain our positive view towards personal auto, a line of business that generated a combined ratio of 91.5% in the second quarter. Overall, we're operating in an environment where both competitors and regulators behave fairly rationally, and costs have been generally stable in the recent past.

In Ontario, the government's auto insurance costs and rate reduction strategy has so far led to a reduction in filed rates of 5.4% across the market as a whole. Our process of reducing rates to customers by 5.3% on average began in early April. We believe the newly elected liberal maturity government fully understands that further rate reductions can only come in conjunction with meaningful cost reduction measures. To this end, we're encouraged by the introduction of Bill 15, which is a combination of two pieces of legislation that had been impacted by the dissolution of parliament in the spring.

In the current environment, due to the cost reduction measures already implemented and our own proactive actions. We're comfortable with our margins in this market and we'll continue to pursue growth opportunities. While commercial auto delivered the very strong underwriting performance in the quarter, our commercial P&C business reported a combined ratio of 100.5%. Clearly, we're disappointed by these results and we're taking action.

Earlier this month, we implemented a new pricing algorithm with which we'll continue to push through even more targeted rate increases. We've also geo-mapped our risk to better highlight potential concentration issues. I expect these actions should enable this line of business to generate a combined ratio in the low 90%s.

When it comes to our outlook for the industry, we foresee low single-digit growth in personal auto and commercial lines, but upper single-digit growth in personal property. We continue to expect the current hard market conditions in personal property to accelerate for the foreseeable future. While we did not see significant acceleration in the first half of the year, the commercial P&C market has shown signs of firming in the past year. Renewal rates across the portfolio for us were up by close to 5% in the second quarter roughly double the pace from a year ago.

The low interest rate environment and elevated losses from catastrophes should support our growth outlook. From a profitability perspective, we expect the industry's combined ratio to improve in 2014, given the unprecedented level of cats seen in 2013. Overall, we expect the industry's ROE to trend back towards its long-term average of 10% this year. Looking specifically at Intact Financial, we believe we will outperform the industry's ROE by at least 500 basis points aided by our strong relative performance in Q1 with a combined ratio six points better than the industry.

As we've discussed in the past, our objective is to leverage this outperformance by reinvesting our excess capital into growth initiatives. At the end of June, our financial position was strong with more than $650 million of excess capital. Our view towards capital deployment has not changed. Clearly, our focus has been and remains on finding actionable manufacturing or distribution opportunities right here in Canada.

In fact, during the first six months of the year, we invested more than $160 million into our distribution activities. BrokerLink for example has grown its premiums from $625 million at the end of 2013 to $830 million today, well on its way to reach the $1 billion level we spoke about a few years back at Investors Day. Benefits from these investments are starting to become meaningful in our results as distribution income reached $30 million in the quarter.

I've also spoken many times about our planning for future growth. A portion of which we expect will come from abroad. It's in this context that we made a small investment during the quarter in an online insurance broker in Brazil. While we're still continuing to explore various opportunities around the world, we've decided to invest in distribution in Brazil, where we can leverage both our data analytics as well as technology skills. This investment is consistent with our strategy to expand beyond Canada in a prudent manner and build an organic pipeline with meaningful impact over time.

In conclusion, we remain energized by our prospects for the remainder of 2014 and beyond, and believe that the disciplined approach in operating our business will continue to serve us well. I'm confident that we're well positioned in the current environment aided by a strong capital position, which enables us to execute upon opportunities for profitable growth.

I'll now turn the call over to our CFO, Louis Marcotte.

Louis Marcotte {BIO 18040440 <GO>}

Thanks, Charles. Today, we reported our highest quarterly net operating income per share to-date of $1.53 per share, up from $0.89 last year. The improvement year-over-year was driven by solid operating results, including $110 million fewer catastrophe losses, compared to the second quarter of last year. The actions we took in the personal property line of business, in response to the severe weather continue to bear fruit and helped drive a combined ratio of 93.5% this quarter.

Lower catastrophe losses in the quarter were offset in part by storms in June that did not reach our cat threshold of $7.5 million. The continued severe weather has been supportive of hard market conditions, such that despite our rate and product changes, retention to date has been better than expected, helping drive underlying growth of 6% in the personal property line of business.

In personal auto, continued growth in our direct-to-consumer business and rate increases in Alberta were more than offset by the impact of government-mandated rate reductions in Ontario. Our combined ratio remains healthy at 91.5%, despite lower favorable prior year's claims development attributable mainly to risk-sharing pools and to quarterly fluctuations.

