



Alberta Insurance Rate Board

A submission by Insurance Bureau of Canada

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INSURANCE BUREAU OF CANADA. BUREAU D'ASSURANCE DU CANADA

Insurance Bureau of Canada (IBC) is the national trade association representing the private general insurance industry. Member companies account for about 90% of non-government property and casualty (P&C) insurance business in Canada. With invested assets in Alberta exceeding \$5.4 billion, the P&C insurance industry is a significant employer, providing over 13,000 jobs. Sixty-five private sector insurers in Alberta wrote over \$2.6 billion in automobile insurance premiums in 2005. They also paid out over \$1.6 billion in claims, including rehabilitation expenses to those injured in road crashes and other bodily injury incidents, replacement of stolen goods, and repairs to damaged property and vehicles. In 2004 (the latest year for complete tax data), the industry paid \$300.3 million in taxes and levies to the provincial government.

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INTRODUCTION

The Alberta Insurance Rate Board (AIRB) has been entrusted with the important responsibility of fostering an environment where consumers can purchase affordable insurance products from a variety of insurers while maintaining a marketplace where insurers can operate at a profit and remain solvent. While these interests may at times appear to sometimes collide, protection of the public interest and a robust insurance industry are mutually accessible goals. The insurers that provide insurance to Alberta's drivers also recognize the importance of maintaining the public's trust and offer this submission to strengthen the insurance regulatory framework in Alberta.

This submission has 3 sections:

- 1) Competition is the best regulator of price and profit.
- 2) Experience from other jurisdictions. Jurisdictions that have placed restrictions around insurer profitability have well-documented negative outcomes for consumers.
- 3) Specific recommendations for the AIRB.

This submission is supplemented by the expert witness testimony of:

- 1) Dr. Richard Phillips, Professor, Georgia State University
- 2) Dr. Sharon Tennyson, Associate Professor, Cornell University
- 3) Dr. Richard Derrig, Opal Consulting
- 4) Richard Gauthier, PriceWaterhouseCoopers.

These testimonies will review and summarize the academic literature regarding the cost of capital for property and casualty insurance, particularly automobile insurance and provide a critique of methods for estimating appropriate costs of equity. It includes a discussion of current actuarial practice in Canada. Their submissions will document the history of regulation in this area in the United States.

This submission is also complementary to the submissions made by individual IBC member companies.

COMPETITION IS THE BEST REGULATOR OF PRICE & PROFIT

The government of Alberta has made the purchase of auto basic insurance mandatory for drivers in the province. It has not mandated which insurer individual consumers should buy from. With more than 65 insurers actively competing to provide insurance, drivers have a great degree of choice of auto insurance suppliers; more so than when buying almost any other consumer product. Competition is alive in Alberta's auto insurance system.

This makes auto insurance different from other regulated sectors. Most market regulation in Canada is directed to curtailing the operation of monopolies to protect consumer interests. This is a valid undertaking where there are monopoly profits or rents to be regulated. Alberta's auto insurance system, on the other hand, is a competitive market with more than 60 firms. This has the potential to make regulation more complex, but it also puts another tool in the hands of regulators that is not available in uncompetitive markets.

IBC recommends that the AIRB harness these competitive forces to assist it in delivering on its mandate. This submission seeks to provide a blueprint for harnessing the competitive marketplace to deliver better outcomes for insurance consumers and desired public policy goals.

Economists often speak about the importance of competition in a marketplace, but it is often difficult to put blind faith in what they describe as "the invisible hand". It is easy to say something is competitive, but harder to prove. One economist, Harvard's Dr. Michael Porter, has attempted to assess the level of competitive forces within a marketplace. We encourage the AIRB use this model to measure the degree of competition in the insurance market. It demonstrates that Alberta's auto insurance industry is very competitive.

