ANNUAL INDUSTRY-WIDE ADJUSTMENT OF RATES FOR BASIC COVERAGE

EFFECTIVE NOVEMBER 1, 2006

RE: SECTION 4 OF THE AUTOMOBILE INSURANCE PREMIUMS REGULATION

ALBERTA AUTOMOBILE INSURANCE RATE BOARD

BOARD DECISION REPORT

Order No: 01-06

July 31, 2006

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1.0 BACKGROUND

1.1. LEGISLATIVE AND REGULATORY AUTHORITY

The Automobile Insurance Rate Board (referred to herein as either the AIRB or the Board) was established on October 1, 2004 under Section 653(1) of the *Insurance Act* (the Act). The mandate of the AIRB is defined in the Act and the *Automobile Insurance Premiums Regulation* (the Regulation) and includes the duty to:

- annually determine if rates for basic coverage[1] should be changed through an industry-wide adjustment;
- monitor optional coverage;
- review and approve rating programs for new insurers granted a license to sell automobile insurance in Alberta by the Superintendent of Insurance; and
- fulfill the duties and responsibilities carried out by the previous Automobile Insurance Board regarding non-private passenger insurers.

Section 4 of the Regulation requires that the Board announce on or before August 1 of each year whether premiums for basic coverage for private passenger vehicles are to be adjusted effective November 1. The Board must consider, in respect of basic coverage for private passenger automobiles:

a) Industry wide loss costs;
b) Administrative expenses, which may include:
    - Commissions;
    - Federal, provincial, and municipal taxes; and
    - General expenses;
c) Other industry wide costs or expenses that the AIRB considers appropriate; and
d) Any other criteria recommended by the Superintendent and approved by the Board.

1.2. RECENT LEGISLATIVE REFORMS AND GOVERNMENT ACTIONS

In 2003 the Alberta Government enacted Bill 53, *the Insurance Amendment Act*, which provided for:

- a cap on pain and suffering for minor injuries at $4,000;
- introduction of treatment protocols;
- elimination of the double-recovery of compensation from more than one source;

[1] Basic coverage is the third-party liability and accident benefits portion of an automobile insurance policy.

- determination of wage loss based on net, rather than gross, wages;
- an increase in the maximum medical/rehabilitation benefits under accident benefits to $50,000; and
- the introduction of the "take all comers" underwriting system.

As part of the reforms, the Government also ordered premiums to be frozen from October 30, 2003 until November 1, 2005.

The reforms set out in Bill 53 became effective October 1, 2004, with the exception of the consideration of collateral sources and the determination of wage loss based on a net, rather than gross, wages, which became effective January 26, 2004. Also on October 1, 2004, the Government introduced the grid rate system, which set maximum premiums to be charged for basic coverage, and established two risk sharing pools[2]. Effective October 1, 2004, the Government also mandated a 5% rate reduction for premiums for basic coverage that were not limited by the grid.

In April 2005, the Government mandated a rate reduction for basic coverage of at least 6% by July 1, 2005. This reduction, however did not apply to the grid rates.

The initial annual review process in 2005 resulted in a further 4% reduction in premium level for basic coverage.

1.3. THE MERCER REPORT

On May 31, 2006, Mercer Oliver Wyman (Mercer), the Board's actuary, released a report titled, "Actuarial Analysis for Industry-wide Rate Level Adjustment Effective November 1, 2006" (Mercer Report). The Mercer Report presented Mercer's analysis and findings regarding the private passenger insurance rates being charged in Alberta for basic coverage. The Mercer Report was commissioned by the Board to provide information and professional advice to assist the Board to fulfill its mandate with respect to the annual uniform industry-wide rate level adjustment for private passenger vehicles.

[2] Coverage for insureds whose premium for basic coverage is limited by the grid can be ceded to one of the risk sharing pools. Insurers may voluntarily cede up to 4% of their insured vehicles rated below the grid through the second risk sharing pool.

Mercer prepared an Addendum to the Mercer Report which was presented to the Board at a duly constituted meeting held on July 21, 2006. The Addendum addressed certain issues arising from the public meetings in June 2006.

Based on the actuarial analysis, the Mercer Report, as modified by the Addendum, found that for private passenger automobile insurance policies to be written during the period November 1, 2006 through October 31, 2007 (hereafter referred to as policy year effective November 1, 2006), the industry average street premium for basic coverage is expected to exceed the required average premium for basic coverage by 2.9%.

Indicated Industry-wide Rate Level Adjustment

Policy Year Effective November 1, 2006

Private Passenger Automobile

Table 1

Policy Year Nov 1-06 to Oct 31-07	TPL and Accident Benefits	Indicated Rate Level Adjustment
Required Avg. Premium	$591	
Average Street Premium	$609	-2.9%

2.0 PUBLIC MEETINGS

2.1. NOTICE

On April 12, 2006 the Board published notice of public meetings to be held in Edmonton on June 14 and 15 and in Calgary on June 20, 2006 for the purposes of determining if rates for basic coverage should be adjusted on an industry-wide basis effective November 1, 2006. All interested parties were invited to submit a letter of intent to the Board by April 21, 2006. In addition to the notice, the Board placed newspaper ads in Edmonton, Calgary and Red Deer on April 15 and Medicine Hat, Lethbridge, Grande Prairie and Fort McMurray on April 17.