The commercial auto line of business continues to deliver excellent underwriting results, with a combined ratio of 79.5%, 10 points better than last year, aided by higher favorable prior year claims development and lower claims frequency. Commercial auto premiums were up 3% from a year ago, despite competitive market conditions.

On the commercial P&C side as Charles said, we are taking corrective actions as this line of business delivered a combined ratio of 100.5%, 8 points better than Q2 2013 on lower catastrophe losses, which were partially offset by higher claims severity.

Premiums in commercial P&C grew 2% in Q2 2014, despite our actions to reduce earthquake exposure and improved profitability in the worst-performing segments of our portfolio. Next quarter will be our final quarter under the earthquake reduction program.

Our expense ratio improved half a point from Q2 2013 to 31.3% driven by lower general expenses and reinstatement premiums in Q2 2014, offset by higher variable commissions. Our effective income tax rate of 14.7% benefited by 5 points from the settlement of an old tax file.

Net investment income of $105 million in the second quarter of 2014 was up 3% from a year ago as higher investments more than offset the small decline in yields. We expect net investment income in the second half of the year to be similar to the level reported in the first half of the year. We now have 5% of our portfolio in U.S. bonds and equities in order to provide geographic and sector diversification.

We remained in a strong financial position at quarter end with an estimated MCT of 208%, $657 million in excess capital, and debt-to-total-capital ratio of 17.8%. Book value per share grew 4.3% quarter-over-quarter to $36.29 driven by solid earnings and the positive impact from capital market strength.

Our results this quarter, again, demonstrate that we have both the expertise and balance sheet strength to build for growth. We are pleased with the performance of the home improvement plan, both from the top- and bottom-line perspective, and are taking corrective actions in our commercial P&C business with similar discipline.

This quarter, we have taken a first and prudent step towards gaining expertise in an international market through our investment in Brazil. But we continue to focus our growth ambitions, first and foremost, on the domestic market.

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

Dennis Westfall {BIO 15155973 <GO>}

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

Q&A

Operator

And 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. First question I had was just on M&A. I know you talked a little bit about the Brazil opportunity, as well as on the distribution side. I just wanted to get a sense from the Canadian, if I just focus on Canada first – on the manufacturing side, how that market is? Has it changed at all in the past quarter or two? Then also with respect to Brazil, obviously it is a small investment at the moment. But just kind of what – the thought process in terms of how you build this out going forward?

A - Charles Brindamour {BIO 7012323 <GO>}

Thanks, Geoff. I think from a manufacturing point of view in Canada, our perspective has not changed. We think they'll be 15 points, 15 to 20 points of market share that will change hands, probably within five years. We think it's not going to be back-ended, it's likely to be front-ended. And the catalysts for change really have not changed in that regard, so we see this clearly as the main area to deploy our excess capital in the near to mid-term, and that's right up there, on the list of things we're focused on.

When it comes to the investments we've made in Brazil, I think – and our thought process was the macro one that is identifying Brazil as a fantastic market to deploy our core skills of data analytics, of claims management as well as technology or web expertise. The investment opportunity that we found is small but leading edge as far as we're concerned. It is in distribution, and therefore, data analytics and web skill set are areas where we hope to lend some expertise in that partnership. We're in a minority position at this stage.

So, the strategy of the business units itself, we think is very exciting and potentially transportable. And then this is a fantastic platform to understand what we think is a fantastic market as well. And as we validate some of our assumptions over time, this is potentially a market where you could see more capital being invested, either in that investment or potentially in manufacturing in time.

Q - Geoffrey Kwan {BIO 7413168 <GO>}

Okay. Then just the second question I had was on Ontario auto, with the liberal win. With the conversations you have had with them, how has the tone or your sense of the speed and the potential magnitude of the changes that they are looking to put in place – has that changed versus pre-election?

A - Charles Brindamour {BIO 7012323 <GO>}

I've always been confident about the liberals' understanding of the issue and their intent to bring cost reduction measures to generate 15 points, even though I've said that 15 was really quite a stretch. We've engaged either through ourselves or the Insurance Bureau of Canada over the past year or two in very constructive discussions about cost reduction measures. And you've seen either and what's been done so far and what's in Bill 15.

Many of these measures, there's another long list of meaningful cost reduction measures that we've been talking about with them, and that they've been open about. And I think the fact that they're in a majority position really helps to make sure that they do what's best for Ontarians. It's I think less political and much more focused on getting the best outcome for Ontarians. So I think that net-net, the situation is positive as far as we're concerned.

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. Just wanted to expand upon the distribution that the increase. You talked about the deployment that took her (00:18:32) during the capital. What's the pipeline for additional deployment? And where do you think the run rate contribution for this can end up heading into 2015?

