Q1 2013 Earnings Call

Company Participants

- Alain Lessard, SVP of Commercial Lines
- Charles Brindamour, CEO
- Dennis Westfall, VP of IR
- Mark Tullis, SVP and CFO
- Martin Beaulieu, SVP of Personal Lines
- Mathieu Lamy, SVP of Claims

Other Participants

- Andre Hardy, Analyst
- Bryan Brown, Analyst
- Doug Young, Analyst
- Mario Mendonca, Analyst
- Paul Holden, Analyst
- Shubha Khan, Analyst
- Stephen Boland, Analyst
- Tom MacKinnon, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. Thank you for standing by. We apologize about any technical difficulties. My name is Martina. I will be the operator assisting your call today. I would like to welcome everyone to the Intact Financial Corp. First Quarter results. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. (Operator Instructions)

I would now like to turn the call over to Dennis Westfall, VP, Investor Relations. Please go ahead, sir.

Dennis Westfall {BIO 15155973 <GO>}

Thanks, Martina. Good morning, everyone. 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 to our discussion on the conference call today.

Joining me today are Charles Brindamour, Chief Executive Officer; Mark Tulles, Chief Financial Officer; Martin Beaulieu, Senior Vice President of Personal Lines; Alain Lessard, Senior Vice President of Commercial Lines; and Mathieu Lamy, Senior Vice President in Claims. We will start with formal remarks from Charles and Mark, followed by a Q&A session. Martin, Alain and Mathieu will be available to answer your questions during the Q&A session.

With that, I will ask Charles to now begin his remarks.

Charles Brindamour {BIO 7012323 <GO>}

Thanks, Dennis. This morning, we announced net operating income per share of CAD1.27, or CAD1.02, excluding a one-time tax benefit, down from the First Quarter of last year, which had benefited from exceptionally strong underwriting results. Our combined ratio of 95.1% reflects the impact of more seasonal weather conditions versus last year's mild winter, which led to an increase in claims frequency across all lines of business.

From a topline perspective, premium growth of 9% reflects encouraging early growth indication from the addition of Jevco. I'm pleased with our ability to leverage the Jevco products across our distribution platform. This has offset the expected impact we have seen from re-underwriting parts of the acquired business. Our earnings over the past year have generated an operating ROE of 16%, a 12% increase in book value per share and strengthened our financial position, as we ended the quarter with close to CAD750 million in excess capital.

The strength of our financial position enabled us to announce our intention to buy back shares under an NCIB. While we continue to expect capital deployment of opportunities in the form of acquisitions over the coming period, we feel our own shares present such an opportunity. As such, we announced today that we filed to buy back up to 5% of our outstanding shares over the next 12 months. To be clear, our outlook for (M&A in) Canada has not changed, as we continue to expect 20 points of market share to trade within the next five years.

I want to make a few comments regarding the business that has been receiving a lot of attention lately -- Ontario Auto, which represents less than one-quarter of our portfolio. Last week's liberal budget included a cost and rate production strategy to reduce average auto insurance rates by 15% over a period of time. We believe the government's intention to implement cost reduction measures is important, as it serves to build momentum for actions that will bring, in our view, meaningful improvements to the system, both in the short and in the long run.

The government understands, in our view, that without such measures, the proposed reductions in premium will be very difficult to implement, as it would put additional pressure on the industry and lead to availability issues in the Province, particularly as the combined ratio at the industry level was approximately 103% in 2012. So we are working with the government and the Insurance Bureau of Canada to identify and quantify these cost reduction measures.

On the topic of mediation, I am pleased to say that good progress is being made on that front. At an industry level, FSCO's work to reduce the backlog is proving to be successful, as it is down approximately 16% thus far in 2013. As for IFC, our own mediation backlog has been reduced by more than one-third. The resulting mediation outcomes solidify our view of the effectiveness of the 2010 reforms.

Despite the political noise, we maintain our view on the Ontario auto market. Given the complexity of this market, we've adopted a perpetual improvement strategy, as demonstrated by our own pricing, segmentation. And claims actions over the past years. As a result, we have demonstrated an ability to maximize our performance in periods of market turmoil. Our teams are approaching the current environment with the same level of determination.

Finally, I think it's important to highlight that our view on the bodily injury environment, both in Ontario and Alberta, has not changed. We have not seen deterioration in Ontario. And we expect to offset the impact of last year's deterioration in Alberta by taking the full amount of approved rate changes in the (minimum) portion of the product.

Moving to personal property, I would say that this year's 93.5% combined ratio is much closer to what one should probably expect in the First Quarter than was last year's 83.5%. We continue to strive for a combined ratio sustainably below 95%. And implemented a successful batch of improvements in 2012 as well as during the quarter. I remain confident that we have the right action plan in place to achieve our target level of profitability.

When it comes to our outlook for the industry, growth last year played out as we had anticipated. As the drivers beyond this growth will likely continue to impact 2013, we foresee similar growth in the coming 12 months. We expect low single-digit growth in personal auto and commercial lines. And mid to upper-single digit growth in personal property. We continue to expect firming conditions in approximately one-quarter of the commercial P&C industry in 2013. And the low interest rate environment should support our outlook.