According to Dr. Porter:

...the intensity of competition in an industry is neither a matter of coincidence nor bad luck. Rather, competition in an industry is rooted in its underlying economic structure and goes well beyond the behavior of current competitors. The state of competition in an industry depends on five basic competitive forces. The collective strength of these forces determines the ultimate profit potential in the industry, where profit potential is measured in terms of long run return on invested capital. Not all industries have the same potential. They differ fundamentally in their ultimate profit potential as the collective strength of the forces differs.¹

Porter's 5 competitive forces are: ease of entry and exit, threat of substitution, bargaining power of buyers, bargaining power of suppliers, and rivalry among current competitors. Together they reflect the fact that competition in an industry goes well beyond the number of established

¹ Porter, Micheal E, *Competitive Strategy: Techniques for Analyzing Industries and Competitors*, Free Press, June 1998

players. Customers, suppliers, substitutes, and potential entrants are all "competitors" in the insurance pool.

Ease of entry and exit

Porter suggests that the fewer barriers that exist for firms entering or leaving the market, the more competitive the industry will be. There are few barriers to entry for any insurers that wish to enter the Canadian insurance marketplace. A potential barrier to entry facing a new insurer lies in finding a means to reach consumers. Porter argues that the more diverse channels of distribution for a product, the greater the potential for competition. P&C insurers use a variety of channels to reach consumers in Alberta including independent brokers, direct retail operations, or call centres.

Another barrier to entry lies in the capital requirements of the federal regulator; however even the start-up capital for a P&C insurer is smaller than other financial institutions. In fact, start-up capital requirements for insurers licensed by Alberta are less than those of the federal government and among the lowest in Canada. In the past 3 years, approximately 25 new insurers have been licensed by the federal government. This is more than the life insurance or banking sectors. The relative ease of entry is offset to an extent by some barriers to exit introduced as part of Alberta's recent reforms. All told, the auto insurance industry is very competitive in this realm.

Threat of substitution

The easier consumers can switch one product for another, the greater the degree of competition within an industry. Consumers are free to move from one insurer to another annually with minimal switching costs. Insurers try to package many product features to differentiate their brand of insurance.

Bargaining power of buyers

The greater the bargaining power of buyers within a market, the higher the degree of competition. Drivers hold significant bargaining power because most auto insurance contracts last one year or less. Each year consumers make a choice about their insurer. Some switch insurers, but most stay with their insurer. The key is that consumers have that choice. Moreover, in Alberta the take-all-comers rule means that the consumer chooses which insurer they want and the insurer must accept the risk.

Bargaining power of suppliers

The greater the bargaining power that suppliers hold, the greater the degree of competition. In the insurance sector suppliers include lawyers and paralegals, medical and rehabilitation professionals and auto repair shops. It is well known that a number of these professions have two price lists, a lower one for services not paid for by insurers and higher prices for insured services. Insurers pay higher prices in most cases. This suggests that there is significant "bargaining power" among insurance suppliers.

Rivalry among current competitors

According to Porter, the greater the number of firms in an industry, the greater the potential for competition. A large number of diverse competitors will reflect different strategies, goals and origins. Strategies that work are retained and copied by the competition. Strategies that fail are discarded. In this respect Alberta's auto sector is very competitive. Examples include:

- Insurers that conduct business only in Alberta are competing with some of the world's largest international insurers.
- There are different ownership structures for insurers in Alberta. Some insurers are owned by shareholders. Others are owned by private investors. Still others are mutual companies that are owned by their policy holders.
- Some insurers are owned by non-profit institutions. In fact, one insurer operating in Alberta is owned by the Government of Saskatchewan.
- Some insurers believe that success comes from focusing on segments of the market. For example, some insurers focus on one or more categories of insurance such as commercial vehicles, recreational vehicles, commercial fleets, long-haul, family insurance profiles, older drivers, or other driver profiles. Others insurers believe that being bigger and serving all of these markets is the key to success.
- Some insurers cover only higher risk drivers. More conservative companies target drivers they consider to be lower risk profiles.
- Some insurers sell products directly to consumers. Others use independent brokers to reach consumers. Some use both.

Another factor in measuring the degree of rivalry is the degree of concentration. By this measure, the less concentrated an industry, the greater the level of competition. P&C insurance is not concentrated. The 5 largest companies writing private passenger auto insurance in Alberta have a market share of 39.3%, while the top 10 firms have a market share of 64%. Another way to measure concentration is the Herfindahl-Hirschman Index ("HHI"). Market concentration is a function of the number of firms in a market and their respective market shares. The HHI is calculated by summing the squares of the individual market shares of all the participants.