A - Charles Brindamour {BIO 7012323 <GO>}

So when it comes to distribution activities, John, there's really – you can think about it in two buckets. The first bucket is our broker link distribution platform, which I referred to in my remarks. This is clearly a business unit that has grown tremendously. We think that if you take a 24 to 36 months' perspective, we'll see meaningful growth on that side of the house. It's heavily personal lines driven. It provides tremendous optionality in distribution for us. And it's a big supporter of Intact Insurance. So it helps on the distribution front but I think in time, certainly, we'll move the needle in manufacturing front. That's the first half, and I will let Louis Marcotte, our CFO, to talk about his perspective for prospective earnings in that business.

The second half of the distribution operation are what we call broker financial services where we have a number of partnerships from coast to coast, 50%/50% partnership with very good brokers, very entrepreneurial brokers who understand that growing through acquisitions is the way to win the game in the personal line distribution. And that's the second half of our investments in distribution.

We're prepared to invest provided the returns in both these segments are very good. And clearly, a lot of upsides in BrokerLink and certainly a fair bill of upside in broker financial services, so two areas we're prepared to support. I've talked about the fact that this generated in the quarter only $30 million. So it gives you a sense, I think, prospectively of the earnings power, but I will let Louis complement some of the points I've made.

A - Louis Marcotte {BIO 18040440 <GO>}

So, firstly, on the pipeline, Charles talked about the pace in the quarter. We expect a similar pace going forward in the next 12 months, maybe a bit slower but in the same range. On earnings, on distribution earnings and I will point out that those are not including in our underwriting income. They're separately reported, but they're part of the operating income. And the run rate, annually, were roughly in the $75 million, and we expect that the acquisitions will grow that by 15%, 20% going forward. So it is a point of combined ratio if you compare it to premiums, and that will grow as we take it forward. And then, obviously, there are some premiums that will benefit from through those acquisitions.

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

Great. Thanks. I appreciate the color.

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. Good morning.

A - Charles Brindamour {BIO 7012323 <GO>}

Good morning, Tom.

Q - Tom MacKinnon {BIO 2430137 <GO>}

I was wondering if you want to elaborate a little bit more about what you are going to do to improve results in commercial and some of the actions you are going to be taking. It sounds like a rate hikes haven't been able to keep up with the increase in severity. It is – are you going to be planning on taking a little bit more segmented approach to your business with respect to commercial lines?

I know that this is a bit of a balance, because you have got to certainly maintain – you don't want to lose any of your good groups there, and you want to maintain your relationships with your distributors as well. So maybe you can elaborate as to what you might be looking at trying to do in commercial, and how long before we would be able to see the results hit your target of, I believe, low 90%s.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. So, I think, Tom, we're disappointed by these results and we will act and accelerate our action if needed until we're comfortable that this thing is going back in the low 90s. That's the first point I will make. Now, we've taken action based on slightly over a year of bad results which included some bad luck in there. And as such, we think that what we have in the pipeline right now is enough to get us in the low 90s, but it's in a quarter or two, our perspective change you'll see the actions change further than what we've changed right now.

And when I talk about – look, I'll give you an example, of course, there has been storms, we've had large losses from the past, creep up a bit, and when I look at the second quarter, unlike the previous three or four quarters, the commercial lines performance was highly uneven depending on the region and in fact, the poor combined ratio of 100% is driven exclusively by one region where the other three regions were operating well in the 90%s.

So I think what we ought to do is assess the opportunities available in the market where we can move the needle on rate, where we're convinced that it's not bad luck but pure bad performance and that's on that basis. Fair bit in the pipeline, and I will let Alain Lessard to talk about some of these action.

A - Alain Lessard {BIO 21962461 <GO>}

Yes, thank you, Charles. So I think, Tom, you have to look at also the rate increase, the keeping up of the rate increase. The rate increase in this quarter are about 4.8% basically 5% in the last two months and that's being increasing quarter-to-quarter for the last quarter. We started six quarter ago at pushing about 1.9% rate increase now we're pushing up to 5% rate increase. And those rate increase are not – they're in average, but they're pretty segmented – pushing a lot more rate increase towards the worst part of the portfolio, the worst 25% that we've mentioned so there's a little bit of time for that to take effect.

We've also implemented following the catastrophe of last year minimum deductible on flood coverage, okay? We're also have geocoded all our risk to improve the capacity management but I think that's important to understand that geocoding brings us also alternative because we will be implementing in the third quarter, new rates for sure backup and flood, and the flood territory are basically based on all the geocoding we've done on our risk to make sure that the risks that are within close vicinity of a river or exposed to flood are the one getting the higher rate increase or even higher deductibles.

