Q3 2017 Earnings Call

Company Participants

- Alain Lessard, SVP, Commercial Lines
- Charles Brindamour, CEO
- Darren Godfrey, SVP, Personal Lines
- Ken Anderson, VP, IR and Treasurer
- Louis Marcotte, SVP and CFO
- Patrick Barbeau, SVP, Claims

Other Participants

- Brian Meredith, Analyst
- Doug Young, Analyst
- Geoff Kwan, Analyst
- Jaeme Gloyn, Analyst
- Kai Pan, Analyst
- Mario Mendonca, Analyst
- Meny Grauman, Analyst
- Meyer Shields, Analyst
- Paul Holden, Analyst
- Tom MacKinnon, Analyst

Presentation

Operator

Good morning. My name is Kierstan and I will be your conference operator today. At this time, I would like to welcome everyone to the Intact Financial Corporation's third-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. (Operator Instructions)

I would now like to turn the call over to Mr. Ken Anderson, Vice President of Investor Relations and Treasurer. Please go ahead, sir.

Ken Anderson {BIO 19997596 <GO>}

Thank you, Kirsten. Good morning, everyone, and thank you for joining the call today. A link to our live webcast and published information for this call is posted on our website at intactfc.com under the Investors tab.

As a reminder, the slide presentation contains a disclaimer on forward-looking statements, which also applies to our discussion on this conference call.

Joining me here in Toronto today are Charles Brindamour, CEO; Louis Marcotte, CFO; Darren Godfrey, SVP of Personal Lines; Alain Lessard, SVP of Commercial Lines; and Patrick Barbeau, SVP of Claims. We will begin with prepared remarks, followed by Q&A.

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

Charles Brindamour {BIO 7012323 <GO>}

Good morning, everyone, and thank you for joining us today. Yesterday evening we announced third-quarter net operating income of CAD1.61 per share, an increase of 59% on the back of stronger underwriting results. Our top line was up 1% driven by personal property and specialty lines. Growth in personal auto and commercial P&C was tempered by our rate actions taken ahead of the market.

On the combined ratio 91.8% is a good overall result for the third quarter. While we benefited from lower catastrophes underlying performance in personal property and commercial P&C, it is very strong and improving. We also continued to see benefits from rigorous expense management. On the other hand, personal auto remains a drag on performance, and I'll come back to these results in a moment.

We also closed in the quarter the OneBeacon acquisition, putting in place a strong platform for long-term North American growth. And following the closing of OneBeacon, we ended the quarter in a strong financial position, with MCT above 200%.

Our operating ROE improved to 13.3% for the last 12 months and our book value per share is up 12%. When comparing ourselves to the industry at the end of the second quarter, we outperformed on ROE by 550 basis points. We expect to increase that advantage in the coming months.

So, let's look in more detail at our results by line of business.

Personal auto growth was muted in the quarter, as our rate actions, taken ahead of the market, are resulting in some top-line pressure, as we expected. Despite our rate and other actions, the combined ratio was disappointing. Prior-year claims development was unfavorable by 3.2 points, reflecting a couple of actions this quarter.

Firstly, in response to pre-reform trends observed earlier in the year on long-tail claims, we performed a detailed file-by-file review and increased reserves. We followed this with an actuarial review of the auto portfolio and took a more cautious stance, leading to additional net reserve strengthening. With these reviews now complete, we're in a much better position going forward.

The underlying auto performance deteriorated 2.2 points year over year, mostly attributable to pools and the impact of the net reserve change we recorded. Overall, our view is that the auto combined ratio run rate is currently in the upper 90%s. This is higher than we expected, given the actions taken so far, and certainly not an acceptable level of profitability.

While we've largely eliminated inflation so far this year in this segment, we expected a reduction in severity. It has not materialized as physical damage costs have risen more than anticipated. To address this, we're increasing our actions. We plan to take further rate increases across the country and to add to our claims management and segmentation initiatives. With the plans already in place, the further actions to come, and strengthened reserve levels, we're strongly committed to bring personal auto combined ratio back to the mid-90%s in the coming year.

When it comes to the industry outlook, we've seen rate increases now in many markets this year. We also see expansion of the industry risk-sharing pool and our non-standard auto business is growing. These factors point to a firming market condition across the country, and so we expect mid-single-digit growth for the industry in the coming 12 months.

In personal property, premiums grew 4% as rate increases were deployed in favorable market conditions. The combined ratio of 85% reflects excellent underlying performance, which positions this line very well going forward. With a combined ratio of 92.4% year-to-date in personal property and an average sub-90% for the three years prior, we believe this line of business is priced to take into account the ongoing levels of natural disasters.

The industry outlook for personal prop remains unchanged. Elevated catastrophe losses year-to-date support continued firm market conditions with mid-single-digit growth expected over the next 12 months as the industry continues adjusting changing weather patterns.

Looking at commercial P&C, on top line we see rate increases flowing through in select segments, while conditions overall remain competitive. This line of business continues to produce excellent results. Excluding the unusually-high favorable prior-year development from diversification, this business delivered an impressive combined ratio just over 80%. Our pricing and segmentation actions are paying off nicely and this line, too, is well-positioned moving forward.

In commercial auto, premiums grew 5% on the back of multiple initiatives, in specialty lines in particular. The combined ratio for the quarter was very strong at 86.8%. We continue to drive our profitability actions to deliver a sustainable 90% combined ratio in this line of business.

In terms of outlook for commercial lines in Canada, we expect low single-digit growth in the coming year as markets remain fairly competitive across the country.

Turning to our recent strategic expansion, we closed the acquisition of OneBeacon on September 28, few months after announcing it, combining the strength of our specialty teams in Canada as well as in the US to create a leading North American specialty lines insurer. Under leadership of Mike Miller actions are well underway to grow the business and leverage the stability of IFC's ownership and expertise that will be provided to OneBeacon and its distribution partners.

New growth pipelines are now open with underwriting desks on each side of the border supporting customers with businesses in both countries. We're leveraging the OneBeacon industry-leading expertise by introducing new specialty products in Canada as well. We recently launched an entertainment product and technology products will follow in the coming weeks.