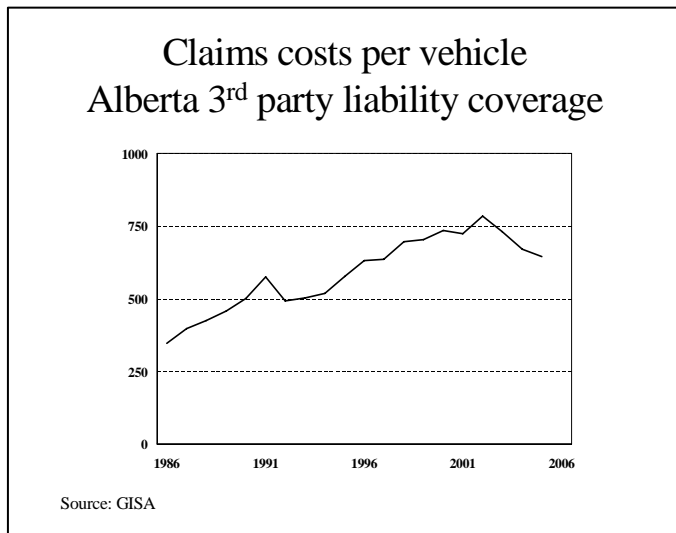
The Competition Bureau of Canada uses the HHI index to analyze concentrations before and after mergers. Competition authorities define the spectrum of market concentration by dividing the HHI into three regions that can be broadly characterized as un-concentrated (HHI below 1000), moderately concentrated (HHI between 1000 and 1800), and highly concentrated (HHI above 1800). IBC analysis of the Alberta auto insurance market in 2005 resulted in a HHI of 633, well below the 1000 threshold characterizing an un-concentrated market.

A key observation made by Dr. Porter in his measurement of competition is that the greater the diversity within an industry the greater degree of competition. Indeed, the very diversity that makes insurance so difficult to regulate is a benefit to consumers. Alberta's drivers benefit from insurers competing for their business. Each has a different market strategy that can vary investments, marketing, product development and so on. This competition takes many forms including price, endorsements, speed of claim settlement and customer relations. The diversity of insurers in the market ensures that the best practices available to drivers anywhere in the world are brought to Alberta. Arguably consumers could benefit from an even greater scope of competition including product variety and choice.

The implication of this diversity for the AIRB is that for each insurer a different set of prices will be appropriate, depending on their unique costs of production and the unique set of consumers they serve. There is no single driver. There is no single insurer. The way that each company

approaches business will be different. These differences are normal and are found in all competitive insurance marketplaces. A healthy marketplace attracts and retains companies operating in the province and maintains and expands choice for consumers. As well, it is the surest way to offer consumers the lowest price available for the products they need and choose to purchase. In the words of Nathaniel S. Shapo, former Director of the Illinois Department of Insurance “*competition is the most ruthless regulator of price*”².

EXPERIENCE OF OTHER JURISDICTIONS



Competitive insurance markets do not eliminate the need for government involvement or regulation. Appropriate regulation reduces the risk of company insolvency and enhances public confidence in the system. The most efficient and effective regulation strikes an appropriate balance between government intervention and reliance upon market forces.

Experience over the past 20 years suggests that in most years the actuarial evidence will show rising insurance costs. To illustrate this point, the attached chart shows average claims costs for 3rd party

liability insurance in Alberta. Over this period costs have risen in 14 years and fallen in 5 years. Reductions in the cost of insurance almost always occur following government reforms to the insurance product. In between product reforms, the cost of insurance, like all costs in the economy, rise.

There are a number of jurisdictions in North America with insurance rate boards. These rate boards pursue a variety of strategies for carrying out their mandate. This offers the AIRB a tremendous opportunity for identifying and pursuing best-practices in Alberta.

In general, there are four different methods used by rate boards to execute their mandates:

- 1) Relying on competitive markets;
- 2) A low price ceiling and price-cost uniformity;
- 3) Monitoring the market average and allowing a range for competition;
- 4) Setting an effective price ceiling by using conservative cost parameters.

