S&P Global
Market Intelligence

Intact Financial Corporation TSX:IFC

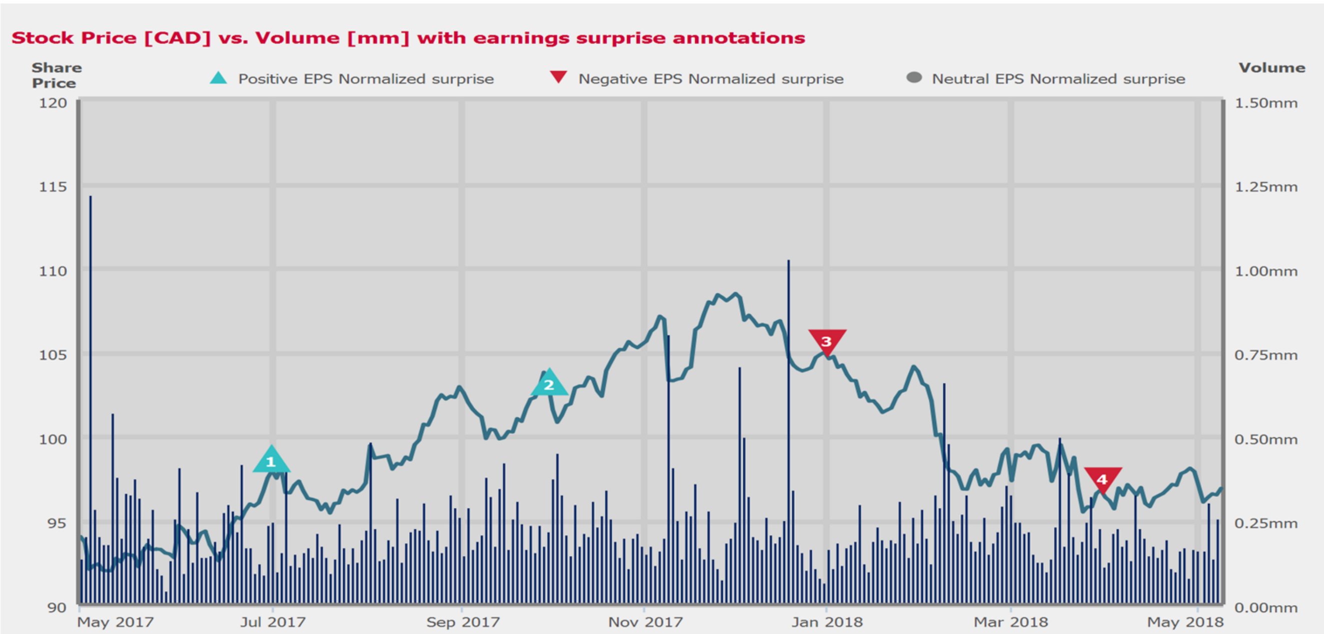
FQ2 2018 Earnings Call Transcripts

Wednesday, August 01, 2018 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2018-			-FQ3 2018-	-FY 2018-	-FY 2019-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.22	1.38	13.11	1.68	5.58	7.46
Revenue (mm)	2342.62	2424.00	3.47	2428.25	9593.60	9895.00

Currency: CAD
Consensus as of Aug-01-2018 12:05 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2017	1.32	1.44	1 9.09 %
FQ3 2017	1.59	1.61	2 1.26 %
FQ4 2017	1.73	1.63	3 (5.78 %)
FQ1 2018	0.87	0.81	4 (6.90 %)

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EXECUTIVES

Charles Brindamour
CEO & Director

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Kenneth Anderson
VP of Investor Relations & Treasurer

Louis Marcotte
Senior VP & CFO

Patrick Barbeau
Senior Vice President of Claims

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RBC Capital Markets, LLC, Research Division

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National Bank Financial, Inc., Research Division

Kai Pan
Morgan Stanley, Research Division

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TD Securities Equity Research

Meny Grauman
Cormark Securities Inc., Research Division

Tom MacKinnon
BMO Capital Markets Equity Research

Presentation

Operator

Good morning. My name is Sarah, and I'll be your conference operator today. At this time, I would like to welcome everyone to the Intact Financial Corp. Second Quarter Results Call. [Operator Instructions] I will now turn the conference over to Mr. Ken Anderson, VP, Investor Relations, and Treasurer. Please go ahead, sir.

Kenneth Anderson
VP of Investor Relations & Treasurer

Thank you, Sarah. 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 the disclaimer on forward-looking statements, which also applies to our discussion on this conference call.

Joining me here in Montréal 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'll begin with prepared remarks, followed by Q&A.

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

Charles Brindamour
CEO & Director

Thanks, Ken. Good morning, everyone. Thanks for joining us today. Last night, we announced second quarter net operating income of $1.38 per share, driven by solid underlying results, including improved personal auto performance.

OneBeacon also delivered strong results, adding approximately $0.12 to our net operating income per share, and net investment income grew by 28%. Early in the quarter, however, many of our customers in Central Canada faced the consequences of 3 severe storms. These CATs impacted net operating income per share by $0.75, almost twice the expected level. But as usual, our troops across the country worked tirelessly to help get customers back on track.

Top line growth, as reported, was 16%, driven primarily by the addition of OneBeacon. And when I look across our entire North American operation, on an organic basis, the portfolio grew by about 2%. We're seeing strong growth in profitable segments on the back of favorable market conditions.

And in segments where profitability actions are in progress, we saw top line declines as expected, a clear sign that our people across North America are executing quite well.

The overall IFC combined ratio was 96.1%. The Canadian performance at 96.6% reflects improvement in personal auto and strong underlying fundamentals in personal property and commercial business. Our U.S. operation delivered a solid performance, with a combined ratio of 93.8% as we drive towards a sustainable low-90s level.

Book value per share grew 15% over the past year. Operating ROE was 12%. And we ended the quarter with a total capital margin in excess of $1.2 billion.

When we compare ourselves to the industry at the end of the first quarter, we outperformed by 660 basis points on ROE, well above our target of 500 basis points. But to be clear, while we exceeded our ROE outperformance target, I'm not happy with 12% ROE, and we remain focused on actions to return the ROE to the mid-teens.