Turning to the industry's ROE, we do not expect material improvement in the near-term from the 10.6% level reported in 2012. Although underwriting might improve slightly, we anticipate this would be upset by the negative impact on investment income from the low yield environment. Looking specifically at Impact Financial, we believe we will continue to outperform the industry's ROE by at least 500 basis points, our stated objective.

Mark will provide updates on our integration in a moment. But clearly, we made some good progress in the quarter on our synergy run rates, particularly for AXA Canada. I continue to be impressed with what's been achieved to date. And I want to thank our employees for their hard work in ensuring our customers and brokers continue to receive top-notch service.

In conclusion, I believe the disciplined approach we take towards operating the business will continue to serve us well. And I am confident that we will confront new challenges with the same level of determination that has brought us to where we are today. Given the quality of the operations and the flexibility provided by our financial position, we firmly believe that we will continue to outperform the industry and defend our superior level of profitability.

I will now turn the call over to our CFO, Mark Tullis.

Mark Tullis {BIO 4180270 <GO>}

Thanks, Charles. Today, we announced underwriting results more indicative of a typical First Quarter than those reported in Q1 last year. The 95.1% combined ratio was in line with the five-year First Quarter average of 94.9%. But above the unusually strong 92.3% reported in 2012.

In personal auto, the 11% growth in premiums reflects the addition of Jevco as well as organic growth. From an underwriting perspective, the combined ratio improved 1.1 points from last year, due to higher favorable prior-year claims development. And solid results outside of Quebec and Atlantic Canada. The underlying current year loss ratio, excluding catastrophes, was higher by 1.3 points, as a result of an increase in claims frequency due to the more normal winter weather conditions.

Growth in personal property of 5% was primarily driven by higher rates, though we experienced 1% growth in units, despite our rate actions. The combined ratio increased 10 points from the exceptional 83.5% of last year. Current-year results, excluding catastrophes, were negatively impacted by an 11% increase in claims frequency, reflective of more seasonal weather conditions.

Our commercial P&C business experienced fewer large losses than in First Quarter last year. But this was more than offset by lower favorable prior-year claims development in Q1. The combined ratio in commercial auto of 97.3% was 12.1 points worse than last year's very strong performance, primarily due to unfavorable prior-year claims development and an 11% increase in claims frequency. The expense ratio at the total company level was 0.7 points improved versus last year. This change was driven by a drop in variable commissions from the lower level of profitability in the quarter. And acquisition-related synergies, partially offset by higher IT expenses, including non-recoverable sales tax.

On the investment side, net investment income of CAD96 million in the First Quarter was down CAD4 million from a year ago, as additional investments, primarily related to Jevco, were more than offset by declining yields. The market-based yield of 3.4% was down from 3.7% last year. We expect the prevailing interest rate environment to essentially offset the growth in our investments in the coming quarters.

Our financial position remained solid at the end of Q1 2013 with CAD744 million in excess capital and a book value per share 12% higher than a year ago. We ended the quarter with a debt to total capital ratio of 18.5%, below our internal target level of 20%. As discussed last quarter, we typically use NCIBs to help manage capital while retaining flexibility for strategic growth. But we did not then have a program in place on the yields of our two recently completed acquisitions.

We believe we are now at a point where it makes sense to utilize our full array of capital management options. One of these is to execute buybacks at attractive levels in the context of our objectives for ROE outperformance and net operating income per share growth. This in no way changes our view as to opportunities in the M&A landscape.

From a tax point of view, although we paid CAD284 million in cash taxes during the quarter, on an accounting basis, we reported a slightly negative effective income tax rate. It's common to have one-time adjustments which impact the reported accounting tax rate. And this quarter, we had an adjustment related to the recovery of prior year's taxes paid. Without this benefit, our EPS and net operating income per share would each have been lower by CAD0.25. The tax rate should return to a normal level for the remainder of the year.

We continue to make good progress on both of our integrations. For AXA Canada, system shutdown projects are well underway. We maintain our CAD100 million aftertax synergy target. And estimate that our run rate at the quarter end was CAD84 million. About half of these synergies come through in general expenses and the rest are reflected in claims expense. Much of the remaining synergies should coincide with a system shutdown in early 2014.

Early indications are positive with respect to the Jevco acquisition. The impact on growth from cross-selling the new product suite within our distribution platform has been better than expected, while overall retention is in line with our expectations. Initial underwriting results are also positive. We continue to expect the acquisition to be accretive to net operating income per share in 2013. And annual synergies amounting to CAD15 million after tax are expected from a combination of external loss adjustment expense reductions, shared service savings, reinsurance. And system-related cost savings. And we expect our run rate to be at this level by the end of 2014.

In summary, we are pleased with the significant progress made to date on both of our integrations. We plan to leverage our solid position to take advantage of opportunities in the market and to bolster our excellent long-term earnings power. This, combined with our disciplined approach to the business, provides a strong foundation for continued growth.

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

Dennis Westfall {BIO 15155973 <GO>}

Thanks, Mark. Martina, we are now ready to start the question period.

Questions And Answers

Operator

(Operator Instructions) Tom MacKinnon, BMO Capital.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Question, I guess, with respect to, you've done a good job of talking about quarter -- year-over-year results. But I'm trying to get a handle on some quarter-over-quarter results. The 92.1% that you reported in the Fourth Quarter, you said, was indicative of the underlying performance in that quarter. And based on what came in this quarter would suggest that there was a much bigger quarter-over-quarter seasonality factor. So what was driving that bigger quarter-over-quarter seasonality factor?