Relying on competitive markets

² Testimony of Nathaniel S. Shapo. House Financial Services Committee Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises April 10, 2003.

There are jurisdictions where regulators rely on competitive forces and focus on monitoring the health of the market as a whole. In these systems, regulators control the amount that consumers put into the insurance system by focusing on how much money flows out of the insurance system.

Quebec

Quebec does not regulate insurance rates. Each year the Quebec insurance regulator, the *autorité des marchés financiers* (AMF) publishes an annual report on the performance of the provincial auto insurance marketplace. In its most recent report it reported that the industry was functioning well with high levels of competition ensuring availability and accessibility for consumers. The insurance product is different in Quebec where the government provides the bodily injury portion of the mandatory product, while the private marketplace in Quebec works well in meeting the property damage and collision needs of consumers. It is worth noting that the significant price increases that occurred in many parts of Canada three to five years ago did not occur in Quebec.

Illinois

Illinois is widely considered one of the most stable insurance marketplaces in North America. In his 2005 appearance before the Newfoundland and Labrador Public Utilities Board, former Insurance Superintendent Nathaniel Shapo described the Illinois experience:

“Since 1971, Illinois has allowed competition to regulate ... auto insurance rates for thirty years, with excellent results for consumers. There is no review of rates for excessiveness or inadequacy. Instead, the most ruthless regulator known to economics, supply and demand, ensures that prices are appropriate. Illinois consumers benefit substantially from this regulatory regime. Availability is the best in the nation -- the number of companies writing auto ... insurance is the highest of any State. Rates are at or lower than the national average; despite the high concentration of consumers in congested urban areas (two thirds of the population is in the Chicago area), auto rates are 27th highest in the nation and homeowners are 39th. Statistical analyses of the market demonstrate its competitiveness; the Herfindahl/Hirschman Index for the Illinois auto and homeowners markets indicates broad penetration by many sellers in a non-concentrated marketplace. Availability concerns are negligible; only a tiny proportion of consumers (.03 % in the auto market and .22 % in homeowners) are forced to obtain coverage through residual market plans.”

Industry believes that allowing insurance prices to be set in the competitive market produces the best outcomes for consumers. However, we recognize that Alberta has regulatory restrictions that will not allow AIRB to adopt this recommendation at this time.

A low price ceiling and price-cost uniformity

Massachusetts

In Massachusetts, the insurance commissioner controls all aspects of the sale and delivery of auto insurance. Since 1978, the regulator has set the price of auto insurance across the State after a long adversarial proceeding. Insurers can deviate downward with approval of the Commissioner but often they do not offer reductions from the State-set price. Derrig (1993, Chart 2), reports that the State insurance regulator under-stated claims costs for ten out of twelve years between 1978

and 1989. Variables used in the cost equation tended to be ultra conservative claims growth trends that missed the mark by an average of 6.9% of premium even after rejection of the original commissioner's rates by the Massachusetts Supreme Court. This led to the majority of large national insurers withdrawing from the state. Additionally, rural drivers subsidize the cost of insurance for drivers in Boston and other urban areas. Drivers in Massachusetts have many fewer insurers to choose from than do those in Alberta. US Census Bureau reports the population of Massachusetts was 6.4 million in 2005. In comparison, Alberta's population according to Statistics Canada in the same year was 3.2 million. With half the population and 65 insurers compared to Massachusetts' 17, Albertans enjoy 3.8 times the choice of the Massachusetts marketplace. There is growing long-term evidence that the reduction in competition and cross subsidization have resulted in higher overall claims costs and thus higher premiums.

We strongly recommend that the AIRB avoid developing the type of adversarial quantitative approach used in Massachusetts.

Monitoring the market average and allowing a range for competition

New Brunswick Insurance Board (2004)

In New Brunswick, insurers are required to make rate filings annually. The New Brunswick Insurance Board (NBIB) has had a regulatory requirement to analyze rates annually since 2003. In 2004, the NBIB held public hearings to determine the appropriate return on equity to use in its analysis of these filings.