2.2. PRESENTATIONS AND WRITTEN SUBMISSIONS

The Board received 19 letters of intent to participate in the public meetings. Sixteen requested the opportunity to make a presentation during the public meetings while 3 asked to submit a written submission. All parties that requested the opportunity to make a presentation were scheduled a time slot, provided with a copy of the Rules of Procedure for the public meeting and asked to ensure that their comments were relevant to the annual adjustment process.

2.3. PUBLIC MEETINGS

The public meetings were held over 3 days, June 14 and 15 in Edmonton at the Sutton Place Hotel and June 20 at the Metropolitan Centre in Calgary. The Board was assisted by Mr. Jack Donahue, Board Legal Consultant, Mr. Ted Zubulake, Managing Director of Mercer Oliver Wyman and Board Actuary, Mr. Bill Moore, Acting Executive Director, and Board staff Ms Susan Steeves, Mr. Colin Leschert and Ms Kelly Sarmiento.

The following parties made presentations at the public meetings:

1. Alberta Motor Association Insurance Company
2. Allstate Insurance Company
3. Automotive Service and Repair Association
4. Aviva Canada
5. Canadian Direct Insurance Inc.
6. Dominion of Canada General Insurance Company
7. Facility Association
8. ING Canada
9. Insurance Bureau of Canada

10. Merle Taylor, Consumer Representative on the AIRB
11. Peace Hills Insurance Company
12. RBC Insurance
13. Ross Bucsi, Palliser Insurance Agency Ltd.
14. Royal & Sun Alliance Insurance Company of Canada
15. TD Meloche Monnex
16. The Wawanesa Mutual Insurance Company

The following parties made written submissions to the Board, which were tabled publicly on June 20th in Calgary:

1. Canadian Association of Direct Response Insurers
2. Co-operators General Insurance Company
3. State Farm Mutual Automobile Insurance Company

All information submitted to the Board as part of the public meeting process has been posted its website: www.airb.gov.ab.ca. Transcripts of the proceedings are also posted on the website.

3.0 ACTUARIAL EVIDENCE AND ANALYSIS

3.1. OVERVIEW OF MERCER'S ANALYSIS AND FINDINGS AT PUBLIC MEETINGS

Mr. Zubulake, Managing Director of Mercer, provided the Board with Mercer's findings that were posted on the website on May 31, 2006. The key issues contained in the Mercer Report were:

- The industry-wide adjustment applies to policies written in the policy year effective between November 1, 2006 and October 31, 2007. Mercer refers to this period as the policy year effective November 1, 2006. This is in contrast to insurance industry financial results, which are typically presented on a calendar year basis, which is the year when claim payments, claim reserves, or changes in reserves are recorded in a company's financial statements. Since claim payments and changes in claim reserve estimates occur over a period of time following the year in which the insurance policy was written, an insurer's reported financial results are affected by claim activity over a period spanning many policy years. A policy year will reflect the experience of policies with an effective date in the given year, regardless of when payments are made toward the policy. The difference between policy year and accounting year explains in part why findings presented by Mercer and other actuaries may appear to be inconsistent with recent financial results reported by the insurance industry.

- Virtually all of the numbers presented to the Board by Mercer or by other parties, whether on a policy year basis or on an accounting year basis, are either estimates or based on estimates. Insurers will not know for certain what their costs will be for the claims of drivers they insure in the policy year effective November 1, 2006 for some time as it takes several years for all claims that occur to be reported and settled.

- The data upon which the Mercer based its analysis and findings includes all insured drivers in the province, including those in the Facility Association and those in the Risk Sharing Pools.

- The latest claim data that was provided to Mercer by the General Insurance Statistical Agency (GISA) through the Insurance Bureau of Canada (IBC), was as reported up to December 31, 2005.

- There are three components to the premium charged by insurance companies:
  1. a provision for claims and claims administration/adjudication expenses that must be paid, including a discount for the investment earnings expected to earned on the premiums until the claims are fully paid. The claims provision represents about two-thirds of the premium dollar;
  2. a provision for insurance company operating expenses, which represents about one-fourth of the premium dollar; and
  3. a provision for cost of capital or profit.

Mercer projected the total of the three components, on average, for polices that will be written in the policy year effective November 1, 2006. This is referred to as the "required average premium." This "required average premium" was compared to the average premium expected to be charged by insurers for the policy year effective November 1, 2006, which Mercer referred to as the "street premium." The percentage difference between Mercer's estimate of the required average premium and Mercer's estimate of the street premium represents Mercer's estimate of the adequacy of the industry-wide rates, on average.

3.2. ESTIMATE OF THE REQUIRED AVERAGE PREMIUM

3.2.1. The Provision for Claims

The provision for the cost of claims and the claims administration/adjustment expenses is the largest component of the premium dollar and the most difficult to estimate. The best indicator of what the provision for claim costs should be is claim costs in the recent past, adjusted for environmental changes or trends. Mercer considered recent past experience in a three-step process:

1. First, they estimated what the ultimate claim costs will be for claims incurred in the recent past, which Mercer has defined as the policy years (accident years) 2001 through 2005. Mercer applied generally accepted actuarial techniques to develop the reported claims to their expected ultimate level.