And what would you deem to be the -- kind of an underlying performance of this quarter if you had more of a seasonal -- or more of a long-term, I don't know, seasonal quarter-over-quarter factor? I know it's really difficult to judge a property and casualty insurance company based strictly on quarterly results here. But anything you could give here would be helpful. Thanks.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. No. I think it's a good observation, Tom. It's fair. You're right -- it is tough to judge quarter-by-quarter. But I think your observation is a good one. And maybe, Mark, maybe you can share your perspective on that?

A - Mark Tullis {BIO 4180270 <GO>}

Yes. I'll make a few comments here. I mean, first of all -- and I know you are addressing Q4. But Q1 last year, keep in mind, did have exceptionally mild winter. And generally, we plan and expect more seasonality in Q1, certainly, than the recent track record.

I think the other thing to keep in mind here, our increased penetration in Quebec, post-AXA, means we are more subject to winter weather exposure than we have been the prior few years prior to that. And this really translated into a meaningful increase in frequency in Quebec and Atlantic Canada in the quarter. The other thing that was going on this quarter, I think, in addition to the weather-related items, is that the commercial lines performance at 97% to 98% was worse than one would expect in the long run from that line of business.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. Exactly. And I think, Tom, sitting back and looking at the historical seasonality that we present in our public disclosure, well, first of all, I think we've had a few exceptional First Quarters in the past few years. But the second comment I would make -- and Mark touched on it, which I think is probably more important -- that is, distributional shift by Province as a result of the AXA transaction has had an impact there. And I think one of the things we need to do on the back of this quarter is go back on the public disclosure there and see if there is an improvement we could bring. Because I think your observation is a good one.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Then one final question, if I could squeeze it in. It looks like, was there any Jevco of the CAD15 million aftertaxes, any of that in the quarter? Or is that supposed to be all -- virtually all of that CAD15 million we should expect through -- by the end of 2014, along with the additional CAD16 million from the AXA acquisition in terms of aftertax synergies?

A - Mark Tullis {BIO 4180270 <GO>}

Yes. We actually did experience some in the First Quarter, a little less than CAD3 million -- about 50/50 split between expenses and through the claim side.

Q - Tom MacKinnon {BIO 2430137 <GO>}

And what would it take in order to exceed those numbers? What would you see as happening if you were able to exceed these targets?

A - Mark Tullis {BIO 4180270 <GO>}

On the Jevco side?

Q - Tom MacKinnon {BIO 2430137 <GO>}

Both the Jevco and the AXA side.

A - Mark Tullis {BIO 4180270 <GO>}

We feel very confident about the targets we have laid out on the synergy side.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. And I think that, in the case of Jevco, I mean, we are six months into the conversion. So far. So good, I would say, on the retention level. The combined ratio that we experienced after a quarter, a little better than what we had modeled. The piece that we are a little bit surprised by on the Jevco front is the -- I don't know if excitement is the right word. But we are certainly cross-selling a fair bit. And there is a fair bit of demand for the new product across the channel. And that's in part why growth was at that level at this stage. And the indications so far are that that's likely to continue for a portion of the year.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay. Thank you very much.

Operator

Doug Young, TD Securities.

Q - Doug Young {BIO 5640851 <GO>}

I guess just -- my first question is, just on the Ontario Auto. And Charles, I guess on your slide 4, you talk about -- you think the outcome could be margin-neutral. But additional cost reduction measures are critical. I guess, two parts to my question. I guess, margin-neutral doesn't mean that earnings can't come under pressure. And I just want to confirm that that's the case.

And the second is, what gives you confidence around that? And maybe you can unpack some of those things -- or some of your thoughts behind that statement.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. I think that the outcome of margin-neutral means that the sort of underwriting performance we see in that market, we'll do everything we can to maintain in that environment, I think as we have shown, historically, as well, an ability to outperform it.

I think that the government understands very well, I think, what needs to be done in the Ontario automobile environment in terms of additional measures to, A) reduce costs in the system; but B) and almost more importantly to me, reduce the risk of inflation going forward. The government has a very good grasp of that. I think they also understand the reality that the industry is running at 103% right now. And you don't need to go back in history very far to understand that if you force the industry into a position of unsustainable loss, that there will be an important availability issue. I think they get that.

These are rational and responsible people. And I think they are focused on improving the environment for Ontarians. And my interactions with them, I'm impressed with their intent on that front. Now, 15% is a big number for sure. There's a number of things that are on the table that would be, I think, good for the system, that could bring premium reductions. And maybe I can ask

Mathieu to give you a few examples of the sort of things that could be considered to improve the system.

So Mathieu?

A - Mathieu Lamy {BIO 15207469 <GO>}

Yes. As discussed in the budget, already we see that confirming the MIG being binding would be a good thing to sort of define the reform benefit that we saw since 2010. Reform of the CAT definition would be a good initiative and it's discussed right now. The Anti-Fraud Task Force reported a series of measures that was recommended to government. Some of them were regarding regulating the clinics and the towing industry. And that we think would have a positive outcome on the industry. And some BI reform -- bodily injury reform, such as eliminating the $30,000 disappearing deductible, such as lowering the prejudgment interest would have positive outcome on the claims front. So those are some of the suggested measures that we are discussing with government.