We are also reducing our earthquake exposure. I think Louis mentioned that it's going to be the third or the last – the next quarter will be basically the last quarter of our earthquake management. This will translate also in reduced cost of earthquakes that will materialize in the future quarter.

We're reviewing broker performance in the worst region to make sure we're getting the best portfolio of the broker, we are not anti-selected. We have implemented in early Q3, basically two weeks ago, a new pricing algorithm based on GLM that will also help us improve the selection and the risk segmentation.

So we think that all of those, all combined together, are sufficient to bring us back to the low 90%. But like Charles mentioned, if more action are needed and are warranted following the next quarter, or two or three quarter, we're prepared to take on more action, both on rate selection or segmentation.

A - Charles Brindamour {BIO 7012323 <GO>}

Thanks, Alain. I think what's important to realize also is the fact that despite the fact that we think our commercial lines performance is not good, it's still industry-leading. And what that tells me in a low interest rate environment is that the industry is bound to change. And I think, Alain pointed to the fact that the industry has changed in the past year but it might be worth, Alain, giving some flavor on what you see in the market these days.

A - Alain Lessard {BIO 21962461 <GO>}

Well, like we've seen, we have a few facts that tells us that the market is really firming up. We are pushing more rate increase every quarter and our retention is still holding, we had pushed a lot of rate increase also on new business, mostly at the last quarter of 2013 and early in 2014, and we saw because of that some pressure on the closing ratio. The closing ratio is how much of our submission transform into a new business. So, we had seen a lot of pressure and a drop on that.

And in the second quarter, we're seeing an increase in our closing ratio on commercial P&Cs, so that's telling us that our rates are better accepted in the market. Okay? And on more anecdotal basis, we also see company pulling out from niche market. We're seeing company that are more and more taking a firmer stance in rate increase at renewal. Although there's still a healthy appetite for good profile or the best risk profile business, we see a lot more action anecdotally on increasing or firming up the market.

So, we think that this is in fact the reaction to low interest environment. We think it's about the third year in a row that the commercial P&C business had a combined ratio in excess of 100%. The insurance cost increased a little bit in 2014. So, all of that seems now to converge into a market firming up.

A - Charles Brindamour {BIO 7012323 <GO>}

I think, though, let's be clear, it's still very competitive for new business in aggregates. I wouldn't want people to think that we're headed full speed in a hard market at this stage. I think there's still a fair bit of appetite for new business in the market, but I think directionally speaking, we think it's headed in the right way.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Charles, you mentioned you think what's in the pipeline is enough to get in the low 90%s, although you sometimes you come across in a quarter a bit of bad luck. Was there any bad luck in this quarter? It doesn't look like there was any kind of cat loss issue, and the prior development was actually pretty good. So was there any bad luck in commercial P&C in this quarter?

A - Charles Brindamour {BIO 7012323 <GO>}

So the issue was the performance in the west primarily, and I will let Alain comment on what we've observed there because, as I've mentioned, all the other divisions had a pretty good performance. Not good enough but pretty good, just for the record.

A - Alain Lessard {BIO 21962461 <GO>}

Yes. So overall, the underlying loss ratio deteriorated by a few points versus year-on-year last year. It's driven basically by two elements. There's a little bit more large losses on a national basis, all of them mostly concentrated out West. We also saw an increase in severity. And the severity increase is driven pretty much by fire losses. We had more fire losses.

Although the severity was stable, the mix between liability and fire losses changed, and the severity of fire losses are much higher than any severity of liability, the severity of enlarged – in fire are both six times what we normally see our liability, which are smaller cases. So clearly, the fact that we have more fire, more increase on the fire side as translated into deterioration. And that relates to what Charles was saying because we have different quarters, and the situation from quarter-to-quarter has been very different.

Last year was pretty much cat driven issue. The first quarter was more related to weather losses as well as some large losses, but more water damage. And this quarter, it's much more out West fire losses that are being affected. So we don't see a common pattern or something emerging out in every quarter. But in spite that, it's still five quarter in a row that we're disappointed with the results, that's why we're taking the current corrective action.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. That's it. We're not going to rest until we're confident. This is headed in the right direction. Tom, at the end of 2013, we had 3 points loss ratio outperformance to the industry. So that feeds into our view about where the market is going.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay. Thanks very much for the color.

A - Charles Brindamour {BIO 7012323 <GO>}

All right.