2. Second, they adjusted the estimated ultimate claim costs in each year to reflect environmental changes or trends that have occurred that would cause the claim costs for the policy year effective November 1, 2006 to be different than the estimated ultimate claim costs for the policy years 2001 through 2005. The two major environmental

changes that Mercer reflected are: the expected impact of insurance reform (Bill 53) and trends in claims frequency and claim severity.

3. Finally, they applied discount factors to the expected payout pattern of claims and claims administration/adjudication expenses to reflect the expected investment earnings on the premiums based on an expectation of a 5.2% rate of investment return.

Making these adjustments resulted in five separate estimates of what the average claim cost component will be for the policy year beginning November 1, 2006 - one estimate for each of the five years in the experience period considered by Mercer. Mercer selected a best estimate from among the five estimates, which was an average of the five estimates, with most of the weight given to the policy year 2005 and 2004 estimates.

3.2.2. The Provision for Expenses

Mercer selected an expense provision of 22.9% of premium based on the insurance industry's actual expenses over the years 2000 through 2004 as reported through the Insurance Bureau of Canada (IBC). Insurers report their expenses to the IBC on a voluntary basis and 2004 is the latest year for which this expense experience is available. In their review following the public meetings, Mercer chose to incorporate information on other expenses for private passenger vehicles from the Quarterly Automobile Survey for the fourth quarter of 2005.

3.2.3. Profit

Mercer used the same profit provision that was established when the initial grid rates were determined, namely 5% of premium.

3.2.4. Mercer Finding – Required Average Premium

Mercer found that the required average premium for basic coverage (which is the total of its selected claim cost, expense, and profit provisions) is 2.9% less than the street premium.

3.3. Estimate of the Street Premium

Mercer estimated the average street premium for the policy year effective November 1, 2006 based on "fast-track" written premium information reported by insurers to IBC for the months of March and April 2006. Mercer tested the reasonableness of its estimate by adjusting the reported

Industry-wide average premium in Alberta during the second half of 2005 for premium adjustments ordered by the Government and rate changes approved for individual insurers by the Board. Mercer's estimate of the street premium is $609.

3.3.1. Estimate of the Industry-Wide Adjustment

Mercer's estimates of the required average premium ($591) and street premium ($609) for the policy year effective November 1, 2006 leads to their finding of a redundancy of 2.9%. That is, Mercer's estimate of the industry-wide rate level adjustment is -2.9%.

4.0 ISSUES FROM PUBLIC MEETINGS

There was discussion of several of the components that enter into determination of the required average premium, as listed below. The two more controversial items from the 2006 meetings were expense provisions and rate of return on investment.

- frequency trend,
- impact of Bill 53,
- health services levy,
- expense provisions,
- rate of return on investment, and
- projected street premium.

4.1. LOSS TREND AND LEGISLATIVE ADJUSTMENT

4.1.1. Discussion of Issue

The selection of loss trend rates and the legislative adjustment factors entail a considerable degree of judgment, and the indication for a required change in average premium level is very sensitive to the selections that are made.

There are two components to loss trend: 1) severity trend, which reflects change in average cost per claim over time, and 2) frequency trend, which reflects change in the claim incidence rate over time. Mercer selected a past trend rate and a future trend rate for each coverage.

Anecdotal evidence was presented that filings of bodily injury claims may have been withheld because of the constitutional challenge to the limit on non-pecuniary damages for minor injuries, thereby distorting the data on claims frequency. If this proves true, these claims will be reported in the future.

The legislative adjustment factors are to reflect the impact of Bill 53 on claim costs. Mercer selected a separate adjustment factor for the Bodily Injury and Accident Benefits coverage.

Mercer applied a regression model to the industry loss data to develop its selected loss trend rates and legislative adjustment factors. In doing so Mercer refined the model that it used last year to better capture the patterns in the loss experience.

The 2005 data provides the first full year of experience reflecting the impact of Bill 53. Based on the 2005 claim experience Mercer's model determined there have been savings of 33% for the Bodily Injury coverage and savings of 10% for the Accident Benefits-Medical/Rehabilitation coverage. Analysis performed by KPMG prior to implementation of Bill 53 (KPMG Report) indicated savings of 31% for Bodily Injury coverage and a cost increase of 97.7% for Accident Benefits. Since the impact of Bill 53 is based on only one full year of data, Mercer selected as the Bodily Injury legislative adjustment factor a savings of approximately 31%, which represents a 50%-50% weighting of the estimate from its model and the KPMG estimate (adjusted to include a 2% cost increase estimated to result from the Fatal Accidents Act, which KPMG did not reflect in its estimate). With respect to Accident Benefits – Medical/Rehabilitation, Mercer selected a legislative adjustment factor for an increase in costs of approximately 18%. This represents a 75%-25% weighting of the estimate from Mercer's finding and the KPMG estimate. Since much of the historical experience in policy years 2001 through 2004 occurred before Bill 53 was enacted, Mercer adjusted its ultimate cost estimates for policy years 2004 and prior to reflect the estimated effects of Bill 53.