The NBIB heard from a number of witnesses on this matter including insurers, the provincial consumer advocate, independent experts and investment bankers. The Board concluded that:

The Board will not abdicate its responsibilities by creating fixed rate of range return on equity. The Board will review the requested rate of return on equity in each application and decide what the rate should be based on the criteria of setting "just and reasonable" rates for the policyholders of New Brunswick.³

The discussion was summarized by the NBIB's independent economist Dr. Richard McGaw, Professor of Economics at the University of New Brunswick in Fredericton. Dr. McGaw heard all of the evidence presented and provided the following advice to the NBIB:

...if I were asked the question which I posed to myself, why are we doing -- why should we set an ROE? My answer would be that we shouldn't. The performance of the last 30 years has given a rate of return that I think could not in any way be characterized as excessive. And as I said at the beginning, you know, I have no interest in the outcome of this hearing except as a -- you know, that I have a car. And I would say on that front that I would rather have myself at the whim of the marketplace than not.⁴

³ Decision, New Brunswick Insurance Board, July 2005

⁴ Testimony of Richard McGaw, Professor, University of New Brunswick, The Return on Equity for Automobile Insurers, at the New Brunswick Rate Board hearings, June, 2005 page 426

We believe that a similar approach, adapted for the more complex regulatory system in Alberta would benefit the province.

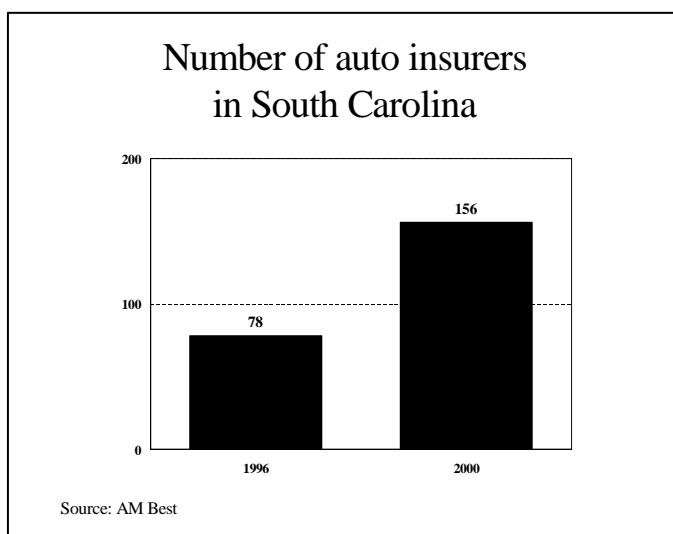
The two features of this system that would benefit Albertans is its ground-up approach to market supervision and its effort to maintain the link between prices and costs. It builds on the actual costing and filing of actuaries within the industry rather than taking a top down approach and imposing uniform parameters on the competitive market. This preserves and enhances choice for consumers also by tracking emerging trends in premiums and claims it prevents excessive competition from de-linking these trends. This serves consumers by promoting stability. There are aspects of the New Brunswick approach which the industry does not favour and which the industry believes do not serve consumers. In particular, the requirement of prior approval of filings introduces rigidity into the marketplace, but these positive features are worthy of note.

New Jersey

The history of auto insurance regulation offers a wide spectrum of insights into the relationship among regulation, competition and protection of policyholders. New Jersey's auto insurance marketplace changed in 1972 with the simultaneous introduction of a no-fault insurance system, strict price regulation and an actuarially unjustified rate rollback, which together led many major insurance companies to flee the state. Eventually, the price suppression led to more than 26 auto insurers exiting the market, greatly reducing capacity. As capacity shrank, legislators moved, in 1983, to create a residual market called the New Jersey Automobile Full Insurance Association. This residual market subsidized prices for some drivers, and insurers could not recoup the subsidy from other drivers in the State. This system failed. In 2002, New Jersey enacted a new auto insurance law that recognized that a healthy insurance market is one that best serves insurers and consumers, and that a balancing of interests was the best way to achieve it. There are indications that the New Jersey auto insurance marketplace is healing. Some of the major national insurers have returned to the market and consumers have greater choice, both in terms of the number of insurers to shop from and a greater variety of new and innovative products brought to the market by those insurers.