Let's look in more detail at our results by line of business, starting with Canada. So as we anticipated, our personal auto portfolio continues to shrink as our rate actions started a full 18 months ahead of the market. We expect that trajectory to reverse in the coming year as the market continues to firm up. In the meantime, we're seeing bottom line benefits. The combined ratio of 95.6% improved 2.2 points compared to last year, driven by a stronger underlying performance and lower expenses. This was despite 2.3 points of unfavorable prior year development, which was largely

[Audio Gap]

accident benefits in Ontario.

The underlying current accident year loss ratio declined almost 3 points to below 70%. Excluding pools and the impact from lingering winter weather, we see close to 5 points of improvement year-over-year. Our action plan in risk selection and in claims are delivering results in our view and showing signs of taming inflation. But we have more to do. Our actions on all fronts will continue, and we expect to reach a mid-90s run rate by the end of the year.

The environment in which we compete continues to tighten with capacity constraints and rates increasing. Industry growth in the first quarter was above 6%, and we saw further rate increases across the country in the second quarter. We've also seen sustained growth in the residual markets, confirming our view that the market is firming fast. This environment supports our profitability improvement plan, and we expect mid-single-digit growth for the industry in the coming year in that segment.

In personal property, premiums grew by 2%. And while rates are up, our actions in auto are putting pressure on growth in that line given many of our customers have a joint home and auto policy. The combined ratio in property for the quarter of 102.7% was disappointing but includes more than 18 points from CATs.

That said, I'm pleased with the underlying performance where our strategies over time have been fairly successful and proven to be sustainable. Personal property continues to be positioned well for the future.

The outlook on property is also favorable as changing weather patterns and elevated catastrophe losses support continued firm market conditions. The industry grew north of 5% in the first quarter, and we expect mid-single-digit growth over the next 12 months.

Looking at commercial lines in Canada. Top line growth was quite strong at 7%. We saw accelerating growth in both commercial P&C at 6% and commercial auto at 8%. The combined ratio was 92.9% despite close to 7 points from CATs, 3x the expected level. The underlying fundamentals of this business remain strong and the outlook is trending fairly, where we expect mid-single-digit growth for the industry in the coming year.

Given our loss ratio outperformance in this line is north of 10%, we're uniquely positioned to take advantage of a firming environment, with a very strong footing of profitability.

Turning now to results for our U.S. commercial segment. Premiums of $374 million bolstered IFC's top line growth significantly. On an organic basis, growth was 2%, including low double-digit growth in the segments we're focusing on for expansion. We saw declines in segments undergoing profitability improvement as we expected.

The combined ratio of 93.8% is an improvement of 1.5 points over last quarter and a second sequential improvement since closing. Strong progress has been made on synergies, and we will provide more details in these remarks. We continue to monitor this business very closely as we work towards a sustainable low-90s combined ratio. We're well on track to deliver mid-single-digit run rate accretion to net operating income per share by the end of 2019.

Looking at the U.S. specialty industry outlook. Market conditions, since the transaction closed, have evolved better-than-anticipated, with modest upward pricing trends continuing. Overall, we expect low to mid-single-digit industry growth for U.S. specialty over the next 12 months.

Turning to strategy. Digital engagement with our customers is an important lever in our customer-driven strategy. In May, we launched the Intact Insurance mobile app across the country. Together with belairdirect app, we now have in place an industry-leading platform to connect with our customers like never before. App features include, amongst others, electronic proof of insurance, document access, claims filing, claims tracking and so on. In the coming weeks, the app will also integrate our latest telematics offer, which is also very popular with our customers. We see mobile users engage with us more than twice as often as users of other digital platforms. This is meaningful progress and highlights the potential to come from our leadership in digital engagement and customer-driven transformation.

So in conclusion, while the weather impacted results, the resilience of our platform was evident in the quarter. Actions to improve performance are paying off, and market dynamics continue to evolve in our favor. Commercial lines in Canada are performing well, and we're taking advantage as growth momentum takes hold. In personal auto, there's more work to be done. But our action plan is gaining traction, and underlying performance is improving. We're on track to bring the auto combined ratio run rate to the mid-90s by year-end.

Profitability in our U.S. franchise is improving nicely towards our low-90s goal, and we're moving fast to capture growth opportunities. IFC's financial position is strong, and we're gaining momentum. Our strategies, initiatives and discipline position us well to deliver on our financial objectives to outperform the industry ROE by at least 500 basis points every year and grow our net operating income per share by 10% per year over time.

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

Louis Marcotte
Senior VP & CFO

Thanks, Charles, and good morning, everyone. For the second quarter, net operating income of $201 million improved 4% over last year despite almost $40 million of additional CAT losses. The improvement was driven by personal auto results, investment income and OneBeacon, which contributed $21 million of new underwriting income to our quarterly results.

Our balance sheet is strong, with over $1.2 billion in total capital margin and a debt-to-total capital ratio of 22.5%. Book value per share is up 15% year-over-year and 3% since the end of the first quarter.

Let me provide some additional color on our second quarter results, starting with Canada. The combined ratio in personal auto improved 2.2 points over 2017 as we made good progress this quarter. The overall improvement of 5 points to the underlying current-year loss ratio that Charles discussed was driven mainly by a 5% rise in earned rates, combined with a decline in both frequency and severity. While there is more to do, the results demonstrate the effectiveness of our action plan.

In terms of new premiums, our written rates are up 5% at the end of Q2.

The personal auto combined ratio run rate is estimated by removing the noise from unusual weather, normalizing for prior year development and pools and adjusting for seasonality. On that basis, we estimate the combined ratio run rate to be approximately around 97% at the end of second quarter, 1 point better than where we stood at the end of the first quarter on an apples-to-apples basis. We are encouraged by these results, but we will maintain our efforts until we have reached our mid-90s run rate on a sustainable basis.

Our Canadian expense ratio remains low and stable at 29.4%. We have been able to diligently manage expenses while reinvesting in brand and technology to support our customer-driven strategies. We expect the expense ratio to remain at current levels for the remainder of the year.

Our distribution business is strong and added $52 million to operating earnings in the quarter. We still expect to grow this income stream by 10% in 2018, driven by broker network growth and profitability improvements.

Now turning to U.S. commercial. We reported a solid 93.8% combined ratio, driven by a healthy underlying current-year loss ratio of 56.5%, minimal prior year development and a respectable 37% expense ratio. Although there is still more work to be done as we move towards a sustainable low-90s level, our profit improvement plan is proving to be effective so far.