Every party that presented actuarial evidence selected different loss trend rates and legislative adjustment factors. In some cases the selected rates or factors were higher than those selected by Mercer and in some cases they were less than those selected by Mercer. As respects the legislative adjustment factors, there was general agreement that the 2005 data showed greater savings than the KPMG report had anticipated. Divergence of opinion generally related to the degree of credibility to be assigned to the preliminary results.

However, there was general acknowledgement by the parties that the claim cost provisions selected by Mercer, after application of the selected trend rates and legislative factors, but before application of the investment rate discount factors, were generally reasonable.

4.1.2. Board Position

The Board recognized that the rate indications developed by Mercer are very sensitive to the trend rates and legislative adjustment factors that are selected, and that a considerable amount of judgment underlies the selections. In particular, the Board agreed that it is likely too early to

determine what the full effect of reforms will be. The Board also noted that in spite of variances in selected trend rates and legislative adjustment factors by the parties, there was reasonably close agreement between on the estimate of the claim cost provision before consideration of the investment rate discount factor. The Board accepts Mercer's estimate of the claim cost provision.

4.2. HEALTH SERVICES LEVY

4.2.1. Discussion of Issue

Auto insurers are required to repay the province's costs of providing health care to people who are injured in automobile accidents. Each year the Government of Alberta, in consultation with automobile insurers, sets aggregate assessment levels for the industry. Subsequent to the public meetings, the Board was informed that the Government will increase the health levy to $80 million in 2007, an increase of $5 million over 2006. This figure is consistent with Mercer's initial estimate and final estimate, which Mercer revised following the Public Meeting to reflect the change it made to its selected expense provision.

4.2.2. Board Position

The Board agreed that the actual 2007 Health Services Levy should be reflected in the analysis for the annual adjustment. Since the actual health levy is now known and the final Mercer estimate and technique were determined to be appropriate, the recognition of the health services levy is not an issue.

4.3. EXPENSE PROVISION

4.3.1. Discussion of Issue

The expense provision represents the portion of premium that covers the insurer's operating expenses. Mercer initially selected an expense provision of 22.9% as the amount it believed would be required by insurance companies on average in Alberta for the policy year effective November 1, 2006. Mercer's initial selection assumes that, for every $1 received in premium, $0.229 on average is necessary to cover insurance companies' operating expenses, including commissions, license and fees, premium tax, and other operating expenses.

The expense provision that Mercer initially selected is based on expense information produced by the IBC under the Expense Allocation Program (EAP) for the years 1999 to 2004 for the companies operating in Alberta. Mercer's initial selected expense provision included selected provisions of: 12.3% for "commission & profit commission," 3.0% for "premium tax," 0.3% for "license and fees," and 7.3% for "other operating expenses." The selected "commission & profit commission" provision of 12.3% assumed that the reported industry ratio for 2004 (13.1%) was elevated due to high profit levels achieved for that year that are not expected to be characteristic of the policy year commencing November 2006.

It came to light during the public meetings that Mercer had been given erroneous information regarding the "other operating expenses" ratio reported under the EAP. The reason for an increase in other operating expenses for 2004 was not due to one-time expenses incurred by a large insurer as was initially reported. In addition, the reported ratios for 2003 and 2004 were incorrect. The IBC issued a revised report with corrected information.

IBC states in their June 21st letter that both the EAP and Quarterly Automobile Survey (QAS) reports "...are imperfect tools for the purposes for which they are being used in Alberta's annual adjustment process. In part, that is because both surveys are voluntary and experience year to year variation in their participant companies. It is also the case that in neither survey is there a perfect sample match with the driver population that is affected by the Rate Level Adjustment, i.e., all private passenger vehicles, including those insured through a risk sharing pool and the residual market, plus farm vehicles." That letter continued further to note that the choice of the EAP "reflects the significantly greater credibility of the EAP expense information, which is a refinement of the information posted in P&C 1 & 2, page 80.20 for use by the federal insurance regulator and is very detailed and subject to clear definitions. This is in sharp contrast to the QAS where 'other expenses' are not defined in the cursory instructions to insurers and are reported in only a single line."

Several presenters expressed the view that the "other operating expenses" provision initially selected by Mercer may be too low. The reasons cited include:

- The fixed nature of certain expense costs, coupled with the recent industry-wide rate reductions in Alberta, suggest a higher expense provision;
- More of the fixed expenses incurred by insurers should be allocated to basic coverage, which would cause the expense provision to increase; and
- The new grid system has caused companies' operational expenses to increase.

IBC and some insurers argued that the fixed nature of some expense must be recognized – that is, not all expenses vary directly with the magnitude of the premium. While average premiums have declined, other costs such as salaries and occupancy costs have not declined proportionately, but rather have increased due to inflationary pressure.

During their oral presentation, Canadian Direct spoke to inflationary pressures inherent in the robust Alberta economy.

> *In a number of areas we …are seeing very strong upward pressure. It's to some extent being driven by the – the economy.*
> *…The employment rate in Alberta is at an all-time high, …so the wage expectations are considerably higher than you might normally expect to see.*
> *…but as a component of costs and drivers to everything that we're talking about, rather than looking aver our shoulder which is what, of course, we can do with the …results that we're using from 2005, looking forward we do have to consider these things.*
> Canadian Direct Incorporated

The issue of whether fixed expenses should be allocated to basic coverage or distributed across all coverage was addressed in the 2005 decision.