South Carolina

From the mid-1970s through 1998, South Carolina intensively regulated auto insurance. Rate levels and structures were restricted, insurers' underwriting discretion was limited and large cross-subsidies were channeled through its residual market. The distortion of economic incentives resulting from rate regulation escalated costs and prices and caused the residual market to balloon. By 1997, South Carolina suffered from a significant availability crisis as the suppression of both voluntary and residual rates prompted insurers to exit the State.



The 1999 auto insurance reforms replaced the prior-approval system with competitive market rating. In addition, underwriting

restrictions were substantially eased as the requirements for uniform classification, merit rating and rating territories were all abolished. The residual market and its large subsidies are currently being phased out and will be ultimately replaced by an assigned risk plan where adequate rates are charged.

Since the reforms for competitive rating were instituted, there are more insurers operating in the state. Further, South Carolina's ranking in terms of average premium expenditures has improved and the residual market has decreased from 600,000 policies in 1999 to 340 policies in 2003.

The industry offers the New Jersey and South Carolina case studies to illustrate to the AIRB the lessons learned in other jurisdictions. Invasive regulations, when removed, offered many benefits to consumers.

Setting an effective price ceiling by using conservative cost parameters

According to the Government of Alberta's website⁵ it established the AIRB with the mandate to set premiums for basic coverage, monitor premiums for optional coverage and review and approve rating programs for new insurers entering the Alberta market. The new Board will annually set the maximum premiums for basic coverage that all insurers can charge. This is different than the mandate of most other rate boards in North America. The presence of the premium grid and the decision to set a price ceiling is unique to Alberta.

The industry recommendations concern how to set an effective maximum and an effective ceiling, which will also allow the Board and Alberta drivers to benefit from competitive market forces.

Summary of the lessons from other jurisdictions:

The AIRB can benefit from the experiences of other jurisdictions that have sought to protect the public interest through heavy-handed regulation. A central lesson from the US experience is that the adoption of low-end or even average financial and actuarial assumptions and applying them uniformly across insurers in the marketplace in an effort to tightly manage insurance premiums is not a sustainable approach, and it negatively impacts consumers.

The academic literature that examines these markets highlights a number of warning signs of insurance market instability:

Increased reliance on residual markets

A common early symptom of problems in the insurance marketplace is larger than average residual market population. This is a problem for several reasons. First, residual markets offer insurance at prices that are below cost. As a result, residual markets, by design, lose money. The residual market shortfall is funded by drivers who are not in the residual market. The larger the subsidized portion of the market becomes, the greater the price that other drivers in the market must pay.

Alberta has a very large residual market. IBC has voiced concerns about this in other submissions. For sustainability, residual markets normally need to be in the range of 2-3% of the

⁵ <http://www.autoinsurance.gov.ab.ca/questions.html>

market. History in other jurisdictions shows that when the residual market becomes the largest insurer in a State, problems are not far behind. A large residual market increases the required risk premium for investors by raising the uncontrollable risks facing an individual insurer. In periods of rising claims (which is most periods), claims costs for the residual market tend to rise faster and farther than for the regular market by virtue of the claims in that pool. This creates bigger residual market deficits. An individual insurer knows this but is never certain whether such a deficit would be fully reflected in the premium adjustments permitted to regular market drivers. If it is not, it becomes a tax on capital. In light of the uncertainty in the actual claims liability facing an insurer in this type of market and the fact that it is beyond that insurer's management or control, investors require an additional risk-premium on capital exposed. The upcoming AIRB decisions in periods of rising insurance costs will determine the ultimate sustainability of the province's premium grid.

Lower investment in new technologies and a reduction in marketplace innovation;

Harrington (1992) suggests that substantial changes in insurance capacity take time to materialize. Eventually, however, firms will make decisions about investments in new technologies and levels of service. An investor with a choice between making an investment in a market that has a history of freezing prices and regulatory intervention and other markets without such a history is likely to choose the latter. The Alberta insurance marketplace competes for capital internationally so we are not surprised that our members have begun to report that product innovations available to consumers outside of Alberta are not being offered to drivers in this province.