We realized almost USD 6 million of synergies in Q2 and USD 10 million year-to-date. We have now reached our USD 25 million run rate target ahead of schedule. Savings have been realized across IT, investment management, shared services and reinsurance costs. Near term, we expect the expense ratio to remain steady around 37%.

On the claims front, we have already begun to internalize legal work, and we expect most of the benefits to materialize towards the back end of our profitability plan. With regards to improving OneBeacon's lines of business, we are seeing good progress on the lines undergoing profitability improvement plans, but the benefits are also back-ended in terms of timing. Prior year development was minimal in the quarter as expected, and we still have significant capacity remaining on the adverse development cover, which we purchased at closing.

Net investment income increased 28% in Q2 to $134 million. Our investment team completed the integration of OneBeacon's investment portfolio faster than anticipated and were able to optimize the structure of the portfolio based on tax and capital considerations across countries. They also leveraged the transition to accelerate the reinvestment of fixed income securities at higher yield. These changes were made without increasing the risk envelope. We now expect to report slightly north of $500 million in net investment income in 2018.

A few words on our balance sheet. We ended the quarter in a strong financial position, with a total capital margin in excess of $1.2 billion. In Canada, our MCT was 201%, and in the U.S., the RBC regulatory capital stood at 405%, both well above minimum required levels.

During the quarter, we took advantage of positive market tone and strong investor demand to issue $250 million rate reset preferred shares, with an annual yield of 4.9%. The issue brought preferred shares to 10% of our capital structure, consistent with our long-term target. The issuance has minimal impact to net operating income per share, while strengthening our balance sheet and providing additional capital to pursue growth opportunities.

In conclusion, our personal auto profitability plan is showing progress and the underlying performance in our personal property and commercial lines remain solid. OneBeacon is well on its way to meet our profitability targets and establish its position as a leading North American specialty insurer. Overall, I am very pleased with the progress shown in this quarter. But we will continue to work to ensure the sustainability of these results.

With regards to net operating income per share growth. We have multiple levers to meet our 10% growth objective. These include improving our personal auto results, the addition of OneBeacon's earnings, higher investment income and growing distribution results. In addition, current market conditions are increasingly conducive to organic growth in personal lines. And finally, we have a strong balance sheet at our disposal to capture inorganic growth opportunities. I am therefore confident in our ability to meet our growth target over time.

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

Kenneth Anderson
VP of Investor Relations & Treasurer

Thank you, Louis. [Operator Instructions]
So Sarah, we're now ready to take questions.

Question and Answer

Operator

[Operator Instructions] And your first question comes from the line of Geoff Kwan from RBC Capital.

Geoffrey Kwan
RBC Capital Markets, LLC, Research Division

First question is on personal auto. When I think about the level of -- or how should we think about your level of conviction around at your target of reaching the mid-90s combined ratio by the end of the year? Like if you have to rank it on a scale of 1 to 10, how do you feel about it today and where would you have been at the start of the year? And then, also, if I can ask on the year-over-year trend in the DPW or number of insured risks. When do you expect that to start to stabilize and then maybe start to improve?

Charles Brindamour
CEO & Director

We start with the last part of your questions. I'll ask Darren to talk about the marketplace as we see it now, the lag in competitive position and the sort of timing you see from a top line point of view. And then you give your perspective on conviction, but I'd encourage you not to go in too much scaling.

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Yes, so -- thanks, Charles. So I mean, I think, initially, as Charles said, definitely, the market capacity continues to tighten. So we see right momentum pretty much coast to coast from most players. We see residual markets continue to grow. In fact, facility association, which is a sign that we look for in the marketplace around capacity, was well up also in the quarter. Markets are tightening eligibility rules, et cetera. So all

[Audio Gap]

continuation of a hardy market, which will support our plan. Now as far as growth is concerned, now clearly, when we look at sort of, say, in the last 24 months, even though the gap between the position that we have taken on rates and what the industry has taken is declining that gap, is declining, the industry is still is a fairway behind where we are at sort of around interactivity in the last 24 months. So when you look at the industry results, combined ratio is well in excess of 100%, supported by favorable PYD. Clearly, there is further inadequacy within the marketplace. So we expect further rate increases to come from the industry. Now that does take some time obviously. There's filing processes to go through. So while that process continues from an approval standpoint, we expect to see that firming up, will very much continue, very much in the near term. I think from an Intact growth standpoint, you're right there, Geoff, in terms of we continue to be challenged from a short-term standpoint. I think in the near term, as that gap on rate shrinks, we'll still see some of that pressure. However, I would suggest though that growth opportunities will become available in the near term, of which we will be very cautious in terms of how we assess those opportunities as we move forward on our profitability action plan. But from an action plan standpoint, we're continuing to drive rate increases. We're continuing to drive risk selection segmentation. So coupled with that, with the market conditions, we believe we're well placed, from a profitability standpoint, with a growth opportunity, still, I would say, a little bit in a few more quarters still to come.

Charles Brindamour
CEO & Director

Yes, I think that is a good summary. We're over a year ahead of the industry on rates. And I think that, that will take time to clear and it's a regulated line of business. So I suspect the trajectory will change, but not at the same bit as you'd see it in other lines of business, and we're quite fine with that. With regards to our conviction, when I look at the actions that were taking place, I -- my conviction is the execution on that is north of 9. And the reason why I say that is because we've done more than what we said we'd do. And I think if sitting here in Q2 with 5% rate increases written and 5%-ish earning, I think that there is momentum there and there is a lot of work done on risk selection. And Patrick and team in claims are gaining traction as well with their claims action plans. So when I look at the execution, I'm pleased with what I see. People are focused, and they know that this is all-hands-on-deck. I think the -- we're seeing -- we're on track to hit the mid-90s run rate by year-end. It is a fairly long tail line of business. There is risk around trend, and that's why I'm not going to give you an overall score. But on track is how I would summarize where we are at this stage.

Geoffrey Kwan
RBC Capital Markets, LLC, Research Division

Okay. And just my -- quickly my second question. I think you recently increased your investment in Metromile. And maybe thinking about that part of your business, not just Metromile, but some of your other investments, are there any key learnings that you observed over the last little bit and how that may apply to your existing businesses, whether or not in Canada or even in the U.S.?