Insurers submitted that the administration of the grid system is more costly. An example of those additional costs was the documentation that must be compiled on risks submitted to the Risk Sharing Pools. That information is at present anecdotal; evidence may emerge with the expense report for 2005.

Following the public meetings, Mercer reviewed its selected expense provisions in light of the information presented at the meetings. As respects its selected provision for "other operating expenses," Mercer acknowledged IBC's position on the two expense reports, but did not dismiss the QAS because it is more current (2005 as opposed to 2004) and it reflects private passenger automobile operating expenses, which is the subject of the annual adjustment. Mercer chose to

average the 2004 figure from the corrected Expense Allocation Program with the "other expense" figure for private passenger vehicles from the QAS for the fourth quarter of 2005. The result of this approach matched the original 7.3% other expense assumption. As a result, Mercer maintained its selected 22.9% expense provision.

Mercer also elected to treat 50% of its selected "other operating expenses" provision as fixed and apply a cost inflation factor of 3% per annum to those expenses, the same cost inflation factor selected by IBC's actuary.

The impact of the changes made by Mercer to its selected expense provisions was an increase (less negative) in the size of the indicated change by approximately 1.1 percentage points.

4.3.2. Board Position

The Board notes that the rate indications in the Mercer Report are sensitive to the expense provision selection, and agreed with the final expense provisions selected by Mercer.

4.4. Rate of Return on Investment

4.4.1. Discussion of Issue

The Board directed Mercer to use a profit provision of 5% in its analysis. A 5% of premium provision on premium was selected because it was consistent with the selection made in developing the premium grid implemented in October 2004. The question of an appropriate cost of capital and profit provision will be the subject of a separate review later this year.

A question that presenters were invited to address is the appropriate rate of return on investment. Most presenters supported a risk free rate of 4.1% to 4.2% provided by Government bonds of approximately three-year duration that would match the average duration of the liabilities. The comment from Meloche Monnex Inc. is illustrative of the view:

> *Because of the quasi-fiduciary responsibility that an insurer has with respect to the premiums it receives from its clients, funds should be invested for durations that correspond to the timing of these payments. For MMI the average corresponds to approximately three years. Appropriate matching of assets and liabilities will ensure that the insurer has sufficient liquidity to meet its financial obligations to its claimants*

> *on a timely basis while minimizing the risks associated with the impact of interest rate volatility on bond market values.*
>
> *Based on a 2 to 1 premium to capital ratio, Meloche Monnex strongly recommends the use of a 4.10% rate of return on investment assumption based on the current yield of a 3-year Canada bond. This is in line with current market yield and the duration of the expected payments for automobile insurance.*
>
> Meloche Monnex Inc.

One insurer used a rate of 5.7% that was a blend of the expected rate of return on the bond and equity components of the insurer's asset portfolio. The impact of the higher blended rate was offset by a lower premium to surplus ratio.

During the public meetings, Dr. Ron Miller in his presentation for IBC, raised the point that as of January 2007, OSFI (Office of the Superintendent of Financial Institutions at the federal level) will require insurers to apply internationally approved accounting standards. The industry may be persuaded to shift to a more conservative investment strategy in the future to minimize earnings volatility.

Mercer elected to maintain the 5.2% return on investment that they developed for the 2005 review, leaving that discussion to the fall review of the profit issue.

4.4.2. Board Position

As stated at the outset, the Board will maintain the 5% of premium profit margin pending the outcome of a separate review scheduled for later in 2006. Noting both the underwriting profits and investment returns in 2005 and a positive outlook for 2006, the Board also found the 5.2% investment rate applied in the Mercer analysis to be appropriate. The 5.2% discount rate used by Mercer was consistent with estimates of the expected rate of return on the aggregate portfolio of the average property casualty insurer operating in Canada and consistent with the approach used by some actuaries when setting automobile insurance premiums.

4.5. ESTIMATION OF STREET PREMIUM

4.5.1. Discussion of Issue

The final key issue considered by the Board relates to concerns raised regarding Mercer's estimate of the street premium. The average street premium estimated in the Mercer Report was based on 2005 data and a "fast-track" report for the first four months of 2006. This figure

matched that calculated by adjusting the average written premium for the second half of 2005 with adjustments for approved revisions to rating programs and the and the impact of the November 1, 2005 mandated adjustments of -4% to market premiums and -1.6% to the Grid.

The estimate of a $609 average premium as of November 1, 2006 was consistent with that determined by IBC and a number of other insurers.

4.5.2. Board Position

The Board notes that there was little debate on the issue of the average street premium and, therefore, accepted $609 as a reasonable estimate.

4.6. REVISED RATE LEVEL INDICATION

As a result of input received at the public meetings, Mercer advised the Board that after reflecting the aforementioned changes: the newly announced health services levy for 2007 and the fixed nature of some operating expenses that its estimate of the industry-wide rate level indication is -2.9%. However, Mercer acknowledges that this number represents their "best estimate," around which there is a range of numbers that could be as equally valid depending on the assumptions that are accepted.