A - Charles Brindamour {BIO 7012323 <GO>}

You know, I think, Doug, in all of this, we are not naive. It is a politically-charged environment. I trust the government's intention that they will do the right thing for Ontarians. But we are not naive. And I think the timing is certainly not clear at this stage. But our view is that this will take some time for this to take place.

We have given you high-level examples. There is a difference between high-level examples and the actual measures that are being implemented, that will also have an influence there. And so when you face some uncertainty like that, our approach has been here to double up inside and bring improvements on our side ourselves, to make sure that we remain in a position of strength in that environment. And these are not just words.

If you go back over the past few years, whether it's the pricing moves that we've made ahead of the curve in '07 and '08; whether it's the fact that, when the reforms took place in 2010, we doubled up on actions that we've taken ourselves to make sure that we would get the full benefits of the reforms and more. And obviously, in an environment that is politically-charged with this one -- like this one, our approach and mindset is exactly the same. So the folks in claims are focused on pushing the actions that we have in the pipeline further, coming up with new actions to make sure that our ability to outperform, regardless of the scenario, is very strong and healthy.

Q - Doug Young {BIO 5640851 <GO>}

So I just wanted to follow up. And I guess when you talk about margin-neutral, should I think of that in a combined ratio-neutral? Is that the way we should kind of think about that?

A - Charles Brindamour {BIO 7012323 <GO>}

Yes, I think it's one way to think about it in a world where the investment income doesn't change. I would say that's probably a fair way to think about that.

Q - Doug Young {BIO 5640851 <GO>}

Then the -- I guess the big benefit you could get from the government would be around the CAT definition. And it seems like that -- they want to have another study after doing multiple studies already. How confident are you around that one topic or one issue being addressed?

A - Charles Brindamour {BIO 7012323 <GO>}

Just to be clear, I think Mathieu lined up a number of ideas here. CAT is one of many ideas. And so CAT isn't -- the CAT definition in my view is important. But it's not the panacea to Ontario. I mean, there are more ideas on the table. I think that this one is -- certainly has a lot of stakeholders involved. And I'm not as confident as I was, let's say, six months ago that this will get through, given how politically-charged the environment it is.

And that's why one needs to have a long list of things to put on the table. And that's the sort of stuff we are putting in front of the government and the Ministers, the Minister of Finance. We strongly see a change in the CAT definition as an effective measure, along other effective measures. I mean, the sort of percentage cost reductions that the government is talking about will call for many measures, as far as I'm concerned, CAT being one of them.

Q - Doug Young {BIO 5640851 <GO>}

Yes. I guess just to be clear, like I'm confident with what you guys have done and you are obviously proving you can outperform the industry. I'm more concerned about the rationality on the government side. And it's obviously a tougher thing to handicap. And I guess just my last question is just around the commercial side. And it just seemed like there was a pretty big deterioration. And I understand the claims frequency and the reserve developments were less.

Is there anything else unusual that kind of came through? Because, Mark, it seems like in your comments, you signaled that this was an unusually bad quarter. Can you help me think through that?

A - Mark Tullis {BIO 4180270 <GO>}

Doug, I think we'll ask Alain Lessard, our SVP of Commercial Lines, to talk about the performance there. I'd just like to point out our combined ratio commercial P&C in Q1 was roughly in line, 98.2%/ 97.6%; commercial auto, though, went up from 85.2% to 97.3%. And I'll let Alain comment.

A - Alain Lessard {BIO 17592535 <GO>}

Yes. Well I think the most unusual piece, really, would be on the commercial automobile, where we saw an important deterioration on the loss ratio. And that is very much driven by severe weather conditions. Just to give you an idea, the snowfall during the First Quarter on Eastern Canada was an increase in Montreal about 70%. And an increase in snowfall in Toronto about 170%. And we have to think that our -- in the case of commercial lines, we are very much concentrated in city. So this affected not only the current year. But it also affected the prior year developments, since some of those snowstorm and even the big one was December 27, 28. And basically we underestimated the amount of reserve or impact on that snowstorm.

So that was really probably during the First Quarter, the most, I would say, unusual event that happened, okay? But overall, if we look at the performance of the commercial automobile also, if we look compared to the industry, in 2012, we basically outperformed the industry in terms of loss ratio for the year by about 15 points, which is also more than double the outperformance of about 7 points in 2011. So that confirms that, during 2012, was an exceptionally good year on the commercial automobile side.

A - Charles Brindamour {BIO 7012323 <GO>}

I think, in commercial auto, Doug, when we look at the numbers, we are seeing frequencies up 11%, which talks directly to the point that Alain is making.

Q - Doug Young {BIO 5640851 <GO>}

Okay. Thank you.

Operator

Paul Holden, CIBC.

Q - Paul Holden {BIO 6328596 <GO>}

So Charles, you mentioned that your view on M&A hasn't changed. Wondering if your view has changed at all with respect to the type of acquisitions you would want to make? I guess, specifically, would you be comfortable buying a business today with a high weighting in Ontario Auto?