Charles Brindamour
CEO & Director

We have a number of investments in our venture portfolio that are centered -- is your question about personal automobile or just learning in general out of the bench...

Geoffrey Kwan
RBC Capital Markets, LLC, Research Division

Well, your learnings. I know most of the investments are on the personal auto side, so maybe focus a little bit more on that, I guess.

Charles Brindamour
CEO & Director

Yes. Well, I think that the ventures are centered around data and AI. They're centered around new forms of distribution and mobility, to a certain extent. And as you know, when we look at the very long-term future of personal automobile, we have said that what matters here is us leading in data, emission out of vehicle and telematics, us leading in sharing, which is also a part of our venture strategy, and keeping an eye on what's happening on the autonomous front of things and leading in the commercial automobile as well as ownership of the carpool shifts. And I would say that on each of those sectors, there is a fair bit of learning that is feeding how we think about telematics, how we think about the sharing economy and how we think about the long-term positioning of the automobile insurance portfolio broadly. So a fair bit of learning indeed.

Operator

Your next question comes from the line of Kai Pan from Morgan Stanley.

Kai Pan
Morgan Stanley, Research Division

So my first question is on the personal auto, just a follow-up. And I wanted to believe in the math because you mentioned underlying, seasonally adjusted, 97%. If you start with 95.6% reported, you take out the 2.3 points unfavorable and then you take out the 2 points of these one-off items, which imply you need to sort of seasonally adjust almost 7 points. I just wonder, is that correct or not. And also, can you give a little bit guidance to see what seasonal adjustments for the third quarter and the fourth quarter as well?

Louis Marcotte
Senior VP & CFO

So I guess, on the seasonality part, we would move it roughly between 25 points here. And it's not the precise calculation. We go back into history, the short and long term. So it's a fairly wide range here of seasonality. We would use probably 3 to 5 points of seasonality to measure and come up with our 97%. I would say Q2 is the...

Charles Brindamour
CEO & Director

97% would be at the upper end of the seasonality range.

Louis Marcotte
Senior VP & CFO

Absolutely. Yes. And Q2 is also the one that has the most favorable seasonality impact as a whole. And providing the run rate, I think it's a fair measure to compare with where we were at Q1. And I would say the expectations on other quarters is a bit less drastic than it has been in Q2. So we don't -- we have not published exact seasonality per line of business, but they would be certainly less important than the one we've used in Q2, which is the most significant seasonal difference.

Kai Pan
Morgan Stanley, Research Division

Okay. Great. And then my second question, on catastrophe losses. If you look in the last 3 years, you've been pretty elevated. And so I just wonder, would you be able to update the $275 million annual guidance or more importantly, how do you -- pricing in or in recent selection, these -- since the elevated level of the CATs losses.

Patrick Barbeau
Senior Vice President of Claims

Yes, we regularly update our projected CATs for many reasons, for pricing, as you point out, but also to reflect in those projections the learnings we get from every new event. This $275 million was updated last November. And we look at averages over the 5, 10, 15 years. And when you use that, if I focus on 5 and 10 years' averages over the past, you need to factor in the fact that at least 2 of the events during that period, I'm referring to the forest fires of Fort Mac and some of the floods in 2013, repeat periods that are longer than those 5 and 10 years, so you need to smooth those out. But when you do so, that's how we came to a range that was around the $275 million at the end of 2017. We will continue to update that on a regular basis. But at this point, nothing points out to a different number with the recent experience. Even if it was somewhat more elevated than that in the first half of the year, this is a short period of time to adjust that.

Louis Marcotte
Senior VP & CFO

Yes. And from a pricing standpoint, as Patrick alluded to, internally, we do a lot of work in terms of what is our expected level of CATs. We incorporate that very much into our pricing strategy, but also in terms of our product design as well too. So I mean, I think that as weather evolves and if we feel as if that there is a shift in weather and so forth, we will obviously clearly look at both price and product. We are not there yet today, clearly, in terms of our expected levels to increase from a CATs standpoint. What I would say though from, particularly -- in particular, from a personal property standpoint, yes, even though we do see elevated levels of CAT in Q2, this is a part that continues to be well sustainable. We continue to see strong results from an underlying standpoint. Even though Q2 -- even though '17 was elevated, 2017 itself turned out to be still another strong year as well too. So our view in terms of sustainability of that particular part has not changed at all, given what we've seen in the quarter, and we're well placed from a personal property standpoint.

Charles Brindamour
CEO & Director

And if I come back to your first question, Kai, in terms of the impact of seasonality. You look at the combined ratio in Q2 at 95.6%, you neutralize it for CATs or pools or PYD, you get to a combined ratio of about 91.5% to 92%, okay? And then Louis talks about the seasonality range of 3% to 5%, we sort of go at the upper end of the range, you go from 92% to 97%. So that's sort of how we're thinking about it and giving you a sense for where we think we are and the fact that we're on track to hit the mid-90s, clearly given where we're now by the end of the year.

Kai Pan
Morgan Stanley, Research Division

And so if frequency severity remains favorable, there's a possibility you could overshoot to the -- to your 95% target by year-end?

Charles Brindamour
CEO & Director

We're -- if I sum up where I think we are, I'd say, on track.

Operator

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

Tom MacKinnon
BMO Capital Markets Equity Research

Just 2 quick questions, one with respect to -- in personal property. I know, in the quarter, you talked about an increase in large fire losses. That certainly has been something that is in the news of late. So maybe you can talk about some of the large fire losses that are happening this summer and what you see as impacting your results, if any, for the third quarter. And I have a follow-up.

Charles Brindamour
CEO & Director

Yes, Tom, let me ask Patrick who's keeping an eye on these things to give you his perspective.

Patrick Barbeau
Senior Vice President of Claims

Yes. So maybe the first thing to clarify is the fire losses we are referring to for Q2 are single fires, not really related to the forest fires that you -- we have seen in the news. So those are 2 different things. There had been -- weather has been good and dry, which created more forest fires overall in Canada. So far this year, more than 1,000 have been active at different points in time. Most of them are quickly put under control. Right now, there is about 30 of those fires that are set to be not fully under control. Only 2 of them are representing potential threat to living -- surrounding communities, one in Northern Ontario and one in Central B.C. But they're still quite far from the communities. We're monitoring all of them on a daily basis. And -- but no imminent threats from the existing forest fires at the moment.