4.7. THE GRID

During the Board's public meetings many presenters urged the Government to proceed with amendments to the Premiums Regulation that emanated from the review of the Grid. Insurers further urged de-linking the Grid and the annual adjustment process. The Board considered this advice but noted that the Regulation explicitly links the application of the annual adjustment to premiums on the grid.

5.0 ORDER NO: 01-06

ANNUAL ADJUSTMENT OF RATES EFFECTIVE NOVEMBER 1, 2006

In accordance with Section 4 of the *Automobile Insurance Premiums Regulation,* the Board hereby orders that the rates under rating programs for basic coverage (third party liability and accident benefits) of private passenger vehicles be reduced uniformly on an Alberta industry-wide basis by 3.0% effective November 1, 2006.

The Board has considered all of the oral and written information presented through the public meeting process, including the analysis and findings presented by its actuary, Mercer Oliver Wyman, in coming to its decision.

The Board has chosen to round the -2.9% indication of its consulting actuary to -3.0%.

The annual adjustment represents an industry average, and is based on an average premium. As a result, there will be companies within the Alberta market-place that will be able to absorb at least a 3% decrease, while there will be others that will have some difficultly. However, the Board points out that under Section 6 of the *Automobile Insurance Premium Regulation*, insurers have the opportunity to petition the Superintendent of Insurance to request that the Board review their rating program if they cannot absorb the 3.0% reduction.

6.0 APPENDIX A - AUTOMOBILE INSURANCE PREMIUMS REGULATION

Part 1, Section 4

4(1) On or before August 1 in each year, the Board may adjust uniformly on an Alberta automobile insurance industry-wide basis, in accordance with the criteria described in subsection (3), the rates under rating programs for basic coverage of private passenger vehicles.

(2) In accordance with the procedures of the Board, the Board may hear representations with respect to an adjustment under this section.

(3) The criteria for an adjustment are

(a) the Alberta automobile insurance industry-wide loss costs, as that term is understood by the Board, for basic coverage for private passenger vehicles;

(b) the administrative expenses relating to basic coverage for private passenger vehicles, on an Alberta automobile insurance industry-wide basis, that the Board considers appropriate to consider, which may include commissions, federal, provincial and municipal taxes and general expenses, as reported in the annual returns submitted by insurers to the Superintendent or a similar regulatory authority in another jurisdiction;

(c) other Alberta automobile insurance industry-wide costs or expenses that the Board considers appropriate relating to basic coverage for private passenger vehicles;

(d) any other criteria recommended by the Superintendent and approved by the Board.

(4) An adjustment under this section is effective November 1 of the year in which the adjustment is made by the Board.

(5) Notwithstanding subsection (4), if the Board increases the rates under a rating program for basic coverage in respect of private passenger vehicles, the increases may be applied by an insurer over a period of not more than 3 years commencing November 1 of the year in which the adjustment is made by the Board.

(6) Information about adjustments under subsection (1) must be made publicly available in a manner satisfactory to the Superintendent.

7.0 APPENDIX B – PRESENTATION SCHEDULE FOR PUBLIC MEETINGS

Wednesday, June 14, 2006 – Edmonton
The William Tomison Room, Sutton Place Hotel, 10235 – 101 Street
TD Meloche Monnex
Aviva Canada
Automotive Service and Repair Association
Allstate Canada
Royal & SunAlliance
RBC Insurance
Merle Taylor, AIRB Consumer Representative

Thursday, June 15, 2006 - Edmonton
The William Tomison Room, Sutton Place Hotel, 10235 – 101 Street
Peace Hills General Insurance Company
Insurance Bureau of Canada
Facility Association
Canadian Direct Insurance
Alberta Motor Association Insurance Company

Tuesday, June 20, 2005 – Calgary
Strand/Tivoli Room, Metropolitan Centre, 333 – 4th Avenue SW
ING Canada
Dominion of Canada
Ross Bucsis, Palliser Insurance Agency Ltd.
The Wawanesa Mutual Insurance Company

8.0 APPENDIX C - DEFINITIONS OF KEY TERMS

To assist the reader in his or her understanding of the Decision, several insurance terms are defined and explained below.

8.1. AUTOMOBILE INSURANCE COVERAGE

We begin with a general description of the insurance coverage. We note that throughout this discussion of the insurance coverage, the term "insured" is generally used to mean the family of the owner of the policy, as well as any passengers or other drivers using the car with the owner's permission.

Third Party Liability (TPL) There are two parts to this mandatory coverage:

Bodily Injury (BI) coverage protects the insured against liability arising from an accident that causes bodily injury to another person. Coverage amounts available in Alberta range from the legal minimum of $200,000 per claim to well over $2,000,000 per claim.

Property Damage (PD) coverage protects the insured against liability arising from an accident that causes damage to the property of another person.

Accident Benefits (AB)
This coverage provides for such items as reimbursement of lost income, medical care costs, and funeral costs; it also provides benefits to the dependants of a deceased insured.

Underinsured Motorist (UIM)
This optional coverage protects the insured if he or she is caused bodily injury by an at-fault driver who is insured, but who does not have sufficient insurance to cover the liability; in this case the insured collects, from his or her own insurer, the amount of the damage that is in excess of the at-fault driver's liability coverage and up to the limit of UIM coverage purchased.