A - Charles Brindamour {BIO 7012323 <GO>}

Yes, I would be comfortable today. Knowing where we are today, I would be comfortable growing to acquisition in Ontario. I think I would do it, obviously, at a price that reflects some uncertainty. And I'd want to make sure that the reserves are on the basis of our own reserves. But at this stage, given our ability to outperform in that Province, I think there is a good opportunity to create value. I mean, the value you create in a transaction, it comes from the fact that you have outperformed. And you can replicate that outperformance on a target, provided that the starting point is what you think it is.

Q - Paul Holden {BIO 6328596 <GO>}

All right. Okay. Good. Then, in terms of some of the cross-selling opportunities you were talking about related to Jevco, wondering if any of that is related to specialty lines and the opportunity you have to expand that line of business, given the that Intact's currently underrepresented in specialty lines?

A - Charles Brindamour {BIO 7012323 <GO>}

I'll ask Alain to take this one, Paul.

A - Alain Lessard {BIO 17592535 <GO>}

The two strategic additions that came from Jevco from the commercial lines would be on the surety side and on the trucking side. On the surety side, clearly, that's an interesting addition. And so far, it's been very profitable. Surety for Jevco was targeting small contractor. That's an area where we wanted to move. We are more focused on larger contractor. And we are currently focusing on opening small contractor units out West and in Quebec. So that's going well as well.

On the trucking side, while basically the trucking, right now, we are integrating both Jevco and AXA integration. We have an opportunity on the trucking side, mostly in Ontario. But I would think at this time it would be fair to say that we have not maximized or opened the cross-selling on the trucking side.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. Fair enough. I think, Paul, if I gave you my sort of high-level perspective on top line in the context of Jevco, there's three blocks in my mind. There is how much of the actual business you retain in personal lines; how much of the actual business you retain in commercial lines; and how much new business you actually generate because of the products. And so, overall, we are retaining a little better than we thought in personal lines. We are retaining less than we thought in commercial lines. We are deep in re-underwriting that portfolio.

And so, net-net, I think we are sort of retaining what we thought. But then, in particular on recreational vehicles across the country, we are getting more new business than we originally anticipated, what -- that was part of the strategy. So we are pleased with that development. Would you agree, Martin?

A - Martin Beaulieu {BIO 15316652 <GO>}

Yes. And that additional new business that we are getting is mostly our broader reach in the distribution channel. So we have more brokers than Jevco had to sell the product. And that's where I think we are getting some of those benefits.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. Exactly.

Q - Paul Holden {BIO 6328596 <GO>}

Great. And final question, with respect to cost synergies from AXA. I know you mentioned that you're comfortable maintaining your CAD100 million target. But I mean, given where you stand today. And given that policy retention has been better than you first assumed, is there not a reasonable expectation that probably synergies will come in above that had CAD100 million target?.

A - Mark Tullis {BIO 4180270 <GO>}

We are confident in hitting the CAD100 million. We are not publicly adjusting the target at this point. And I think it's important to keep in mind, you'll probably see a bit of a plateauing of the reported synergies the next few quarters, before the system shutdowns come through in 2014, which is when you will see a ton of them. I think the other thing to keep in mind, there is some additional synergies that we don't include there, such as subrogation and things like that, that we get on top of that. But we are comfortable with CAD100 million target. I (multiple speakers) --

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. And I think at the Investors Day, Mathieu actually made it relatively clear the additional sources of synergy, in our view, has not changed there. So I would refer people to the claims presentation at the Investors Day.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. That's all the questions I had. Thank you.

Operator

Bryan Brown, Macquarie Capital.

Q - Bryan Brown {BIO 16358540 <GO>}

In Ontario Auto, you talked about the rate cut and cost reduction strategy to be margin-neutral. Does that include the reduction in the ROE benchmark for rate filings?

A - Charles Brindamour {BIO 7012323 <GO>}

Yes, I think this is one where we will have to see what that means in practice. Are we talking about average ROE? Are we talking about flat ROE? Are we talking about a range, et cetera? And depending on how that looks like, we will adapt our strategy to make sure that we are not overly impacted by that.

This one is hard to assess at this stage. I think, the reality is that there is a benchmark at 12% right now, roughly. And the industry has generated about 7% over 10 years and we've outperformed over that period. So for me, I sort of wait to see exactly what that looks like when that comes to the table. But I must admit this is not an item that is critical in my mind at this stage. And again, I don't want to be naive. It's a politically-charged environment. But I don't see that the industry has room for forms of ROE compression here, just because it has not achieved the sort of target ROE that this market anticipated.

Q - Bryan Brown {BIO 16358540 <GO>}

Okay. And in the mediation backlog, you guys are seeing good progress. And what does that mean for the possibility of redundancies? I guess if you are seeing interpretations of the 2010 reforms through the mediation.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. I will let Mathieu give his perspective on what we've seen so far and I'll come back at the end.

A - Mathieu Lamy {BIO 15207469 <GO>}

Okay. On the mediation, we see both at the industry level a good reduction. And in our own open cases, a good reduction in our mediations pending. So in our view, that sort of defines the benefit of the reform. As expected, though, we see a small increase in the backlog of arbitration. So that keeps a certain level of uncertainty there. But overall, we estimate that near 20% of our post-reform mediation have settled to date. So that, too, we think, reduces uncertainty going forward.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. And I think that, of course, arbitration is where a bit of a backlog is being created. We remain cautious. But there's nothing we have seen in the mediation outcomes that would lead us to take a more conservative view than we've had so far. And we are looking forward to development on the arbitration side of things. And I think that the sort of measures that the government has in mind, in relationship with what's in the budget, would be helpful in terms of increasing the comfort level that the reforms will remain effective.