Tom MacKinnon
BMO Capital Markets Equity Research

And of the -- I think your guidance for CAT losses, is that still on the $275 million annually? Is that...

Charles Brindamour
CEO & Director

Yes.

Tom MacKinnon
BMO Capital Markets Equity Research

And you expect half of those generally to be in the third quarter? Is that right?

Charles Brindamour
CEO & Director

Yes. Our view hasn't really changed there.

Tom MacKinnon
BMO Capital Markets Equity Research

And given that we had higher-than-expected CAT losses in the first quarter and in the second quarter, do you think -- is it necessary to revisit this $275 million number? So I mean...

Louis Marcotte
Senior VP & CFO

Maybe, our new year -- yes, so we talk about this every quarter, but reality is, we've updated it in November. Reupdating it within the year, given that we base ourselves on long-term averages, would be a bit too fast. And it doesn't take long, like -- although we expect Q3 to be half because of historical statistics, it may not be that way. So I think it would be fair for us to really take another good look at the end of November, a year after we've updated the -- last year's and update that if necessary.

Charles Brindamour
CEO & Director

Yes.

Louis Marcotte
Senior VP & CFO

Doing it faster would be, I think, a bit too soon, given the lumpiness of the CATs.

Charles Brindamour
CEO & Director

Yes. I think, Tom, that your observation on a quarterly basis is right in my view. When I look at personal prop and I look at the last 5 years, so 6 months into the year, into '18 in personal prop, combined ratio is 96%, okay? In 2017, for the whole year, 89%. In 2016, 91%. In 2015, 86%. In 2014, 89%. So CATs are creating noise, but it's, overall, been helping the demand for the product. And I think the product is priced to do well in periods of CATs. I understand it is indeed noisy, and that's why we often disclose if we think disclosure is worthy at the end of the quarter to make sure that most of you are on it -- well, all of you actually.

Tom MacKinnon
BMO Capital Markets Equity Research

And any commentary on personal auto rate increases that you filed for in the second quarter and in the third quarter?

Charles Brindamour
CEO & Director

I'll ask Darren to share his perspective on that.

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Yes. I mean, I'll be careful with my comments here given the competition, but I mean, we continue to assess where we can take rate increases. We continue to file very slightly from province to province. But where we feel as if market conditions are sufficient, such that we feel as if we can take-rate and also, there is a need for take-rate, we're continuing with our strategy, from an action standpoint, to file for rate increases.

Charles Brindamour
CEO & Director

Yes.

Darren Christopher Godfrey

Senior Vice President of Personal Lines

It varies coast to coast. But -- and that's probably as far as I'll probably want to get there, Tom.

Charles Brindamour
CEO & Director

Yes. And I think the Q2 numbers are out in some jurisdictions. We've taken rates in a few places.

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Yes. And there's obviously, sometimes -- I mean, you're right, Charlie. In terms of Ontario, numbers are out there. But the numbers that are out, sometimes, we will see quarter-to-quarter, a little bit of difference between our actions and the industry actions. Sometimes, there's timing differences. Sometimes, I know, like for example, in Q2, on the fiscal numbers, it will show minimal rate increases from us, but you'll also see that we took more in Q1. So you'll see a little bit of noise there.

Charles Brindamour
CEO & Director

We're -- overall, I'll say this. So the market is firming up. There's a big lag to catch up before our price point is becoming competitive. We're open to growth at our conditions. And we're still on the mindset of getting rate where needed or where we can. And therefore, we have plans for the fall as well as '19, and we're working on that.

Operator

Your next question comes from the line of Meny Grauman from Cormark.

Meny Grauman
Cormark Securities Inc., Research Division

Just a question on physical damage costs, if you could just talk to that specifically. And so any commentary for the quarter, especially when it comes to the rate of inflation and how that's tracking the 4% trend?

Charles Brindamour
CEO & Director

Yes. Patrick?

Patrick Barbeau
Senior Vice President of Claims

Yes. So we've talked about physical damage pressure in costs. In the past, it's been, for a period of time, even somewhat higher than the 4% you're quoting. We said that, in Q2, it was actually a decrease in overall severity in cost for auto. And when I look specifically at the cost of PD, our action plans in claims were targeting 3 main components of that PD cost. There was the actual cost of the parts and repairs. There's the cost of rentals and tolling fees. And there's also some other fees around storage for total loss and all that. And we're working on all 3 fronts. What we see in Q2 is that -- well, those plans we're targeting to temper the inflation, and we see that the inflation, coming from the cost of parts and cost of repairs, is still there. But some of our actions are up than down, and I can give you a few examples of what we're starting to see in Q2 from a claim's perspective. One key example is the cost of rentals. We have reduced our cycle time by close to 2 full days with our action plans in repairs and total loss. That has reduced the rental cost by slightly more than 10% compared to prior quarters. And this is a key portion because we can actually benchmark ourselves with the industry. And we see that, that reduction has created a bigger gap between us and the industry. So that's a portion of the severity trend that we can link back directly to our actions. From an actual cost of repair perspective, we've seen the cost of repair overall, so parts and labor together, slightly go down year-on-year in Q2, which is the first quarter we've seen that in a while. So we can link back some of those components. So overall, this quarter, the severity was actually down. But we're seeing a good portion of that coming directly from our actions. There might be some situations from quarter-to-quarter that explains the rest.

Meny Grauman
Cormark Securities Inc., Research Division

And if I could just ask another question on just the regulatory landscape we had in the election in Ontario. It sounds like, especially in Ontario, but across the country, it's pretty benign. But I'm wondering if there's any specific regulatory issues that are on your radar screen, anything that you're worried about.

Charles Brindamour
CEO & Director

Darren, why don't you give your perspective on the regulatory landscape from coast to coast and focus on automobile insurance?