Collision
This optional coverage generally provides coverage (subject to a deductible) for damage to the insured's vehicle arising out of a collision.

Comprehensive
This optional coverage generally provides coverage (subject to a deductible) for damage to the insured's vehicle arising out of a peril other than collision (e.g., theft, vandalism, flood, hail, fire, etc.).

All Perils
This optional coverage combines the coverage for both collision and comprehensive into one coverage, subject to a common deductible level.

Specified Perils
This optional coverage, like collision and comprehensive, provides coverage (subject to a deductible) for specific perils to the insured's vehicle.

8.2. Other Terms

Accident Year
The year in which an incident that gives rise to a claim occurred, regardless of when the claim is actually reported to an insurance company. For example, a claim reported on January 15, 2003 for injuries suffered in an automobile accident that occurred on December 15, 2002, is considered to be an accident year 2002 claim.

Allocated Loss Adjustment Expense (ALAE)
ALAE is the claim and settlement expense that can be associated directly with individual claims (e.g., legal expenses). (See ULAE)

Base Rate and Rate Differentials
Insurers generally determine the premium for a particular insured by multiplying a base rate by a series of rate differentials (or rate factors, or rate relativities) that reflect the particular characteristics of the insured. The terms rate differentials, rate factors and rate relativities are used interchangeably. Typically, there is one base rate for each combination of coverage and rating territory. For example, assume a base rate for the TPL coverage of $200 in Territory #1 and a base rate for the TPL coverage of $300 in Territory #2. Also assume the rate differential for a married male driver, age 40, is 1.25. The TPL premium for this driver would be $250 in Territory #1 ($200 times 1.25) and $375 in Territory #2 ($300 times 1.25).

Case Reserve
The Case Reserve is the provision established by insurance companies for the payment of future losses and claim related expenses associated with a particular claim.

Claim Frequency
Claim Frequency is the average number of claims that occur in a year, per insured vehicle. Claim frequency is a measure of the incidence of automobile claims. For example, if an insurance company provided insurance on 100 vehicles in year 2002 and 5 TPL claims occurred during 2002, the company's TPL claim frequency for 2002 would be 5 percent.

Claim Severity
Claim Severity is the average reported incurred loss and ALAE per claim. Claim severity is a measure of the average cost of automobile claims. For example, if the 5 claims in the previous example resulted in a total incurred loss and ALAE of $100,000, the claim severity would be $20,000.

Claim Count Development
Claim Count Development refers to the change in the number of reported claims for a particular accident year over time. (See Loss Development)

CLEAR
CLEAR refers to Canadian Loss Experience Automobile Rating, a system of categorizing Private Passenger vehicles, by make and model-year, for physical damage coverage rating purposes. CLEAR was developed by the Vehicle Information Centre of Canada (VICC), a part of

the Insurance Bureau of Canada. CLEAR considers such elements as the repairability and damageability of the make and model-year. (See MSRP)

Combined Ratio
Combined Ratio is another common measure of premium adequacy. This is the sum of the loss ratio plus the expense ratio (operating expenses divided by written premium). A combined ratio in excess of 100 percent is an indication of premium inadequacy, before consideration of profit and investment income.

Earned Premium
Earned Premium is the amount of written premium that is associated with the portion of the policy term that has expired. For example, assume an automobile policy with a 12-month term is sold on January 1 for $1,000. The amount of earned premium would be $500 on June 30

Exposure Unit
A measure of loss potential. In Private Passenger automobile insurance, the exposure unit that is commonly used is the number of insured vehicles. For example, all else being equal, it would be expected that the cost to an insurance company to insure 50 cars would be twice the cost to insure 25 cars.

Health Services Levy
As per Provincial legislation, a levy is paid by each insurer to achieve a target amount set by Government. IBC calculates and provides the level as a percentage of earned third party liability premiums. Under the legislation, the Government has no subrogation rights against the at-fault parties who are insured by policies of TPL insurance; but instead, collects the levy.

Loss Cost
Loss Cost is the average incurred loss and ALAE in a year per insured vehicle. The loss cost is the product of claim frequency and claim severity. Using the above example, a claim frequency of 5 percent, multiplied by a claim severity of $20,000, produces a TPL loss cost of $1,000.

Loss Development
Loss Development is the amount by which reported incurred losses and ALAE for a particular accident year change over time. The two main reasons why reported incurred losses and ALAE amounts change (or develop) over time are:

a) Reported incurred losses and ALAE only include case reserve estimates on claims for which the claim adjuster has knowledge, i.e., case reserves are only established on the claims that have been reported to the insurance company. Since typically some period of time elapses between the time of the incident and when it is reported as a claim, the number of reported claims for an accident year would be expected to increase over time. Claims that are reported after the close of an accident year are referred to as “late-reported” claims; and

b) Reported incurred losses and ALAE also develop because, for a number of reasons, the initial case reserves established by claims adjusters, can not fully and accurately reflect the amount the claim will ultimately settle at. This pattern of under-reserving and over-reserving is

common within the insurance industry (although the degree to which reported incurred losses and ALAE are under-reserved or over-reserved varies by company, jurisdiction, line of business, etc.). We further note that, over time, the percentage by which reported incurred losses and ALAE develop for a given accident year should decline. This is because as accident years become more mature (i.e., become older), fewer and fewer reserve estimates are adjusted to reflect newly reported late claims, actual payments, and additional information that becomes available to the claims adjuster.