Q - Bryan Brown {BIO 16358540 <GO>}

Okay. Then just one last thing to clarify. In Alberta, you guys mentioned that I guess you plan on taking the full amount of the approved rate increase. Is that correct?

A - Charles Brindamour {BIO 7012323 <GO>}

That's exactly right.

A - Mathieu Lamy {BIO 15207469 <GO>}

That's already done.

A - Charles Brindamour {BIO 7012323 <GO>}

It's done.

Q - Bryan Brown {BIO 16358540 <GO>}

Okay. Great. Thank you.

Operator

Shubha Khan, National Bank Financial.

Q - Shubha Khan {BIO 16255963 <GO>}

Just wanted to look at commercial lines for a sec here. Just looking at the less favorable prior-year claims development, particularly in commercial P&C, I guess, versus prior quarters. In the past, you've talked about the favorable impact of the AXA book in this regard. And I'm just wondering, has the impact waned on that front? And is the Q1 reserve development more sort of representative of what we should expect going forward?

A - Alain Lessard {BIO 17592535 <GO>}

Well I think two aspects, okay, at this point. Last year's prior-year development at 13% was -- and I think, exceptionally high. It's not something in expect that will continue time over time. This year, there was kind of an extraordinary -- well, not an extraordinary event. But an event relating to surety.

And when it comes to surety, a surety loss is -- when it comes to assigning an accident date to a surety losses, especially in the First Quarter, it's always a little bit tricky because the contractor's condition gradually deteriorated. And we had one surety losses that -- discovered during the First Quarter. But was reported and targeted to an accident date of 2012, which affected the prior-year development. So we've got a little bit of both. It is 6.1, we see right now more normal. It's difficult to call that -- we don't track that year-over-year. And like you said, the AXA portfolio will change that over time.

A - Charles Brindamour {BIO 7012323 <GO>}

Exactly. So I think, for me, there is two key points there. If you look at Q1. And that's what we are talking about, versus last year, 13% was on the high side in commercial P&C. I think there's no doubt. And this time around, for that line of business, (6%) was probably lower than it would otherwise have been had it not been for this large surety bond.

Q - Shubha Khan {BIO 16255963 <GO>}

Okay. Irrespective of that, I mean, you still expect the AXA book to have a favorable impact in the order that we have seen in previous quarters. Is that fair?

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. It is fair. And overall, we are pricing the business and running the business to be in the low 90s in commercial line.

Q - Shubha Khan {BIO 16255963 <GO>}

Okay. And if I can switch gears to Ontario Auto again, to what extent is the planned 15% reduction in auto rates tied to cost reductions? In other words, based on your discussions with the Provincial government and based on your interpretation of what -- of the language in the budget, will the rate and cost reduction strategies be implemented separately? Or are they somehow tied together?

A - Charles Brindamour {BIO 7012323 <GO>}

You know, there has not been a lot of talk about execution here. And you can understand that the context of ongoing improvement in the system was sort of disturbed by the political noise that's taken place in the past month. So I think that there has not been a lot of talk about execution.

Clearly, I think if you go back to the government's intention of being responsible, which I think they have been so far, it's hard for me to see how premiums go down before cost reduction measures actually get implemented. There is always -- if we go back to the reforms in 2010, you make assumptions about what those cost reduction measures are worth. You make them effective and you move your rates accordingly, which has been the case with the reform.

The industry reflected the fact, in their assessment of adequacy or inadequacy of pricing, that reforms were taking place. And you adjust the impact of the reform as you go along. And I suspect that this is likely to happen the same way. Now, again, I want to be clear. We are not naive. It's a politically-charged concept. And sometimes responsibility and accountability is put aside to deal with political pressure. But our interactions to date have shown responsible people being in charge and so we'll help them deliver what is best for Ontarians, I think.

Q - Shubha Khan {BIO 16255963 <GO>}

Okay. That's helpful. And one final question -- very quick one. Just on the -- you mentioned that your view on BI in Ontario and Alberta hasn't changed. It sounds like you haven't seen any deterioration in litigation activity from last quarter. I think that's what you mentioned, as far as Alberta was concerned. Is that a fair assumption? Or, I mean, how is that -- how is litigation activity, court decision, how are those stacking up?

A - Charles Brindamour {BIO 7012323 <GO>}

It's a fair assumption. Let me ask Mathieu to give a bit of color here and we'll see if it answers your question.

A - Mathieu Lamy {BIO 15207469 <GO>}

Yes. It is a fair assumption. In Ontario, we don't see the increase in frequency predicted by the reform at this point. Same view as in Q4. In Alberta, our views from Q4 have not changed. What happened in Q4, we still maintain we see no change in the environment versus Q4, in Q1 2013.

A - Charles Brindamour {BIO 7012323 <GO>}

I think the thing you need to keep in mind when it comes to BI is two things. First of all, we are not talking about a lot of numbers -- a lot of files. So the notion of credibility of experience has always been in BI. That's why, from our perspective, it's important to be cautious with that line of business. And not reach conclusions based on a year worth of data settling, because you're talking about small numbers.