Darren Christopher Godfrey
Senior Vice President of Personal Lines

Yes, I mean, you're right. We haven't really seen material changes in the regulatory landscape and almost as, as you alluded to, in the election in Ontario. Still very early days. They're still going through a transition. Obviously, both from an IFC standpoint and from an industry standpoint, very big proponents of the Marshall Report. So we're really gearing up from a GR standpoint there. But otherwise, really, no other significant changes. The only other, maybe the subtle change that I would mention, would be in Alberta in particular. The government brought out a slight amendment to the minor injury definition in Alberta. So really, as we have talked about in the past, 2 issues in Alberta around minor injuries, one is TMJ, and the other one is around chronic pain. And I'm very much simplifying, but that are the 2 sort of major streams. So they brought about a change in the minor injury definition, really addressing the TMJ issue to a fair degree. And these were effective on June 1, so all claims post the June 1 would now apply under this new definition. When we look at Alberta, when we look at the industry's results for Alberta and the inadequacy that exists there in the industry, there's more work that still needs to be done from an MRI standpoint. But we're encouraged to see early signs about the government addressing some of the cost pressures that we see in Alberta. So that's probably the only, I would say, change that we've seen from a regulatory environment in the last quarter.

Charles Brindamour
CEO & Director

Yes. I think that's exactly right, Darren. I will add that in dialogue, over the years, with the party in power in Ontario, they have been very receptive to the notion that automobile insurance is very, very competitive and that making changes to the approval process to unleash competitive forces to a greater extent is seen as a good thing. And therefore, I think this is an area where I'm hoping that we will, in the context of the Ontario marketplace, have a more dynamic sort of pricing environment that would be good, I think, for consumers in the long run, and I think the party in power certainly gets that. I think that when I think about the political and regulatory landscape from coast to coast at the moment and I look back to our experience as a firm going through cycles, I would say that we're in a period that indeed appears to be benign from a regulatory point of view, but we're in a period where the market is firming up meaningfully. And that means rates are going up across the land. It means that capacity is tightening up. A number of insurers who sat on their hands as inflation was catching up with them, who sat on their hands when it comes to taking rate actions are sitting out there not really wanting to write business at the moment. This tends to fuel growth in nonstandard or residual markets, which we've highlighted. We've seen growth in that segment. We've mentioned that to you guys in the past couple of quarters. And this elevates the tension, so to speak. There's no meaningful issues at this stage, but it is a riskier regulatory environment when capacity is tightening up. And we're working with regulators across the land to make sure they understand the environment and also what they can do about it to improve the dynamics of the marketplace. And I do believe that the change that Darren has talked about in Alberta is a very concrete sign that a government is seeing inflation, seeing the market tightening up a bit and doing their part to improve the availability of driving for Albertans. And therefore, I am encouraged by that.

Operator

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

Mario Mendonca
TD Securities Equity Research

Just a quick question. First, Louis, you concluded your comments with -- you reiterated the 10% growth in net operating EPS. Now what I'm trying to understand is, was -- would you suggest that, that applies to 2019? And the reason I'm asking the question is there's so much that went poorly early on in 2018, the CAT losses, the unusually bad weather, the -- all the significant improvements you're making to auto. There's a good long list I can go through, not the least of which is OneBeacon as well, that would suggest 2019 has to be a lot better than 10%. So I'm asking you, is when you talked the 10%, you emphasized it, were you trying to send us a signal that the 10% is relevant in 2019, or is there some other message here?

Louis Marcotte
Senior VP & CFO

Well, I think I was not trying to get specific for guidance for 2019. I was trying to share the elements of upside that we see as levers. The conditions are favorable, as Charles has alluded to, and NOIPS growth is clearly a key target for us. And we certainly are working on those levers to make sure that we get to that target over time. So -- but I was not very specific, I was not pointing at 2019.

Charles Brindamour
CEO & Director

No, I think the reason why we like that objective is because it's not a plain growth objective, it's an objective that has a number of levers to move the needle. And I would say, when I look at where we are right now, on each of those levers, I see upside, what can drive NOIPS growth, organic growth. While the market is firming up, automobile on 12 months, you should see better organic growth there. You've seen commercial lines is growing at 7% at the moment. So when I look at the NOIPS component, the organic growth lever is certainly clearly positive. When I look at margins, we're working hard on auto, OneBeacon is improving, and the property and commercial lines are doing well. So I look favorably at this lever as well. When I look at capital, we have a strong capital base. There's a lot of opportunities in the market. I'm hoping we can use our capital base to be accretive to earnings as well. And so not at all moments in the cycle do you have all the levers lined up to contribute to NOIPS growth. And I think this is a point in time where most of those levers should move in the same positive direction. I won't go beyond that to talk about a number, but I would say that there's good alignment between what can move the NOIPS here very clearly.

Mario Mendonca
TD Securities Equity Research

So bottom line for both of you, the 10% was not a reference to 2019?

Louis Marcotte
Senior VP & CFO

No.

Charles Brindamour
CEO & Director

No.

Mario Mendonca
TD Securities Equity Research

Okay. Well, let me move on to something else then. Maybe you've already discussed this and I missed it. There were references last quarter to reserve development personal auto being neutral. And this quarter, obviously, didn't work out that way. So a couple of things. What played out this quarter that was disappointing? And then secondly, what's your outlook?

Charles Brindamour
CEO & Director

Patrick, you want to give a perspective?

Patrick Barbeau
Senior Vice President of Claims

Yes. The activity -- the adverse development we've seen in Q2 for personal auto was limited to accident benefit coverage in Ontario, was limited to a large part and more specifically, to a couple accident years prior to the reform of June 2016. Clearly, people are trying to get as much as they can from their claims before the new regime. But that has a -- there's a limit to that as we close more and more of the files from those prior years. And from a claim's perspective, when we get those requests, we are being careful, at the moment, in how we reserve when we're pulling up the reserve. That's really what happened in Q2, really isolated to one line of business. And it might be important to mention that the type of claims that are -- that have developed in Q2 are specifically linked to what the reform of 2016 is trying to address.

Charles Brindamour
CEO & Director

Yes. I think that's a very good way to put it. It is surgical, and it is people and entrepreneurs, so to speak, trying to get the most out of the previous regime pre-reform. Now the thing we're observing, Mario, that we're not giving full credibility to at this stage, is that while there's more demand for CATs in accident benefit for those 2 accident years, the demands that actually translate into CATs, or what I would call the concession rate for CATs, is actually coming down, and that is only partially reflected on how we're reserving.

Mario Mendonca
TD Securities Equity Research

The concession rate being what you will accept as a CAT?

Charles Brindamour
CEO & Director

Yes, exactly.

Mario Mendonca
TD Securities Equity Research

And you're saying that's coming down. So that's a positive, but you haven't reflected that yet.

Charles Brindamour
CEO & Director

Not fully.