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. So, Charles, I recall from last call that you appreciate the reflection questions. I want to change the topic of conversation a little bit here, away from commercial P&C, and ask about personal auto. One of your growth initiatives starting I guess well over a year now was to push the premiums written in GTA specifically, since you thought the risk-price dynamics had improved in that market. Is that still the case? And what kind of progress have you made?

A - Charles Brindamour {BIO 7012323 <GO>}

I guess it's refreshing to talk about Ontario auto in relationship with growth, Paul, so you can take that for credit. I think – so what's our perspective and our appetite for growth in Ontario automobile right now? I'll let Patrick share his perspective on the margin and as a result, what it means for us in terms of growth.

A - Patrick Barbeau {BIO 18476397 <GO>}

Yeah. Our view is still very positive about Ontario auto growth perspective. We have – the industry has taken a bit more than 5% rate decrease as we did as well at Intact. During the second quarter, we have implemented that rate increase and we were doing it a bit later than most of our competitors and...

A - Charles Brindamour {BIO 7012323 <GO>}

Decrease.

A - Patrick Barbeau {BIO 18476397 <GO>}

...decrease, sorry; I said increase. Decrease, 5% decrease. So, it put pressure a bit on our new business production during the quarter. But the reforms on cost reduction measures that have been implemented the ones that are included in the – they'll fit some of the other discussions we're having with the government allow us to be very positive about growing in Ontario and now that this first wave is there I think we're in better position to continue to grow the units in Ontario.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. No, exactly. I think we are assessing – it's been important – rate dislocations, as you know, across many markets. So we're in the process of reassessing where additional opportunities might lie for us. The folks in the direct channel, in better direct in particular, are seeing very healthy growth there and we're pretty comfortable with that growth. And I think the cost environment is actually pretty good.

I think reforms are holding pretty steady. We're pleased with the cost reduction measures that the government is talking about. And we're sitting with BI and AB adjusters last week just to make sure that we were in touch with what these guys saw, and I think very much a good environment to operate in. There is inflation. There's no doubt, a little bit of inflation in the system, but nowhere near what one could have expected as a result of reforms, so.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. Continuing on Ontario auto, rate reductions to date are roughly 5.5% with a 15% objective for August next year. 10 points, call it 9.5 points, 10 points over the next year seems like a pretty aggressive target. Is that achievable at this point?

A - Charles Brindamour {BIO 7012323 <GO>}

Well, I've always said that 15 points of cost-reduction measures focused on Accident Benefit would be very difficult to achieve. And I think I've said that from the moment that the number was thrown out. I think one way to get there, in which we've engaged the government, is to focus not only on Accident Benefit but to focus on the tort side of the house as well, on bodily injury litigation, so to speak, which is available for excess economic damages as well as pain and suffering awards if you're severely injured. We think that there's room there. And I'll let Patrick give his perspective on directionally speaking the sort of measures that could be considered to get towards 15%. So bottom line, long answer to say, 15% is a stretch. But I think it's possible to get there and it's the basis on which we engage with the government.

Go ahead, Patrick.

A - Patrick Barbeau {BIO 18476397 <GO>}

So the bill 15 that is currently being introduced, as Charles I think mentioned in his opening remarks, is the combination of two legislations that were put aside at the last – the last election. Those are worth a few points already in our view and we believe this bill will be passed quickly.

We are already in discussions through the Insurance Bureau of Canada and ourselves with different parts of the government to discuss some of the next steps that could be implemented quickly after the bill 15. And some of those – there are some that continue to be targeting the AB side. So I think the catastrophic impairment definition is one example, trying to shorten the med rehab benefit period from 10 to 4 years to be more in line with other programs from government. There's a threshold also in income replacement benefit that is being looked at.

The tort system and first, in the tort system there are a lot of the fees that are paid and that don't go directly to the injured. And that's the first part we would like to target. And there's also a discussion about potentially revising the filing process. Those are all ideas that are starting to be discussed and there's probably more than the 10 points needed overall in those actions. It's just a matter of how quickly now they can be implemented.

Q - Paul Holden {BIO 6328596 <GO>}

In the past, you have talked about the appetite to increase the proportion of premium that comes from the commercial P&C, including, I believe, through acquisition. Has that appetite changed at all, given your recent experience in the commercial P&C lines?

A - Charles Brindamour {BIO 7012323 <GO>}

Nope. Not all. I think the track record is a great one of 6 points (00:39:10) of outperformance in the past five years. I think that – Tom was asking earlier about segmentation and more segmentation in commercial lines. I would say that when I look at where Alain's team and the actuaries have taken our ability to segment in commercial lines, I mean, it's as sophisticated, if not more sophisticated than in personal lines. I think we have a great business model for small and medium businesses, and the more capital we could put there, the better. I think it's an important core competency of ours and, therefore, if we could put more capital there, we would.