The other thing that's really important to understand when it comes to be BI, is that not only don't you get a large number on which to base your view on. But it takes a while before the number actually becomes credible. So a small number of claims. And then the ultimate takes a while. And that's -- our stance in that environment has been one of caution. And the reason why our stance has been one of caution is because I think we learn from what happened at the industry level 10 or 15 years ago in many jurisdictions across the country. The thing that surprised the industry at that time was the fact that the BI trend had been perking up for a while; but because of the late reported nature of BI claims, people find out then the trend is already well-baked in the system.

We sort of learned, I think, from that period. And we are being prudent in that environment. And this motivates, to a certain extent, the caution that we have expressed in Q4, despite what I thought was a good quarter.

Q - Shubha Khan {BIO 16255963 <GO>}

Okay. Thanks for the color.

Operator

Mario Mendonca, Canaccord Genuity.

Q - Mario Mendonca {BIO 2450557 <GO>}

Just a quick follow-up. Charles, you talked about -- and this is going back to Ontario Auto -- that at some point, if things went too far, the issue would become availability. If you could just take that train of thought one step further. So if availability is threatened, is the next step just some folks are pushed into the Facility Association. And then it becomes a big difference then between -- like the difference between what some people pay for auto insurance in Ontario and others becomes much wider? Is that the sort of the logical progression?

A - Charles Brindamour {BIO 7012323 <GO>}

That's exactly right, Mario. I think that, what one needs to understand is there is rate levels within a company and then there is rate levels within the market. And the rate levels within the market, I would argue, in Ontario in the past two years, has gone down compared to what FSCO publishes, because people shop for better deals. Inversely, in a period where people feel that profitability is difficult to achieve -- and let's keep in mind, this is a highly competitive market. So this whole notion of ROE is funny from the perspective that people have competed historically below the sort of ROEs that were on the table.

But in a world where profitability is under pressure, direct writers in general would stop advertising, for instance; would devote less energy to writing business. Companies that distribute through brokers would not offer the same capacity across Ontario that they would in periods of -- where they have an expectation to actually earn a return. And as a result, writers benefit such as Jevco, who are priced higher than the average market. And the Facility Association.

And this is where you go back 10 years, Mario -- I sound like an old guy now -- but if you go back 10 years, the FA in Ontario had a 10% market share. That was CAD1 billion worth of business. So you can do whatever you want with the rates of one company. But if the business goes to the FA, guess what? The average price that the Ontarians are paying goes up. And I think the government understands that and they don't want to go there.

Q - Mario Mendonca {BIO 2450557 <GO>}

The next question, sort of related, is when we talk about a 12% benchmark ROE, is that applied on an industry basis, an industry average basis? It doesn't seem like it would be if the industry is at 7% today. Or is it applied on a company-by-company basis?

A - Charles Brindamour {BIO 7012323 <GO>}

So the way this works, Mario, is that the rate approval and mechanics in Ontario is one where you actually go with your experience of the past three years. Then you load up a number of theoretical factors, such as how much capital you allocate to Ontario, which is a theoretical number. The ROE number, your expected investment income, depending on your asset mix and so on. And that sort of drives the rate indications. So to speak, that you will be asking for.

So in theory, this number is applied company-by-company as you file for rates. And so the thing that's important to keep in mind -- and I talk about theoretical numbers, because you use three years of data in the past to charge for the coming year or two. And the notion of perpetual improvement. So to speak, in running the business is, you want to make sure that your operation runs so that you outperform how you run your operation in the past three years. Long winded answer, Mario, to say that 12% is a factor you use that is unlevered in your filings with FSCO, to justify the rate position that you want to take.

Q - Mario Mendonca {BIO 2450557 <GO>}

If I could just follow-up on that for a second. If the industry is at 7%, I would guess, then, that there is only a handful of companies in Ontario, including your own, that would be up against the cap. And if the cap is reduced, it would seem to me, then, there would only be a handful of companies that would be affected by it. Am I thinking about it correctly?

A - Charles Brindamour {BIO 7012323 <GO>}

No. I mean, I think everybody tries to achieve the sort of ROE benchmark that the regulator has put on the table. And I think a few have been able to achieve that. But everybody is trying to get that sort of ROE. And I think that, prospectively, this will be the same thing. Some people use data and use the experience of the past three years to achieve a certain level of ROE and run the business as is. Other companies are continually trying to improve what they were doing in the past three years to make sure that, over time, you have a reasonable likelihood of hitting that ratio. So Mario, I don't think that the average companies have filed for 7%. I think that's the outcome here. And so I think that's where we stand on this one.

Q - Mario Mendonca {BIO 2450557 <GO>}

Thank you.

Operator

Andre Hardy, RBC Capital Markets.

Q - Andre Hardy

Just a clarification on Ontario BI. You said that the activity is not increasing since the reform. Did you mean not increasing or not increasing faster than expected? Because I thought it was pretty crystal clear that BI was going to increase in Ontario. And everything we read seems to indicate that, for the industry, it is, indeed, increasing.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. I think it's at the expected level, is what I'm saying.

Q - Andre Hardy

Okay. That makes more sense. I must have misheard. Thank you.

Operator

Stephen Boland, GMP.