Mario Mendonca
TD Securities Equity Research

Okay. And so your outlook then on this matter, let's say, over the next few quarters, neutral or unfavorable?

Charles Brindamour
CEO & Director

I'd say neutral. And it can go either way. It's the right way to think about it, neutral. And in aggregate, for the organization, we've guided towards 2% to 4% at the lower end of that range in the near to mid-term, in part, because of interest rates, which put some lead to a lower provision for adverse deviation and in part, because of the period we're in, in automobile insurance at the moment, where we're taking a cautious look at some of the improvements we're seeing.

Operator

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

Doug Young
Desjardins Securities Inc., Research Division

Just following on that question around the prior year reserve developments. And I get what you said, Charles, about concessions and whatnot. But is there any way to put this in a different perspective in terms of, meaning how many pre-2016 Ontario auto claim files are left open? What's the closing rate that we're going through? And are you assuming, essentially in most of these cases, the worst potential outcome from the CAT stacking? Or is there any other way to kind of put this in perspective?

Charles Brindamour
CEO & Director

Tricky to get into numbers. The point I'm making is that it's not because you say you're deemed catastrophically injured that you actually are, right? I mean, there are -- there was a certain stream of catastrophically injured people that needed real care and then when the reforms came in, in June 2016, reducing the ability to claim psychological damage as a trigger to become catastrophically injured. We've seen now that people claim that to a much greater extent, and entrepreneurs working around the automobile insurance space do that. And our acceptance of those claim is coming down, and we're only partially giving credibility for this. Now the numbers we're talking about, Doug, are actually very small numbers. But as you know, our CAT in automobile insurance is worth $1 million or more, where the stage before, which is called basic claim, would be in the tens of thousands of dollars. So to actually put a number on the number of CATs that one can get, I mean, it's tens of CATs. It's not hundreds nor thousands. They swing, but 6, 7, 8, 9, 10 of them are worth $10 million. And that's the sort of swings you're seeing in the results. And we're taking them, to a certain extent, at face value for now until we see that those reforms become effective and until we see that the concession rate actually holds at a lower level. But it's -- Doug, I'll take your question into consideration. And either ahead of roadshows or ahead of the next quarter, we'll think of a different way to present it, if there is a good one that can be publicly disclosed.

Doug Young
Desjardins Securities Inc., Research Division

All right. I appreciate that. The second is just back to the 97% that you were talking about. I mean, I guess a simple way to think of it for Q4 -- or for Q3 or Q4 is we take the combined ratio, we back out the prior year reserve development, we back out the CATs, so you get to a current year accident combined ratio. And if that current year accident combined ratio is 97% or better, and if it's 97%, Charles, are you saying basically you would say that you've hit your target in terms of a run rate mid-90% combined ratio? Is that essentially the way to think of this?

Charles Brindamour
CEO & Director

That's -- yes, that's not a bad way to think of this. I'm not sure I'd say that at 97%, Doug, but right because when we say mid, we're sort of thinking about mid here. But that would be a good way to do this. In aggregate, we want the line to be in that space all in, just to be clear. When we track our progress, we're trying to make sure that the one-offs don't cloud our read on where we are one way or another. And I think Louis has laid out very clearly that if you take the upper end of what we view as seasonality range, this is how we think about how much more work is needed at this stage, and we think that what's in the pipeline will get us there. And that's why I conclude here that we're on track.

Doug Young
Desjardins Securities Inc., Research Division

So I guess that's where I'm getting confused. Just like is 97%, the 95%? Or is it essentially in Q4? Basically, you want the auto combined ratio to be 95%.

Charles Brindamour
CEO & Director

I think we want the run rate in Q4 to be in the mid-90s when you take seasonality into consideration basically.

Doug Young
Desjardins Securities Inc., Research Division

Okay. And then just lastly, just you mentioned the risk-sharing pools a few times. And it looks like the residual market, it looks like the results have been fine. But the risk-sharing pools, I guess, when I look at the expected combined ratio for this year, it's about 167%. And as you mentioned, this pool is growing. So -- and I know I've asked this before, and hopefully, we can kind of get a little bit of a different flavor to it. But does that concern you? And if not, why not? And I know you probably put in business, and that is a higher combined ratio, but net-net, it's still a drag. And as you mentioned, it's a 1 point drag year-over-year on the current accident year loss ratio in personal auto. So I'm just hoping to get a little color.

Charles Brindamour
CEO & Director

I think it is true that the pools -- the business that is in the pool is performing poorly, but what matters is how poor a business you send in the pool compared to the business that's in the pool. And our track record from that point of view has been very good. In fact, it's been ceding worse business than the business that there is in the pool. But I don't think the pool is actually a structural drag to our performance. And Darren, you might want to share your perspective on this.

Darren Christopher Godfrey
Senior Vice President of Personal Lines

No, absolutely. I think a little bit more context I can provide there within the quarter itself. So Q2-over-Q2, yes, we did talk about pools did impact the current accident year by a point. But pools also favorably impacted the PYD for a point. So if we're looking in aggregate, and particularly in the quarter, pools had 0 impact in totality in Q2. Now when we look year-to-date, pools are actually favorably impacting our combined ratio by roughly 0.6 points, which is very much in line with our long-term expectations. We're going to see, as we have seen in the past, we're going to see some noise from quarter-to-quarter. We're going to see noise between current accident year and prior accident years. That will continue. Obviously, there's an element of the pool, as you talk about, the assumed element, that we're not reserving that. That's coming from the industry. So we do tend to get a little bit of noise. I would expect that. But pools itself, historically and also year-to-date, I mean, I think, are a source of gain for us from a combined ratio standpoint.

Operator

Your next question comes from the line of Christopher Campbell from KBW.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

I guess just first question is on OneBeacon. What are you seeing in terms of actual versus expected loss trends? And then there's liability lines. And are there any U.S. liability trends you're keeping an eye on?

Patrick Barbeau
Senior Vice President of Claims

Well, I would say, right now, on the liability trends that we're keeping an eye on, although we're very little affected without, but we're looking at it, is everything regarding sexual harassments. On the sexual harassment side, we have no coverage on our D&O business, but we have a bit of coverage on the management liability side. And clearly, that's something where, although, we -- a small increase in numbers of losses, but those are normally very smaller ones. This is clearly a trend we're looking at right now. And this is one of the line of business where we're taking an action plan to address some of the issues we have in management liabilities.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Got it. And you're not seeing any uptick in any of the casualty lines, their loss cost trends, above what you would be expecting?