Our OneBeacon profitability improvement plan is also in progress. The company has exited both programs, as well as architects and engineers lines of business. We're also using Intact's analytics and segmentation to take underwriting actions in select other lines. Our proven claims practices are also gradually being deployed in the US.

Then additional synergies are being realized and risk mitigation is in place, both of which we will describe in a moment. We are increasingly confident that our plans will bring the US combined ratio to a low 90%s level within 24 to 36 months to deliver mid-single-digit run rate accretion to net operating income per share by the end of 2019. This is before the growth upside we now see from being able to serve new customers across borders and export our products North and South.

Early observations on US market conditions following closing are better than anticipated. We remain focused on Canada, though, where we continue to accelerate our customer-driven strategy. Leveraging our growing digital talent pool, belairdirect launched its mobile app, while Intact expanded its telematics offer via mobile. We completed the rollout of our online client center from coast to coast, simplifying our customers' lives while gaining efficiencies.

We also began the roll out of our next generation of advanced pricing tools with the launch of our first machine-learning rating algorithm for automobile.

In conclusion I'm pleased with the underlying performance and continued momentum in personal property and commercial line. In personal auto, the reserving actions we've taken position us well, while profitability initiatives will improve our results in the coming year. We're already rolling with OneBeacon, which opens up significant growth pipeline for our business.

Our financial position is strong and momentum is good as we execute with a customer-focused mindset. I'm confident we have the strategies in place to deliver on our financial objectives to outperform the industry ROE by at least 500 basis points, then grow our net operating income per share by 10% per year over time.

Before I finish, I want to take a moment to recognize our people. From coast to coast, our folks are engaged and work tirelessly to improve our performance, widen our advantage, and expand our leadership, and I want to thank them as they really make a difference.

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

Louis Marcotte {BIO 18040440 <GO>}

Thanks, Charles. Good morning, everyone.

Third-quarter net operating income of CAD219 million was CAD82 million better than last year. Our results were driven by lower cat losses and strong underlying performances in personal property and commercial lines, but disappointing results in personal auto.

Earnings per share grew 37% to CAD1.25, driving operating ROE to 13.3%. Our book value per share increased 12% year over year and 10% since Q2.

Our financial position continues to be strong. We closed the quarter having completed the OneBeacon acquisition with an MCT above 200% and approximately CAD1.2 billion in total capital margin, a new metric we use as a measure of our consolidated capital strength. Debt to capital was just below 25%, exactly where we were aiming at announcement. We still expect to bring our leverage back to 20% within two years.

There were two significant items that impacted our reserves this quarter. Firstly, the acquisition of OneBeacon required us to harmonize our actuarial practices which were previously based on Canadian standards. Our revised approach is aligned with IFRS and the practices of global P&C peers. Now that we have operations in Canada and in the US, we recognize the benefit of risk diversification between lines of business and between countries, leading to a reduction of claim liabilities.

The second item is the strengthening of reserves Charles described earlier, which reflected a more cautious approach and impacted mostly personal auto. Although these two items are independent of one another, they can be looked at in isolation as they both are essential in assessing the overall adequacy of claims liabilities.

Together, they had a net positive impact on underwriting income of CAD39 million, or 1.9 points of combined ratio. This benefit is unevenly distributed between lines of business and half of it is included in prior-year development and the other half in current year.

Let me provide some additional color on personal auto, where we remain very focused on improving performance.

Our action plans are delivering as expected with earned rates up 4.4% in the quarter and written rates up 6.5%. Our segmentation actions are also translating into an improved mix of business and a higher-quality portfolio, which ultimately will lead to a lower loss ratio.

Despite this progress, the underlying loss ratio remains above our expectations, mainly due to the higher prices for parts and the time needed to replace them.

The combined ratio is elevated at 105% for the quarter and 102% year-to-date. If we normalize for the net reserve change, prior-year development, and pools, we see the combined ratio running in the upper 90%s. Between the existing action plan and further actions being taken to tame claims' cost inflation, we expect our combined ratio to progressively improve towards a mid-90%s target in the coming year.

Our cat losses in the quarter were well below last year and below our expectations. On a year-to-date basis, however, cat losses are still elevated. With the addition of OneBeacon, we are increasing our guidance for cat to CAD275 million. We still believe 75% of cat losses will impact personal lines and about 50% are likely to occur in the third quarter.

Our rigorous expense management had a noticeable impact on our results, with a 1.6 point reduction in the Q3 expense ratio and 1.8 points year-to-date. This was driven by lower variable expenses and cost-saving initiatives.

At the same time, we continue to invest in our brand, in customer experience, and in technology.

Turning to distribution income, we added CAD30 million of operating earnings in the quarter, bringing year-to-date growth to 19%. However, our full-year forecast for 2017 growth is unchanged at 15%, as indicated last quarter, given a reduction of variable commissions. Net investment income of CAD101 million was essentially unchanged from last year, as the benefit of higher invested assets was partly offset by the continued low rate environment.

Now turning to OneBeacon. As the transaction closed at the very end of Q3, our US operations had no impact on our underwriting and operating results for the quarter. However, there were a few items which did impact non-operating results.

We had about CAD30 million in integration costs, including the net cost of the adverse development cover. There were CAD23 million in investment gains related to the US book value hedge. Going forward, gains and losses on this hedge will flow through OCI.

OneBeacon's balance sheet is now fully consolidated with ours, after converting it to IFRS and into Canadian dollars. We reflected the fair value of the acquired assets and liabilities, including strengthening of reserves at closing. Between the adverse development cover we purchased and the strengthened reserves, the risk of our results being impacted by adverse development from OneBeacon has been significantly mitigated.

With the acquisition behind us, we are totally focused on improving the combined ratio to the low 90%s. Our profitability improvement plan is based on three levers. Charles covered our progress in the lines of business, as well as our claims initiatives. On the third lever, expense synergies, we expect to generate $25 million of savings within 24 to 36 months.

After nine months in 2017, we estimate OneBeacon's normalized combined ratio to be in the upper 90%s, which is our starting point to measure progress. Our profitability improvement plan is expected to deliver 6 to 8 points of enhancements and generate mid-single-digit accretion to IFC's operating income within 24 months.