The other area that we are performing quite well is in specialty lines. And specialty lines, in general, has been on upper 80%s and low 90%s segment of our business. We really bulked it up with the AXA acquisition, and I think we're still quite under represented there. So if we could capital to grow that segment, we certainly would.

And it's not the fact that the past four quarters, five quarters have been bad that will change our strategic perspective on that. I think if you have sustainable outperformance, you ought to build on that. But we have to operate in the low 90%s, and that's what we're focused on right now. So Alain, I don't know if there's anything that you want to add there.

A - Alain Lessard {BIO 21962461 <GO>}

No. But I think you've mentioned that specialty solution or specialty lines also remains an opportunity as our presence or our market share on those is very variable across Canada. And there is some – a region where we are really underrepresented in that segment, and that's opportunity for the future.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. Final question with respect to personal auto and reserve development there. A few quarters ago, I think you suggested that reserve development in that line of business was likely to stay above average for 12 months to 24 months. This quarter it came down, and you identified a couple reasons why. Is there any change in view with respect to the longer-term outlook – or I guess really the short-term outlook, the next 12 months, call it, having higher than normal reserve development?

A - Charles Brindamour {BIO 7012323 <GO>}

No, I think Patrick might want to give additional color on the favorable development but no, I mean it's just the three months, it's three months in automobile insurance, it's not a lot. It's within the range or view. Our view has not changed and if anything, I'm very comfortable with the reserving position that we have. Patrick, maybe you want to give a little bit more color there.

A - Patrick Barbeau {BIO 18476397 <GO>}

Yeah, during the quarter, there was a couple elements that contributed to the lower favorable development we have observed in personal auto. The first one is an unfavorable development coming from the pools of the RSP and the Facility Association. Most of it is coming from Alberta.

Development patterns in those pools contain lags, as they rely on data coming from many different companies. And as you know, on our side we have kept ourselves on top of the situation over the last 18 months, and we believe that this is just now the reflection of the same patterns that's the pool are doing, and that are already recognized in our own portfolio. So we don't expect this to have any impact on a – or any significant impact in the future from the assumed pools.

The other part that we can mention is also just on favorable developments on a very few large old files that affected during Q2. But that's also, in our view, just a one-time impact. When we combine those two considerations, I guess the prior year development during the quarter is very much in the range, as you mentioned, Charles. And year-to-date, even with those impact, it's also within the range of our long-term view.

A - Charles Brindamour {BIO 7012323 <GO>}

It might be good to get Mathieu's perspective at the end of the day, these guys are putting up most of their reserves so any additional color you can bring, Mathieu?

A - Mathieu Lamy {BIO 15207469 <GO>}

Yes, I'll – operationally, we see nothing that concerns us in the prior year development. And as you mentioned, we think the reforms are holding, and we have no adverse decision in arbitration so far. Our percentage of med cases is holding above the reform assumption in the mid-60s. In BI we observe a lower frequency increase than expected with their reform assumptions. So, as you mentioned, talking to adjuster on the floor, no trend that would concern us at this point.

Q - Paul Holden {BIO 6328596 <GO>}

Thank you for your time.

Operator

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

Q - Brian R. Meredith {BIO 3108204 <GO>}

Yeah. Good morning. A couple questions here. First, Charles, I was wondering on the personal auto segment, back there, your underlying combined ratio there, the ex-cat, ex-reserves development deteriorated on a year-over-year basis. Does that have anything to do with some of the delayed stuff coming through in Ontario as far as loss initiatives?

A - Charles Brindamour {BIO 7012323 <GO>}

I'll let Patrick comment. We'll focus on the underlying loss ratio maybe not get into expenses and commissions here, because that's where your question is going.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Yep.

A - Charles Brindamour {BIO 7012323 <GO>}

So I'll let Patrick comment on the fact that the underlying lost ratio deteriorated just a little bit during the quarter.

A - Patrick Barbeau {BIO 18476397 <GO>}

Yeah, it deteriorated by – it was less than a point during the quarter driven by severity. It's comforting, though, when you look at on the severity side the year-to-date numbers, the severity has not increased, so it's flat. So overall, when we look at the year-to-date number, the only impact that's left year-on-year is the increased frequency coming from the other winter conditions.

But if I go back a bit, and all the way up until prior to the Ontario reforms, you would recall that the underlying loss ratio there was in the 76%, 77% range. The Ontario reforms were expecting to get about 12 points improvement coming from Ontario, and the Ontario book being half of the overall book, that meant about 6 points overall.