Charles Brindamour
CEO & Director

No.

Patrick Barbeau
Senior Vice President of Claims

No.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Got it. And just second question on the personal auto trends. Now was there any benefit or estimated benefit that you would be getting from, I guess, better-than-expected frequency trends just in terms of what you would be modeling long-term on either frequency or severity versus where those are coming in currently?

Charles Brindamour
CEO & Director

No. When you look at the U.S. and a number of the players in the automobile insurance space, there seems to have been a decline in frequency, at least for those that are publicly traded that we're tracking. There's been no such equivalent decline in frequency here. We've seen mild inflation when it comes to frequency, but no structural changes as it's been observed for a few of the U.S. players in the past couple of years.

Operator

Your next question comes from the line of Jaeme Gloyn from National Bank.

Jaeme Gloyn
National Bank Financial, Inc., Research Division

Very quick. You talked about the $1.2 billion of capital, and given that integration on OB, it sounds like it's complete now. What can you say in terms of your aggressiveness pursuing M&A transactions, and what type of businesses would you potentially be looking to?

Charles Brindamour
CEO & Director

Well, let me just comment on your conclusion that the integration of OB is completed. I think that we're ahead of schedule on synergies. I think the investment team has done a great job faster than we thought to optimize and integrate the investment mix, which has both income and expense benefits. We're not done. There's more work to be done, in particular, on synergies in a few areas. But when it comes to our underwriting and claims improvement plan, we don't think we're at the end of this. In fact, we think we're right in the middle of the improvement plan there. We're pleased with the traction we're seeing. I mean, our folks in the U.S. are really good at executing on these plans, and there's a lot of focus. And I think it translates into a 93.8% combined ratio in Q2. But what we're looking for is sustainable top quartile low-90s combined ratio. And I would say 93.8% is not bad as far as I'm concerned, and sustainability will take some time. We're quite encouraged by what we're seeing and gaining confidence that we will indeed deploy capital in the U.S., but the integration is not over. I think that we've got a few more months of work there before we reach that conclusion. Louis, anything you want to add?

Louis Marcotte
Senior VP & CFO

No, I think the capital position is strong. If something came up in Canada, of course, we'd deleverage our balance sheet to do it, so use our balance sheet to do it. That remains a priority, whether it's manufacturing or distribution. But I think you're right on. I think we have to be cautious on the integration that's not yet completed, although we're seeing good progress.

Charles Brindamour
CEO & Director

Yes, I think where we're confident is that when you look at the U.S. business, there's 14 different business segments, and some are there and sustainable and great performance, in fact, the majority of them. And would we do tuck-in acquisition to strengthen some of these segments, we might because there, we have the confidence. But I would say, large or broad acquisitions at this stage, I would say, is too early.

Jaeme Gloyn
National Bank Financial, Inc., Research Division

Okay. So a small tuck-in in the U.S. specialty line would be the focus there. And then in Canada, the -- I mean, I see that post-quarter, there's been a couple of brokers picked up for BrokerLink. Is that still more of the focus than potentially anything else on the M&A side?

Charles Brindamour
CEO & Director

So let me just come back. I think priority #1 in terms of meaningful capital deployment is Canada and Canada manufacturing, Canada distribution, no doubt, and starting to think about tuck-ins in the U.S. for the segments where we feel comfortable. Louis?

Louis Marcotte
Senior VP & CFO

On the distribution front, so it was a bit of a tame first half of the year. Little activity picked up just after the end of the quarter, as you've seen, with the few acquisitions on the BrokerLink front. So of course, this can be lumpy. We've said that in the past. There's still plenty of opportunities in the market. We're active on it, and proof is we've concluded 3 but just after quarter end. So we're -- we'll deploy capital there as the opportunities are available and intend to continue on that front.

Operator

Your next question comes from the line of Brenna Phelan from Raymond James.

Brenna Phelan
Raymond James Ltd., Research Division

I just wanted to follow up on Geoff's question on Metromile. And as you invest more capital in that business and spend more time there, do you think there's a fit for a paper use in talks in insurance product in Canada? Are you any closer to that decision?

Charles Brindamour
CEO & Director

Well, it's important to keep in mind that Metromile's approach to business is one that very much relies on telematics. And I would say that it's important to keep in mind that we have a huge telematics program in Canada that is focused on behavior, first and foremost, where Metromile's is focused on driving -- on the amount of driving you're doing. And we've got 4 billion kilometers driven, leveraging artificial intelligence to find new ways to promote and select risk with that product and are very much focused on that. But this is a platform that is evolving. And I'll let Darren share with you where we are in some of the latest deployments we have made in telematics.

Darren Christopher Godfrey
Senior Vice President of Personal Lines

No, that's exactly it, Charlie. I mean, obviously, we're using that $4 billion -- sorry, 4 billion kilometers of kilometers that you referred to. We're continuing to evolve the program. We're continuing to improve the sophistication of the program, not just from a behavioral standpoint, but in fact, actually, from a kilometer standpoint as well too. So I think that as we look at our telematics program, where we're soon launching a new iteration of the program, we're in research for the next iteration of the program as well too. So we're quickly -- continually, I would say, evolving the program and assessing both from a segmentation standpoint, but also from a product positioning standpoint as well.

Brenna Phelan
Raymond James Ltd., Research Division

Okay. Great. That's helpful. And then just last one. The accident benefits related to prior year development in Ontario, do you have a sense, is this an industry-wide phenomenon? Are your competitors feeling the pain here? And do you think there's a chance that as we near the end of when these claims can actually be filed, do you think there's a chance that there's maybe one more last surge over the next year?

Charles Brindamour
CEO & Director

I think the risk of surging is diminishing given the reforms were introduced 2 years ago. And I do think it isn't an industry-wide issue absolutely.

Operator

And there are no further questions at this time. I will now turn the call back over to the presenters for closing remarks.

Kenneth Anderson
VP of Investor Relations & Treasurer

Great. Thank you all for joining us today. Following this call, a telephone replay will be available for 1 week, and the webcast will be archived on our website for 1 year. A transcript will also be available on our website in the financial reports and filings archive. Our third quarter 2018 results are scheduled to be released after market close on Tuesday, November 6. Thank you again, and this concludes the call for today.

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