Let me provide some additional detail on OneBeacon and its contribution to our results going forward.

OneBeacon will be reported separately as a stand-alone line of business. Its results will, therefore, be readily available in our reports. OneBeacon's direct written premiums will increase IFC's top line, starting in Q4 2017, and we expect the impact to be in the mid-teens. The addition of OneBeacon's investment portfolio to IFC's will provide CAD50 million annually, Canadian dollars, in incremental investment income.

And, finally, on the tax side, there's minimal impact from the addition of OneBeacon to our operating effective tax rate in 2018. It should remain in the 20% range.

After reflecting the acquisition on our balance sheet, our financial strength metrics remain strong. We introduced the metric, capital margins, to reflect our consolidated capital level. It is similar in concept to our previously-disclosed excess capital and is well defined in our MD&A.

With a capital margin of CAD1.2 billion and a debt-to-total capital ratio below 25%, we remain ready and well-positioned to participate in Canadian consolidation opportunities as they arise, both in manufacturing and distribution.

In conclusion our Canadian business is showing its resilience thanks to the diversity of our businesses. Our property lines are performing very well. Commercial auto is improving and we are near our targeted low 90%s run rate combined ratio. Personal auto remains a drag on our performance, but we are not relenting on our goal of getting the combined ratio to the mid 90%s.

Our North American specialty business is on solid footing, giving us a strong presence in the US and in Canada. Our transition plan with OneBeacon is well underway and we are beginning to deliver on our targeted combined ratio improvements. We remain focused on delivering on our financial objectives, growing operating earnings over time, and outperforming the industry on ROE.

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

Ken Anderson {BIO 19997596 <GO>}

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

Questions And Answers

Operator

(Operator Instructions) And your first question comes from Kai Pan with Morgan Stanley. Please go ahead, your line is open.

A - Charles Brindamour {BIO 7012323 <GO>}

Good morning, Kai.

Operator

Kai Pan, your line is open. You may be on mute.

Q - Kai Pan {BIO 18669701 <GO>}

Hello, can you hear me?

A - Charles Brindamour {BIO 7012323 <GO>}

Good morning Kai. Yes, absolutely.

Q - Kai Pan {BIO 18669701 <GO>}

Yeah, I'm sorry, we were dealing with new phones here.

So my first question is on personal auto and on the higher physical damage. So, just can you give a little bit more detail about like when do you find it out and what action you are taking, and your ability to raise rates and what time -- like a timely fashion? And what give you comfort that you can improve the personal auto combined ratio to 95%-ish in the next 12 months?

A - Charles Brindamour {BIO 7012323 <GO>}

Thanks for your question, Kai. I think we've seen physical damage inflation for a few years. Our action plan anticipated to address those and I think in the past, say, nine months we've seen that trend pick up a bit. Therefore, the need to increase our action plan.

If I look year-to-date in aggregate at the automobile performance, severity is up 0% in aggregate. Frequency is up 1%, in part because of winter conditions in Q1. So, what we've done so far is largely, in my mind, broken the back of inflation in aggregate. But given the actions we've taken to improve the quality of the portfolio and the risk selection, we would have expected, actually, a reduction in severity.

And so as we dig to find what is upsetting that expectation, we realize that there is more inflation in PD than we anticipated, say, nine months ago. Therefore, the need for greater action.

Now, I'll ask Patrick to give you a bit of color as to what we're seeing in physical damage and some of the actions we've taken so far in the past year or two, and what's in the pipeline. And then we'll ask Darren to get into pricing and underwriting, and why we feel good about our ability to take the combined ratio in the mid 90%s.

So, Patrick, why don't you give it a crack?

A - Patrick Barbeau {BIO 18476397 <GO>}

Sure. As Charles mentioned, the cost pressure on physical damage that has accelerated recently is only on the severity side. We've seen the cost of parts and the complexity of repairing or replacing those parts go up, so also additional labor cost in the repairs. This clearly points to the general sophistication of newer car models and the general technology advances in cars.

Just to illustrate, I guess with simple examples, what we're saying, I could just mention the accelerated number of cameras and sensors of all sorts that we see, for example, in mirrors, bumpers, and windshields. And when you think of those three parts in particular, they are often the first ones getting damaged in car collisions so -- and we've seen the trend on those things accelerate in newer car models.

So, clearly, direct costs that are coming from those parts, but also indirectly it increases other parts of the overall indemnity. When you think of rental costs, when it takes more time to repair, those costs go up as well. Same for the percentage of total losses. So, we've got more to repair, more cars are deemed total loss and that adds to the cost pressure.

And, finally, it also adds pressure to towing and storage fees, because when it's more complex repairs, it's tougher to identify upfront if they will be repairable or should be deemed total loss right away, and we see more storage and towing around costs that we can address.

A - Charles Brindamour {BIO 7012323 <GO>}

And I would say, Kai, overall, this is not a new observation. I would say that the breadth of the impact on stuff like storage, towing, and rental days are certainly bigger than what we anticipated six to nine months ago. We've been on that trend for a while, but clearly need -- more needs to be done.

Why don't we talk about pricing underwriting, what it means in practice, Darren?

A - Darren Godfrey {BIO 19791482 <GO>}

Sure. Thanks, Charles. So, from a starting point, where do we see the current run rate today? So, we've done a lot of -- obviously, as we always do -- a lot of bottom-up analysis from an actuarial standpoint. Looking at our current trends that we see from a claims cost standpoint, where we're at from a rate standpoint today, normalizing for cat pools, et cetera.

We see our current loss ratio run rate in the mid 70%s today. You throw on top of it expenses, takes us into the upper 90%s. So, when we look at our outlook around mid 90%s anticipated within the 12 months, what are the actions we're going to look at from -- to bridge that particular gap there?

So, first comment I would make, though, is that much of the 2017 actions that we're undertaking today, whether that be rate increases, segmentation, risk selection, claims, et cetera, we'll continue to earn into 2018. We will be looking to make further improvements into our risk selection models and re-underwriting the worst segments of the portfolio as we continue into 2018, as we have done actually in 2017. But we will be filing further rate increases from coast to coast, with a very strong bias from a segmentation standpoint to better refine our rating to reflect the trends that we're seeing from a physical damage standpoint.