And that's what you've seen in the two years after that in 2011 and 2012 with about 70% range underlying loss ratio. There was a slight deterioration in 2013, so a bit more than a point. But as you mentioned, Charles, there's normal inflation also a bit in the system. First quarter year-on-year was due to the hard winter conditions, higher frequency and as I said in Q2, just a slight deterioration. But nothing concerning from our point of view.

A - Charles Brindamour {BIO 7012323 <GO>}

No. I think, Brian, so it's 0.8% worse than the same quarter a year ago, and we've seen a bit of severity. We dug into severity and there are many pieces that make up severity. That's why we went, sat down with the adjusters in the past few weeks, tried to figure out whether there was anything of substance there, or any trend. And the answer is clearly no, in my mind. And again, at three months, so 0.8% deterioration, three months over three months, nothing concerning there.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Got you. Then my second question, just to go back to the commercial P&C, because I understand it's a little bit better. If you are talking about getting around 5% rate right now, and I think you said that also you expected the pipeline right now, what you see, is going to get you back to the low 90%s in the commercial P&C business. That would imply to me that the bad luck is close to 10 points of bad luck that you have been having over the last, call it 9 months. Is that correct?

A - Alain Lessard {BIO 21962461 <GO>}

Okay. I think – probably not totally correct, because we have other than only rate action coming through. We think that the rate action are giving us more than just the rate because the segmentation we see – the business we're losing on the renewal are the one where the rate increase are the largest. And these have had very negative loss ratio and combined ratio in the past. So there's more than just the rates affecting that.

We also have some impact coming from the reinsurance cost reduction and exposure on earthquake that's coming through. And it's going to come through more in the second half of 2014 but mostly in 2015, okay? Combined with some increase on deductible we see and some broker management, we feel that there's more than – if you think that the rates of about 5% would account for only 2 points, we see our – the overall plan as being able to generate something more in the range of the 5 points, okay? And that, bringing us to low 90s. Kind of the bad luck we see is much less than the 10 point. We say that's probably more in the region to 3 to 5 points.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Got you. Makes sense. Thank you.

Operator

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

Q - Doug Young {BIO 5640851 <GO>}

Hi, good morning.

A - Charles Brindamour {BIO 7012323 <GO>}

Good morning, Doug.

Q - Doug Young {BIO 5640851 <GO>}

First question, just going back to the prior year reserve development, I just wanted to clarify. So the historical average has been 3% to 4%. Is the indication that you anticipate that you will continue to be above that? Because you have been running quite a bit above that over the last while. And how quickly do you think you get back to the 3% to 4%? And then can you quantify – you kind of outlined two items that happened in quarter in personal auto. Can you quantify what the impact those two items had? That is my first question.

A - Charles Brindamour {BIO 7012323 <GO>}

So, you're at the very high level. I think one should think about favorable development going forward, thinking about the historical average. Is there a bias towards more than historical average in the near term. I would say probably. But I think you want to think about favorable development using the long-term average. Because the visibility around the bias above that is hard to have because it's about the maturity of the reforms. No, you'll have a bunch of new cost-reduction measures introduced in the system. Don't forget that we're going into it with expected impact. We'll need time to figure out what is the actual impact of those future cost-reduction measures.

The second point is BI. As you know, the lag between accident filing, serving the claim, filing the claim and settling the claim in BI is huge. And that has been a source of caution on our part. Every sign we're seeing there turns out to be better than what was expected when the reform came in. So I feel good about where we are from a reserving point of view. But we think about reserving prospectively in line with historical ranges, and we're very happy when it's more than that. But I wouldn't signal more than that necessarily with great certainty in the coming 24 months.

Q - Doug Young {BIO 5640851 <GO>}

And is it possible to quantify what those two items were in the quarter?

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. Absolutely.

A - Patrick Barbeau {BIO 18476397 <GO>}

Yes. If I combine the two elements I discussed, so the unfavorable development from the pools and a few large old files, in percentage of earned premium that would bring our ratio from 0.4% favorable development to around 2%.

Q - Doug Young {BIO 5640851 <GO>}

To 2%? Okay. The second question, I know in the quarter, I think in June, you had a bunch of losses that didn't hit the cat threshold, but I think it had an impact. Can you quantify what that was? And has that all been put through, obviously, in second quarter?

A - Charles Brindamour {BIO 7012323 <GO>}

So it's all been put through in the second quarter. There's no doubt about that. I think it's a hard one to quantify because you don't code these things as cat, and we don't have a code for almost cat. So I think this is when you get into ranges I don't know if Louis, you have more intelligent answer to give but it's a tricky one here.