Loss Ratio
Loss Ratio is defined as reported incurred losses and ALAE divided by earned premium. This is the common measure of premium adequacy. A loss ratio that exceeds a company's break-even loss ratio (100 percent less budgeted expenses) would suggest premium inadequacy.

Loss Reserving Methods: Incurred Loss Method and Paid Loss Method
Loss reserving methods are often based on historical data grouped into a triangle format. A common approach is to have the rows represent the accident years, and the columns representing the value of the loss at specific dates, such as 12 months, 24 months, 36 months etc., from the beginning of the accident year. The historical changes in the loss data from period to period is reviewed to estimate a pattern to predict how current accident years losses will change over time as claims are settled and closed. The Incurred Loss Method refers to the triangle method of analysis, based on reported incurred losses. The Paid Loss Method refers to the triangle method of analysis, based on paid losses.

MSRP
MSRP refers to the Manufacture's Suggested Retail Price, and is a system of categorizing Private Passenger vehicles, by make and model-year, for rating purposes for physical damage coverages, according to the original price of the vehicle. (See CLEAR)

Operating Expenses
Insurance company expenses, other than ALAE and ULAE, are typically categorized as Commissions, Other Acquisition, General, Taxes, Licenses, and Fees.

Paid Losses
The total aggregate dollar amount of losses paid on all reported claims as of a certain date.

Premium Drift
Premium Drift is a more general term, and refers to the changes in the amount of premium collected by insurance companies that is attributed to the purchase of newer and more expensive cars (i.e., rate group drift) as well as to changes in the amount of insurance coverage that is purchased (e.g., the purchase of higher limits of liability coverage would increase the amount of premium collected by insurance companies, while the purchase of higher physical damage deductibles would reduce the amount of premium collected by insurance companies). (See Rate Group Drift)

Rate Group Drift

Rate Group Drift refers to the amount of additional premium collected by insurance companies that is attributed to the purchase of newer and more expensive cars by insureds. The premiums charged by insurance companies are higher for newer and more expensive cars. Therefore, as insureds purchase newer and more expensive cars, the amount of premium collected by insurance companies increases. (See Premium Drift)

Ratemaking Methods: Pure Premium Method and Loss Ratio Method
The Pure Premium Method of ratemaking develops indicated rates that are expected to provide for the expected losses and expenses, and provide for the expected profit.
The Loss Ratio Method of ratemaking develops indicated rate changes rather than indicated rates.

Rating Territory
Automobile premiums vary by the principal garaging location of the vehicle. Based on Insurance Bureau of Canada's automobile statistical plan, Alberta is currently divided into three areas, or rating territories, of principal garaging location; and, therefore, has three separate sets of rates depending upon which of the three territories the vehicle is principally garaged. (see Statistical Territory)

Reported Incurred Loss
The sum of:
(a) the total aggregate dollar amount of losses paid on all reported claims as of a certain date (referred to as the valuation date), and

(b) the total aggregate dollar amount of losses set in reserve by the claim adjusters on each open claim (referred to as "case reserves") as of a certain date (the same evaluation date as for the paid loss amounts).

For example, if two claims were filed against an insurance company, one that settled for $50,000 and the other that was open with a paid amount of $25,000 and a "case reserve" (i.e., the claim adjuster's estimate of the dollars still to be paid on the claim) of $30,000, then the total reported incurred loss on the two claims would be $105,000 (the sum of $50,000, plus $25,000, plus $30,000).

Reserve
A Reserve is the aggregate provision identified by an insurance company for the payment of future losses and claim related expenses associated with claims that have been incurred.

Surplus
The excess of the assets of an insurance company over its liabilities.

Statistical Territory
Automobile premiums vary by the principal garaging location of the vehicle. Alberta is divided into four statistical territories, of principal garaging location. Specific statistical territories are grouped together to represent a specific rating territory. In some cases there is one statistical

territory in a rating territory, in other cases the rating territory is comprised of two or more statistical territories. (see Rating Territory)

Total Return on Equity

Total Return on Equity (ROE) refers to an insurer's profit as a percentage of its surplus, where profit is the sum of (a) underwriting profit, and (b) investment income earned on both the underwriting operations of the company and on the surplus carried by the company.

Underwriting Profit

Underwriting Profit is defined as earned premium, less reported incurred losses and ALAE, less ULAE, less operational expenses.

Underwriting Profit Margin

Underwriting Profit Margin is the provision that is included in the insurance premium for underwriting profit to be earned by the company.

Ultimate Incurred Loss

An estimate of the total amount of loss dollars that will ultimately be paid to settle all claims that occur during a particular accident year.

Written Premium

Written Premium represents the total amount of premium charged by an insurance company for the insurance policies it has sold. It is generally measured over a one-year period.

Unallocated Loss Adjustment Expense (ULAE)

ULAE is the claim and settlement related expense that cannot be associated directly with individual claims (e.g., claim adjuster salaries). (See ALAE)