As Patrick alluded to, augmenting our claims action plans to really address the residual inflationary pressure we see today. So, when we look at it from a rate standpoint, we are expecting roughly 4 combined ratio points of improvement through rate increases that will earn into 2018. What I should say, though, is that of those 4 points, 3 points are already in the bank today from rate increases that we've already taken in 2017. So, 75% of that improvement from -- purely from a rate standpoint is already in the bank today.

A - Charles Brindamour {BIO 7012323 <GO>}

By "in the bank" we don't mean earned today, but rather rolling in the system to be earned next year. So the risk of getting those 4 points is small, given that 3 is already in the bank.

A - Darren Godfrey {BIO 19791482 <GO>}

Thanks, Charles. And further to that, when we look at our non-rate actions -- so in other words, risk selection, underwriting, claims, et cetera -- together with our augmented claims action plan, as Patrick has described, when we look at that net of our expected claims inflation, we're expecting to see a further 1 point of improvement in combined ratio. So that gives us, essentially, a 500 basis point improvement. So, if we're starting from an upper 90%s position, that positions the portfolio quite well to achieve a mid-90%s within the coming 12 months.

Q - Kai Pan {BIO 18669701 <GO>}

Great. Thanks so much for the details. My follow-up question is on the other three segments, which underlying results have been excellent. I just wonder how sustainable are those results going forward.

A - Charles Brindamour {BIO 7012323 <GO>}

Well, I think that, overall, you look at personal prop -- let's start there -- you'll recall, Kai, previous quarters people were saying are you pricing this properly and can you make money in home insurance. Combined ratio year-to-date is slightly above 92%. The average combined ratio in the past three 3 years, including the Fort McMurray year was sub 90% and there's still momentum in terms of protecting those margins there.

So, is a combined ratio sub 95% in bad times and in the upper 80%s, low 90%s in personal prop sustainable? I think that's what we've shown in the past 3.5 years.

If you look at commercial lines, it's been running steady in the mid-80%s. If you look at commercial auto, we said we would get in the 90% range. It's been there now for a number of quarter, there's actions to support that. So, I think in commercial P&C you want to strip the extra favorable development that's taking it in the 70%s. We don't think this thing is running in the 70%s, but it certainly has a strong momentum to stay in the 80%s for a while.

I'll ask Darren to give a perspective of the marketplace in personal prop and some of the things we're doing there, quickly. And then I'll ask Alain to give a perspective of our performance in commercial P&C and commercial auto, and his perspective for those lines of business going forward. So, Darren.

A - Darren Godfrey {BIO 19791482 <GO>}

Thanks, Charles. So, from a personal prop standpoint, we continue to see firm conditions in the marketplace pretty much coast to coast, reflecting the new reality of natural disasters that we see.

Thanks, Charles. So, from a personal prop standpoint, we continue to see firm conditions in the marketplace pretty much coast to coast, reflecting the new reality of natural disasters that we see. So, we continue to -- as Intact, but also from an industry standpoint, we're continuing to see low single-digit rate increases flowing still through personal property. We don't see that abating and we expect sort of the growth to be in that sort of mid to upper single digits moving forward, from a personal prop standpoint.

Obviously, we've made a number of our product changes within the last few years and that's creating that sustainability, as Charles alluded to, from a product standpoint.

A - Charles Brindamour {BIO 7012323 <GO>}

Thanks, Darren. Alain?

A - Alain Lessard {BIO 17592535 <GO>}

Well, when we mentioned in the commercial lines P&C, we are in a competitive market that remains competitive, and in such a market for us, it's very important to protect our margin, our underwriting margins. And currently, we -- despite the competitive market, we are passing rate increase in commercial P&C to the tone of slightly less than 3% and these rates will continue to earn over the next 12 to 18 months.

On top of that, if you look at the growth and the mix of our portfolio, if I were to separate, if you want, that portfolio into two pockets what risk -- where we think these are very profitable risk, the part would currently be growing at about mid-single digits. And the other part, which is risk where we think there are still some action needed, this part is shrinking considerably double digits. So, the mix of our portfolio is changing towards more profitable risk. And this, again, will be earned in the next 12 to 18 months. So, I think we're in a position to keep protecting the underwriting margin going forward.

On the commercial auto side, a lot of our -- we have got rate increase still in the pipelines that -- that will continue to earn in 2018, and a lot of our effort on that portfolio was focused on trucking business where we have double-digit rate increase in 2017. And, again, that has changed the mix of the portfolio and going to be continued to be earned in 2018. So, I think we're in a good path to operate that in the low 90%s.

A - Charles Brindamour {BIO 7012323 <GO>}

Thank you very much, Alain.

Just in aggregate, Kai, I mean when the inflation picked up in auto a little more than a year ago, I mean it was very clear to us that not only did we need to put in place a robust action plan in automobile insurance, no matter what, but it was also equally important to protect or expand the margins in the other lines of business, given how, at the time, important automobile is. Now, it is less today following OneBeacon. And it was also important for us to take expenses out of the system to absorb the uncertainty of automobile insurance. This is very much what we've done.

And I think, to your question, are these performance in other lines of business sustainable? I mean, we've managed those lines to make sure that it is sustainable as this point in time. In aggregate, we're trying to outperform the industry's ROE by more than 500 basis points. We're certainly there and I expect this to increase in the coming year.

We want to grow our net operating income per share, and so it's an earnings growth strategy that we're pursuing. There is growth pressure by line of business, which we're comfortable with, because there's plenty of growth for us to come. If you look at personal property, you look at all the upside there is in Canada in specialty lines, plus what we think is a good market environment coming into the acquisition of OneBeacon, I think that on both fronts when I look at our two big financial objectives over the next 24 months, we're in pretty good shape there.

Last point I'll make is 13.3% operating ROE is not good in our mind and, therefore, we are working hard to make sure that A), we improve auto, but we protect the margins in the other lines of business. Even if we're hitting the two big financial objectives that we've laid out.

Operator

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

Q - Tom MacKinnon {BIO 2430137 <GO>}

Yeah, thanks very much. Good morning.