A - Louis Marcotte {BIO 18040440 <GO>}

Yes, so it's roughly $10 million to $12 million in total in that range for those types. And those are really the ones that don't hit that 7.5 threshold that is in the month of June. So, that's roughly the space we're at.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah, I think when I look at the quarter myself, if I just share timeline here. April was tough, right? We had the tail end of the winter, a lot of water, a tough month and then May and June, despite those non-cat weather events, we're actually pretty good. Like we felt we were on a good run rate. So what the story doesn't clearly tell is that the tail end of the winter weather melting really hurt us in April. But then, with the Angus Tornado and a few things like that, hit a very nice run rate in May and June.

Q - Doug Young {BIO 5640851 <GO>}

Okay. Just my last question. The MCT I believe declined sequentially. I think that was a result of your required capital increasing. I guess my question is: What was that related to in the quarter? Was that just a shift of investment assets and required capital went up? Can you give some color?

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah, so we have the both impact, the higher assets and some investments in higher – that require capital, that really are the main drivers of it.

Q - Doug Young {BIO 5640851 <GO>}

Okay. Perfect. Thank you very much.

Operator

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

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

Good morning. This question sort of may capture some of the answers you have already provided; but, Charles, throughout the press release there is references to higher severity. It is in personal auto, it is in personal property, and also in commercial other. And I don't suspect those three are anywhere related. But can you add anything to that? Like what specifically do you think was driving that across the three segments?

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. So, I would say that property whether it's personal or commercial in the quarter, you've seen wind and storm events that lead to a higher average loss than what you normally see in a quarter. And that's true in personal lines, and that's true to a certain extent in commercial lines. In both personal and commercial, you've seen a greater mix of fires. That leads to a higher average loss in both personal and in commercial lines. So I would say these two things cut across the non-automobile lines of business. And in commercial lines, as Alain has pointed out, we've had a few large losses primarily in the west that have contributed to it. So, on the basis of property, I'm not concerned on the basis of these answers.

I think on severity, Patrick gave a pretty good answer in my mind which is not concerning to us and this is where I think in automobile insurance, while there is a reference to severity, frequency is actually going down. And that's why the underlying loss ratio in automobile insurance is only up 0.8%. And there's a number of small elements there that are, in our view, one-off in nature, but I don't think there's much more to it than that, Mario, and I can tell you that we've been peddling a fair bit in the past few weeks just to figure out what I've mentioned here, and where there was not anything else under. And at this stage, that's pretty much the story.

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

Okay. And then you make reference in your press release again – and this is something I think you always refer to – the increased arbitration proceedings in personal auto, Ontario specifically. Is there any connection between that arbitration or anything that is happening in the arbitration? Is there any new information falling out of the arbitration that could have impacted the reserve development in the quarter?

A - Charles Brindamour {BIO 7012323 <GO>}

I'll let Mathieu take this one, maybe give a broader arbitration perspective and then development in the quarter.

A - Mathieu Lamy {BIO 15207469 <GO>}

Yes. As the mediation have gone down, the arbitration has gone up at the level of the industry, but so far – and in our case, in fact, the number of arbitrations pending is quite stable over the last few years. So on that point, I think it doesn't have an impact on the reserved development.

In terms of decision on arbitration, we've seen only positive news, and we even had the recent decision that reaffirmed that the onus of proof that you're outside the MIG – is on the burden of that proof is on the person applying for being outside of the mix. So those are – this is a positive decision. There is no bad decision or adverse decision thus far. So I would say no, there's no impact here on the reserve development, thus far.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. I think that the thing we tried to understand, Mario, in the prior development, there were a number of large files whether it is BI, NAB. These files were looked at beyond the guys who manage these files to make sure that it's not something in the system that has led to a change in the reserve on these big cases, but rather new information on this file or these files that would change our perspective on reserves, if you know what I'm saying.

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

I do. So the information was specific to those cases and not something that you would apply broadly.

A - Charles Brindamour {BIO 7012323 <GO>}

Exactly right. And so there's about 20 cases across the business units that have been scrutinized by Mathieu and his team. And the very specific question they were after is exactly what you've asked, is there anything in the system that you could read through across these files. And I don't think the answer at this stage is yes.

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

That's helpful. Thank you.

Operator

And this concludes our Q&A session for today. I'd like to turn the call back to our presenters 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. A telephone replay will be available at 2:00 PM today until Wednesday, August 6. A transcript will be made available on our website. Please note that our Third Quarter Results for 2014 will be released on November 5. That concludes our conference call for today. Thank you and have a great day.

Operator

And this concludes today's conference call. You may now disconnect.