Q - Stephen Boland {BIO 5546446 <GO>}

Sorry to keep harping on Ontario Auto. But I think the litigant side of the industry, I think, has gotten pretty excited during the quarter with the one case that Belair went to arbitration on a challenge-the-MIG definition. I guess, in your view, I guess, is the cost-containment going to be defined by the -- sort of new catastrophic definition? Or is it going to be settled by precedents like this coming out of arbitration? And how are you positioned for that?

A - Charles Brindamour {BIO 7012323 <GO>}

I'll let Mathieu take this one.

A - Mathieu Lamy {BIO 15207469 <GO>}

First, on this case, specifically, we are appealing that decision. So we think we have -- we are appealing on both fronts on the point of law and procedural fairness in this case. So hopefully, we will see a positive outcome out of that.

The beginning of the question was --?

Q - Stephen Boland {BIO 5546446 <GO>}

Yes. Just basically, how stable, I guess, is the make definition of it, if it is being challenged in arbitration where it's not defined? Like you said, you are appealing it. But there is probably, from what we've heard, hundreds or maybe thousands of cases lined up behind this one that have similar traits in challenging the MIG; but it doesn't mean that they're going to get catastrophic definition. But definitely increase costs of the insurer.

A - Mathieu Lamy {BIO 15207469 <GO>}

So on this front, though, we are appealing this one. And I think there is positive news in the budget where they want to make the MIG guideline binding as opposed to just in the guideline.

A - Charles Brindamour {BIO 7012323 <GO>}

And I think, Stephen, the other point, which is implicit in our remarks here, is that, as the backlog shrunk, it increased our comfort that MIG -- the Minor Injury Guideline -- actually held in a large number of cases. Our caution remains that there is a bit of a backlog being built in arbitration. The decision you are talking about is a preliminary arbitration. And I think there is good grounds to appeal that decision, which we've done. And to avoid uncertainty in that respect, I think the government in the budget is saying some of the loose ends that emerged out of that decision will appear in the budget.

Q - Stephen Boland {BIO 5546446 <GO>}

Thanks very much.

Operator

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

Q - Tom MacKinnon {BIO 2430137 <GO>}

I know, Charles, you talked a little bit about some of the measures with respect to the budget. And one being the tightening of the CAT definition. But can you remind us -- I think you have gone actually through two reserve builds with respect to that interpretation of the CAT definition. I believe you've got to be over CAD30 million that you put -- that you'd already set up in terms of reserve builds for that? I'm just trying to get -- am I correct in that? (multiple speakers)

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. I think (multiple speakers) --

Q - Tom MacKinnon {BIO 2430137 <GO>}

I mean, one was stacking and one was the -- I don't know, single functional impairment.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. I think, Tom, you're right on. There were 2 court decisions in 2012 -- one at the start -- or late 2011 in December. Then I think in August or September 2012, that sort of weakened the CAT definition. And as a result, we indeed strengthened close to CAD30 million worth of reserves for these files.

I don't know, Mathieu, anything you want to add on that front?

A - Mathieu Lamy {BIO 15207469 <GO>}

That's exactly right. Two court decisions that weakened the CAT definition so far. And the number I think is CAD30 million.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. And that's why we think that having a scientifically-driven objective cat definition is a real good thing. That's why it's one of the recommendations that we are making to the government. But this is an issue that's maybe a little more politically-charged than some of the other measures that are on the table. So that's why I express caution at the start of the earlier questions.

A - Mathieu Lamy {BIO 15207469 <GO>}

Yes. And the government expert panel, in their recommendation, were addressing these two decisions. So if that expert panel recommendation was to be accepted, this would remove that uncertainty that has been created by these two decisions.

A - Charles Brindamour {BIO 7012323 <GO>}

Yes. Exactly.

Q - Tom MacKinnon {BIO 2430137 <GO>}

And if that was the case -- I mean, you never like to release these reserves. But wouldn't they become redundant?

A - Charles Brindamour {BIO 7012323 <GO>}

Well I think that's -- we'd have to see what happens, Tom. I wouldn't want to speculate on redundancy of this.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay. Understood.

A - Mathieu Lamy {BIO 15207469 <GO>}

Yes. And these two cases are already occurred. So the decision, if there was a new CAT definition, would be prospective. So the reserves we have are for past cases. It would change our view of the future. But not the past.

A - Charles Brindamour {BIO 7012323 <GO>}

We have to see the execution of this one.

Q - Tom MacKinnon {BIO 2430137 <GO>}

All right. So you're not sure to what extent they are going to apply to open claims files?

A - Charles Brindamour {BIO 7012323 <GO>}

Right. Exactly.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay. Thank you.

A - Charles Brindamour {BIO 7012323 <GO>}

Okay. Thanks, Tom.

Operator

We have no further questions at this time. I turn the call back over to the presenters for closing remarks.

A - Dennis Westfall {BIO 15155973 <GO>}

Thank you, everyone, for participating. The webcast will be archived on our website for one year. The telephone replay will be available at 2 p.m. until Wednesday, May 15. The replay number is 1-888-859-2056 and the pass code is 33222558. A transcript will also be made available on our website. Please note that we are holding our annual general meeting today at 2 p.m.. And our Second Quarter results will be released on July 31. Thank you. And have a great day.

Operator

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