Question on the prior-year development. I think the guidance now is 2% to 4% of opening claims reserves. I think historically, Charles, you may have been talking this to be more of like a 3% to 4%, and it actually has been trending higher than that. I'm wondering if you can describe what drove this guidance and if you can explain that in the context of bringing in OneBeacon, whether that had anything to do with it.

And what -- how should we be looking at this in terms of lines of businesses? Especially given the fact that your comments about strip -- we should strip out the extra favorable development we're seeing in the commercial lines. Are you insinuating then that the main reason for this decline has to do to -- we shouldn't expect the high levels of favorable development we're getting in commercial lines going forward?

A - Charles Brindamour {BIO 7012323 <GO>}

No. I think that your question is pretty astute, actually, and you partly answered the question in asking it. I've been pretty consistent talking about 3% to 4%. We have outperformed that for many of the past few years. We could highlight a number of reasons why we were above 4%. Our view is that this range is certainly not out of whack with where the future is going.

I think the reason why it's 2% is because OneBeacon is new to us and, therefore, we'll need to learn a little more about OneBeacon in the coming period before we can develop a perspective that the long-term range is 3% to 4%.

Now as you know, new country, new liability profile. The duration of OneBeacon's liabilities is actually pretty short: it's 2.3 duration. Liability, as you also know, we have cut the adverse development potential of that business for accident year 2016 and before by increasing reserves and buying PYD cover. But it's new to us, we're taking a cautious stance. We see 3% to 4% for the Canadian business and we're adjusting our guidance downward because of the addition of OneBeacon, essentially, at this stage.

With regards to commercial lines, I think my point, Tom, is that you shouldn't see commercial P&C running in the 70%s. And commercial P&C is the line that was most favorably impacted by the diversification benefit that Louis has been talking about. Therefore, I'm cautiously saying, hey Tom, just think about that line of business in the 80%s as opposed to the 70%s, because of this one-time benefit in that segment.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay. And maybe one follow-up. Do you know what the pools impact was on your combined ratio in the third quarter? And was it higher than normal? How should we be thinking about the impact of pools going forward?

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. Darren, can you take this one?

A - Darren Godfrey {BIO 19791482 <GO>}

Yeah. So, in the quarter itself, so Q3 of '17, there was an unfavorable pools impact of 0.4. When we look at Q3 of '16, it was 1.3 to favorable, so there's a delta of 1.7. But as I said before, we do tend to see that noise and bounce it around from quarter to quarter. And as I said before there, Tom, year-to-date it's 0.4 favorable over (multiple speakers).

Q - Tom MacKinnon {BIO 2430137 <GO>}

And that's been -- that's for the entire business? Is that the impact on the entire business or just the personal auto business?

A - Darren Godfrey {BIO 19791482 <GO>}

My numbers there, Tom, were on personal auto.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay.

A - Darren Godfrey {BIO 19791482 <GO>}

So, the 0.4 favorable, as we said, is consistent with the longer-term average.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay. Thanks.

A - Charles Brindamour {BIO 7012323 <GO>}

Thank you.

Operator

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

Q - Paul Holden {BIO 6328596 <GO>}

Thank you. Good morning. So, appreciate all the detailed answers on personal auto.

Given the trend towards more complex components in cars, the proportion of cars with those complex components will only increase over time. So, I guess what I'm interested in is how you view pricing and segmentation going forward versus just necessarily catching up with historical trend.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah, I think that's right. And when we look at the profile of the car pools by province, we actually see differences in trends by province.

Yeah, I think that's right. And when we look at the profile of the car pools by province, we actually see differences in trends by province. So, it is here a question of pricing and risk selecting properly to address this trend going forward, having, I think, addressed the claims issues.

So, Darren, maybe you want to share your thought process on that?

A - Darren Godfrey {BIO 19791482 <GO>}

Yes. So, you're right, Paul. I mean, obviously from a rate increase standpoint we'll tackle from an absolute standpoint, but what we've also -- we're doing is a lot of detailed analysis from a segmentation standpoint. So, we've identified a number of variables that we have within our rating structure that we could probably dial up from a segmentation standpoint. We've identified a number of new variables that we can reflect within our rating, which is really targeted on PD.

The net outcome of all of that is to really drive a mix change, to drive a change in the new business profile, to drive a change in the renewal profile, as well, too. To really target from a rate standpoint, from a segmentation standpoint those the particular vehicles that are driving the excessive trend -- and it's mostly related to technology -- and sharpening the pencil maybe on those that are not so much driving that particular trend.

So it really is around driving segmentation. Obviously, absolute rate level, yes. But driving segmentation to pursue a better quality of new business profile moving forward.

A - Charles Brindamour {BIO 7012323 <GO>}

And really refining how we classify those vehicles to a greater degree of granularity than what's been done in the past.

I think claims can be an important lever as well, that same claims practice, so I'll let Patrick give you a bit of perspective on what can be done in claims to break that trend going forward.

A - Patrick Barbeau {BIO 18476397 <GO>}

Yes, thank you. I mentioned earlier what's causing the trend, but in terms of how we can help reducing it in claims there are a few things we can do. And it's somewhat linked to what Darren was mentioning on the risk selection and segmentation parts, because this trend is not happening at the same pace on all types of vehicles, on all models. And when we look at our rely [ph] and the network who's repairing the cars, there's quite a bit of difference between those who are specializing in certain types of repairs and others.

In terms of action plan of what we can do in claims to support all the effort are a few things. We can -- we are improving our appraisal controls and guidelines so that we more quickly identify the types of repairs we're facing. Sending the cars to the best-performing shops for the particularities of the claims we see, we can better estimate the total amount of the repairs early on. So, we determine quickly if it will be a total loss, if it will be repairable, and save on all those other costs I was referring to, so rental, storage, and towing.

Overall, by working closely with our networks, we see opportunities to reduce the cycle times on both repairs and total loss, which have savings as well under rentals. So, those are few of the examples we are implementing at the moment in claims.

Q - Paul Holden {BIO 6328596 <GO>}

Thank you.

Operator

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

Q - Geoff Kwan {BIO 7413168 <GO>}

Hi. Just back on the personal auto. I just want to make sure -- kind of summarizing, I guess, everything that you've been saying is, you've been pricing in for what you've seen from PD issues in the past, but maybe because, over time, more people are getting vehicles that have more technology and it's maybe a bit of a learning experience here, is that's really what's been driving the claims issue. And now you're just kind of reacting to it and adjusting accordingly for that. Is that appropriate or --?

A - Charles Brindamour {BIO 7012323 <GO>}

Well, I don't think it's just the fact that the profile of the car pool is changing. I think that when you start to observe a trend, there is a period where you wonder if you're seeing a trend. Then there is a period where you are actually thinking you have a trend and you want to granulize your understanding of it, and there is a period where you know you have a hard trend.

And I think that we've identified the fact that we had a hard trend in the last 18 months maybe, and I think what we're seeing now is that this trend was stronger than what we anticipated. And this is combined with the fact that over the past two years, while this happened, the car pool changed as well. Therefore, the importance of segmentation and adapting the claims work that we've been doing.

Q - Geoff Kwan {BIO 7413168 <GO>}

Okay. And just the other question I had was it's different types of vehicles, generally speaking, but is there any spillover that we should be thinking about on the commercial auto side, particularly as you get more into the ride-sharing and that part of the business?

A - Alain Lessard {BIO 17592535 <GO>}

Well, we're not seeing the same kind of level of trend on the car, because the mix of our portfolio is a mix of trucks, heavy vehicles, and personal car, and the personal car part is relatively small compared to the rest of the other vehicles. So, we're applying the same kind of review and things like this. It's going through the same claim settlement aspects, but we're certainly not picking up the same kind of trends to the level we're seeing in personal auto.

Operator

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

Q - Brian Meredith {BIO 3108204 <GO>}

Thank you. Good morning. A couple questions here for you.

The first one, back in the personal auto, what are you seeing from the competition right now? Are they having -- taking similar actions and trying to push rate at this point, or are they still kind of lagging behind you? And maybe some lost market share here going forward for you guys as you address these severity issues?

A - Charles Brindamour {BIO 7012323 <GO>}

So, I would say Brian, the picture for me has changed meaningfully in the past quarter in that regard. We are, though, a full year ahead of our peers with moves, depending on the jurisdictions, that are quite significant, and in some jurisdictions we've been at it for two years. So, I think that you won't see top-line pressure for another six months would be my guess.

But I will let Darren talk about some of what we're seeing, both in rates, as well as what we call residual or substandard market.

A - Darren Godfrey {BIO 19791482 <GO>}

Yeah. So, if you look at the market, there's probably 20, 25 players that we're competing against every single day. If we look at recent activity, I would say even within the last three months or so, and what we're hearing about what is potentially coming into Q4, I would say probably a third of the market has started to move from a rate standpoint.

So, as Charles alluded to, yes, we're still continuing to be ahead. We're still continuing to be a little bit counter-cyclical. However, we are starting to see some of that momentum coming from a rate activity from the competition.

As we talked about Charles comments before around the risk-sharing pools, we're seeing meaningful growth in the risk-sharing pools, which is a little bit of a sign of markets starting to use those pools to manage their overall exposure, which talks to a little bit in terms of adequacy as well.

And, obviously, Ontario, with our own non-standard, Jevco, we're seeing meaningful double-digit increase in unit growth right now, or at least in Q3. So, again, that is a sign for us of hardening within the regular market. That's the traditional we've seen in past cycles, whereas markets tend to get harder, it starts to flow through the non-standard, flow through the residuals, and then ultimately, drives into rate increases as well, too.

So, we are seeing momentum, Brian, but we're looking to see, moving forward, what the rest of the market's doing. But it's looking better positioned today than maybe where we were on our last earnings call.

Q - Brian Meredith {BIO 3108204 <GO>}

Great. And then, the second question has to do more with OneBeacon. Charles, I'm just curious. One, what are they seeing right now with respect to pricing in the US and what their outlook is?

And then on top of that, from your perspective, you're right now in a position right now for a period right now at OneBeacon where you're trying to improve your combined ratios. Do you have the ability, are you comfortable at this point, if there's an opportunity in the US, to grow some market share at this point or to take advantage of a firming pricing environment? Are you in a position you can do that at this point?

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah, totally. So, your first question is: What are the teams seeing in the US? As you know, the tone has changed meaningfully in the US commercial lines market. And in particular in property at this stage. We're seeing a change and our folks in the field will attempt to take advantage of the changes taking place and certainly test the market as much as possible. And I view this as an opportunity.

I think that the beauty of the improvement plan at OneBeacon, Brian, is that there are two lines of business that we're shutting down. Most of the lines of business are doing really well and our in full capacity to go and take advantage of a changing marketplace. There are three lines where we are a profitability action plan with very strong teams, and I think that a changing environment will help us do what we want to do in these lines and potentially grow as well.

So, I have mentioned to investors before that one of the things that I was impressed with OneBeacon, beyond the team and the strategy, is the fact that the platform is saleable, and we certainly intend to test that organically in the coming year as I hope market conditions will improve in the US. So, I would say spent a fair bit of time with the teams in the US in the past month or six weeks since closing and I'm quite encouraged, not only by the profitability improvement plan that is rolling already, but equally with our appetite to test what I think is a changing market condition.

Operator

Our next question comes from the line of Meyer Shields from KBW. Your line is open.

Q - Meyer Shields {BIO 4281064 <GO>}

Great, thank you. Good morning. If I can continue on the OneBeacon theme.

You talked about raising the reserves on OneBeacon as part of the harmonization process. Does that also imply that before the impact of rate changes and the discontinued programs that we should anticipate a higher sort of underlying loss ratio for this business compared to what OneBeacon had reported?

A - Charles Brindamour {BIO 7012323 <GO>}

No, because the strengthening we've done to these reserves is done on the lines of business primarily that we're exiting, a big chunk of the strengthening is on the lines that we're exiting. So, when I look at the business in the past, excluding those two lines, and the business going forward, it's pretty consistent and the results in most of these segments this year have pointed in that direction.

Q - Meyer Shields {BIO 4281064 <GO>}

Okay, that's very helpful. And second, also on OneBeacon, should we expect more retention of its direct written premium because the overall base is bigger and more diverse?

A - Charles Brindamour {BIO 7012323 <GO>}

Not clear to me. I think that in the lines of business which we're committed to we'll do everything we can to protect our portfolio. Hopefully, the market conditions will allow that.

What do you mean by retention? Just so I'm clear. Do you mean the customer retention or the reinsurance retention?

Maybe you're on mute, Did you mean --?

Operator

Pardon the interruption, the caller's line is no longer with us.

A - Charles Brindamour {BIO 7012323 <GO>}

Oh, okay.

So, I think that the lines of business that we're committed to will go on growing in the marketplace and taking advantage of the market conditions in which we operate, probably consistently with what they would have done anyways. I think where the growth upside certainly comes in, in the near term, is the fact that we have put in place cross-order desks, both in the US and Canada. This has been an impediment to our growth in Canada in the past, which I'm hoping we're unlocking now, and the early signs are positive.

We brought a technology product in Canada from OneBeacon, an entertainment product from Canada in OneBeacon. And I think the growth potential the cross-order and these two products, when you put that in relationship with the size of OneBeacon, when you leverage the impact distribution in Canada, I think that will be a meaningful needle-mover, for sure.

So, hopefully, I've answered your question and, hopefully, you'll come back on the line.

When it comes to reinsurance retention, if that was your question. Their retention is 20 million right now and we will integrate the OneBeacon program within our program throughout 2018.

Operator

And our next question comes from Jaeme Gloyn from National Bank Financial. Your line is open.

Q - Jaeme Gloyn {BIO 19737597 <GO>}

Yes, hello. Good morning. My first question is related to the impacts of Harvey and Irma and maybe even potentially the wildfires in California. Is there any long-tail impacts from exposure in those states to those events in OneBeacon?

A - Alain Lessard {BIO 17592535 <GO>}

I would say it's fairly limited. The place where they had the most exposure would be Texas and the type of damage is business interruption, but the expectation is not very long tail. And it's been picked up, been properly reserved up until closing, so the expectation is not any long tail.

A - Charles Brindamour {BIO 7012323 <GO>}

It is small, as we anticipated, and we feel very well reserved at this stage. And still subject to the reinsurance threshold of 20 million that's OneBeacon had originally, so I don't expect bad news from those elements at this stage.

And I think, in aggregate, diversifying our natural cat exposure by being more exposed to commercial lines and broadening our geography was, you know, part of an upside of the transaction we've done. And I think, in an absolutely extreme context like the one we've seen in the US, we were really pleased to see how OneBeacon faired very well in that context.

Q - Jaeme Gloyn {BIO 19737597 <GO>}

Okay, great. And my next question is related to the capital structure and the debt-to-capital ratio currently at 24.7%. I understand the target is 20%. Can you refresh me on why 20%? And is there something about the A rating that is absolutely critical in the longer term, rather than maybe even a BBB+ or something along those lines?

A - Louis Marcotte {BIO 18040440 <GO>}

So we established that some while back as the optimal level, because it was the lowest cost of capital to maintain an A-, BBB+ rating level and that's how it was established. So we (inaudible) there and we're comfortable where we are in terms of the rating structure, and that comes with the 20% leverage ratio.

A - Charles Brindamour {BIO 7012323 <GO>}

We've said that in case of acquisition we'd be very comfortable getting in the mid-20%s, but eventually we'll take it back to the 20%s. I mean, we have those big financial objectives and then we have a certain risk appetite. And our thought process initially, when we established the 20% was that within what we think is a cautious risk appetite, a 20% debt to total cap structure allows us to outperform the industry by more than 500 basis points, run the business in the mid-teens ROE, and give us ample room to grow those earnings by at least 10% over time. It is at the slightly cautious end of the financial services landscape in Canada, but certainly not out of whack with it, and there is no intention at this stage to modify that structure.

The other thing to keep the minus is we're using preferred shares, which one has to take into account when you look at the overall capital structure of an organization. And our usage of preferred share also leads us at the lower end of the debt -- pure debt to total cap ratio.

Q - Jaeme Gloyn {BIO 19737597 <GO>}

Okay, thank you.

Operator

And our next question comes from the line of Meny Grauman from Cormark Securities. Your line is open.

Q - Meny Grauman {BIO 15238080 <GO>}

Hi. Good afternoon. I just had a question, clarification about the diversification benefits that you talked about, just in terms of how those benefits or whether those benefits can continue.

Hi. Good afternoon. I just had a question, clarification about the diversification benefits that you talked about, just in terms of how those benefits or whether those benefits can continue. How much discretion do you have there? And is there still an impact going forward?

A - Louis Marcotte {BIO 18040440 <GO>}

Well, we've set up the module calculations, so these will be applied going forward in the same methodology, if you want. So, I wouldn't expect a material impact like we've had this quarter, but that number is maintained, as we had in the past, with our risk margin. So, it evolves over time, but it's not one where we completely change it. We have to apply the same approach on a going concern or going-forward basis.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah, I would say this comes with a range. This was the first time really that we reflected diversification in establishing our provision for adverse deviation. Our bias was to take the cautious to determine where that point was and very much in our historical reserving philosophy.

Q - Meny Grauman {BIO 15238080 <GO>}

Thanks for that. And then if I could just ask another question on OneBeacon, just also clarification. As you go from the high 90%s to the low 90%s in terms of the combined ratio, you talk about synergies as one area of improvement. I'm wondering, I'm not sure if you've mentioned it before, but how much of that reduction specifically is tied to synergies? If you can quantify that.

A - Louis Marcotte {BIO 18040440 <GO>}

Sure. So I shared earlier the dollar amount of synergies we're aiming for at $25 million. Now what our improvement plan calls for is to -- which is a growth of [ph] about 2 points of combined ratio. But recall our entire plan with the three levers is aiming for 6 to 8 points, which will go from the upper 90%s to the low 90%s.

Q - Meny Grauman {BIO 15238080 <GO>}

Thanks for that.

A - Charles Brindamour {BIO 7012323 <GO>}

Two of which would be expense synergy, roughly. Pure expense, not claims. Just expense.

A - Louis Marcotte {BIO 18040440 <GO>}

Correct.

Operator

Our next question comes from the line of Mario Mendonca from TD Securities. Your line is open.

Q - Mario Mendonca {BIO 2450557 <GO>}

Good afternoon. Just, Charles, I'll try to be quick here.

I'm looking at the growth in written insured risks in personal auto over a very, very long stretch. I think the -- I have information going back about 14 years. And there are very, very few occasions when the written insured risks in personal auto actually decline year over year. It happens very, very rarely.

Given the trend we're seeing from the sort of high single-digit growth in written insured risks that we saw, and you see that in '15 and '16, particularly around that time you became a lot more confident with telematics. It sort of trended down to almost zero now. Could this be one of those occasions, short-lived that is, but one of those occasions where the written insured risks in personal auto sinks below zero?

A - Charles Brindamour {BIO 7012323 <GO>}

Could be, yes. Yeah.

I think, Mario, it's not just about rate. There is various digital experiences. We have a broad distribution strategy, but it could be below zero for a short period of time and we'd be comfortable doing that if it helps us get to where we want to be from a combined ratio point of view.

Q - Mario Mendonca {BIO 2450557 <GO>}

And then, just on telematics specifically, and I am certainly no expert in this. But, is it fair to say that telematics really hasn't lived up to all the hype? Specifically -- like, couldn't telematics have been somewhat helpful in giving you an earlier signal of what was happening?

A - Charles Brindamour {BIO 7012323 <GO>}

I think telematics -- I'll tell you, telematics has lived up to our expectations, quite frankly. First, the appetite for consumers to embrace telematics is higher than what we thought. Second, the loss ratio of customers who choose telematics after the discount is better than the average loss ratio. And then, the field of segmentation that we have gathered in the past three years with 3.7 billion, 3.8 billion kilometers driven and the machine learning we were able to do on that is very significant.

The upside of that, in my mind, will be for the coming years and then the opportunity to interact with customers has changed meaningfully. So, it has lived up to what we were set to do with telematics, per se.

Could we have used telematics to a greater extent to better understand these trends in physical damage? Not clear to me, Mario, because it is primarily severity driven. We've used telematics to try to understand frequency changes. We've tried to understand, if people drove more, what impact would it have on frequency and so on. Harder to leverage on severity, per se.

Q - Mario Mendonca {BIO 2450557 <GO>}

That's clear.

And then just finally, is there the political will to take another look at Ontario auto from a regulatory perspective? Or do you believe that bullet's been fired and it's all pricing from here?

A - Charles Brindamour {BIO 7012323 <GO>}

I think that the government has demonstrated, Mario, a lot of appetite since 2010 to improve the product, per se. And so, if I look backwards it's hard for me to question the will of the government, in Ontario. I wouldn't say the same thing in all jurisdictions, but we're talking about Ontario.

They have hired last year and did work most of this year, gentlemen called David Marshall, who used to run WSIB, who has identified a number of what I think are common sense recommendations. The main one being let's get cash out of the system and let's focus on care, which would take a lot of incentives for all sorts of people to play in that system. And I think the government is thinking about his recommendation very seriously as they look at the next months. Therefore, I think there is will.

There will be an election in the spring and what it does to will, I'm not sure. But they're certainly -- they have shown their willingness and they're actively engaged thinking about that would be my read on the situation.

Operator

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

Q - Doug Young {BIO 5640851 <GO>}

Good afternoon. On personal auto, there was CAD31 million negative prior reserve developments and curious how much of that related to the physical damage? How much related to the older file, more older files, so pre-2016, moving into the cat loss bucket? And it's the latter component that I'm more curious about, because that's a bump I think you had in Q2, and just trying to get a sense of where you stand with that issue.

A - Charles Brindamour {BIO 7012323 <GO>}

Yeah. So the bulk of the PYD is long-tail-natured claims and a non-negligible portion of that would indeed be cats. Cats, which have been trimmed, as far as I'm concerned, in the June 2016 reform, which we think are pretty good, at least based on what we observed so far.

And I think you have a couple of things there. You -- if I just talk about cat -- and it's not just cat, it's long-tail-natured, bodily injury-type claims, cats being an important portion of that in the Ontario marketplace. I think we've seen -- in the legal system, you have two years to report a claim and then one year to serve it actually. And we have seen for accident years like '13, '14, '15 a bit of late reporting on big cats, and then we went back to many of the cats that were open where there was a risk of psychological damage to actually strengthen our position.

You look at PYD, and the number you've quoted is small, but if you look at the actual increase in reserves in the quarter in long-tail lines automobile Insurance between IBNR and case reserves, this is a number that is much bigger than that, which helps us with our confidence of adequacy in that segment for these lines of business sitting here today.

Q - Doug Young {BIO 5640851 <GO>}

And so, Charles, just listening to you talk about this, I mean, we've seen some progressive deterioration in the personal auto prior-year reserve development over the last few quarters. I mean, as we go into 2018-19, do you think -- I mean, should we move back into positive developments in personal auto?

I mean, should we move back into positive developments in personal auto? I mean has this -- have these issues been dealt with, in your view?

A - Charles Brindamour {BIO 7012323 <GO>}

Well, the reserves have gone up meaningfully. I think these issues have been dealt with. And when I look progressively or prospectively, the reforms, in particular in Ontario, are meant to limit that sort of outcome to a greater extent, yes.

Q - Doug Young {BIO 5640851 <GO>}

Okay, great. Thank you.

A - Charles Brindamour {BIO 7012323 <GO>}

Thanks, Doug.

Operator

And we now have reached the end of our Q&A. Time is over. I would like to turn the call back over to our presenters.

A - Ken Anderson {BIO 19997596 <GO>}

Thank you all for joining us today. Following this call, a telephone replay will be available for one week and the webcast will be archived on our website for one year. A transcript will also be available on our website in the financial reports and filings archive.

Our fourth-quarter 2017 results are scheduled to be released after market close on Tuesday, February 6, 2018.

Thank you, again. This concludes our call for today.

Operator

Once again, this does conclude today's conference call. Thank you for your participation, you may now disconnect.