Reduction in insurance capacity

There is a direct link between industry earnings and capital. The vast majority of new insurance capacity is generated internally through earnings. IBC's analysis shows that the industry aggregate return on equity in a given year is very strongly correlated with the supply of insurance in the following year. Historically, years when ROE is low are followed by years when real capital (the supply of insurance) falls and availability problems arise.

As this analysis demonstrates, there is an important relationship between return on equity and the supply of insurance. The strong growth in Alberta's economy and population means there is a need not only for a steady supply, but a growing supply of insurance in order to underwrite all of the economic activity projected for the province. As long as availability of insurance is of concern, attention must be paid to ensuring, or at least facilitating, returns to be sufficiently high to continuously attract a sufficient supply of capital. Conversely, artificially suppressing returns or establishing market, regulatory, product or price circumstances that produce suppressed returns, will ultimately create availability problems in the marketplace.

The same dynamics reflected in these industry aggregate figures also bear themselves out within an individual firm context. As discussed above, the cost of capital varies from firm to firm depending on the risk profile of the particular enterprise. Regulatory requirements that impose or imply a uniform cost of capital that is set at industry averages or at an otherwise-determined single value, will understate this cost for some insurers. As a result, these companies will allocate less capital to the undertakings in the suppressed-cost market, curtailing availability of the products that the company offers.

Increased intervention in insurance prices has certainly been the case through the recent hard market. This kind of intervention, whether in the form of rate freezes, roll-backs and rate approval regimes is not common today in insurance markets around the world. Moreover, markets that have been characterized by price controls in the past are moving away from these policies in favour of market-determined rating. Capital is mindful of these global trends and imposes a regulatory-risk surcharge on Canadian investments because of its relatively interventionist approach.

Higher than otherwise explainable average claims costs for all drivers in the long-run.

Academic research on Massachusetts⁶ and South Carolina⁷ has found that over time the strict price regulation systems used in these States resulted in higher average loss costs and higher claim rates. The researchers conclude that the increase in average claims costs arose from reduced competition in the marketplace, less efficient state-based insurers and a reduction in incentive to drive safely due to the subsidized rates.

Academic research and international precedent have come together in recent years to present very compelling evidence that intervention in insurance rate-setting falls short of achieving the public policy objectives it purports to be able to achieve, and in particular, that it contributes to premium volatility and market instability for consumers.

The implication for the AIRB and these hearings is that there are serious risks in forcing all-industry adherence to a single profit provision, and there are particularly concerning risks if the number chosen is low. While the competitive market will work to keep prices in line with costs if it is allowed to operate, a low profit provision will ultimately cause insurance to remain a public policy issue for many years. The regulator and the AIRB have a powerful force at their disposal, a regulatory tool gaining global acceptance, and finding strong endorsement in the academic community – the competitive marketplace.

RECOMMENDATIONS FOR THE AIRB

In this submission IBC has argued that constraining insurance rates through using low parameters that do not foster competitive diversity has been shown in other jurisdictions not to benefit consumers. Against the background of this experience, we believe that the AIRB should exercise great caution in establishing the parameters for its own rate administration activities.

All of IBC's recommendations are based on the premise that competitive insurance markets benefit consumers, insurers and the province at large. We believe that the AIRB can carry out its mandate best by capitalizing on competitive forces, which in the context of the annual adjustment process for mandatory product means establishing **an effective price ceiling on the basis of appropriate ceiling estimates for all cost parameters, and facilitating competition on all fronts below the ceiling price.** We believe that this approach is consistent with the Government's

⁶ Tennyson, 2004

⁷ Martin F. Grace, Robert W. Klien and Richard D. Phillips, Auto Insurance Reform: Salvation in South Carolina, *Deregulating Property-Liability Insurance*, J. David Cummins, ed. AEI-Brookings Press, 2002.

broader public policy goals of promoting stability, availability, affordability of insurance and guaranteeing the fair treatment of consumers.

Rate setting will never be an exact science. Indeed, virtually every component of the typical rate setting formula involves the need to make major assumptions about the future in an environment that is fraught with uncertainties. Yet, as we have emphasized throughout this submission, the consequences of being insufficiently attentive to market forces can be very treacherous for consumers, insurers and governments.

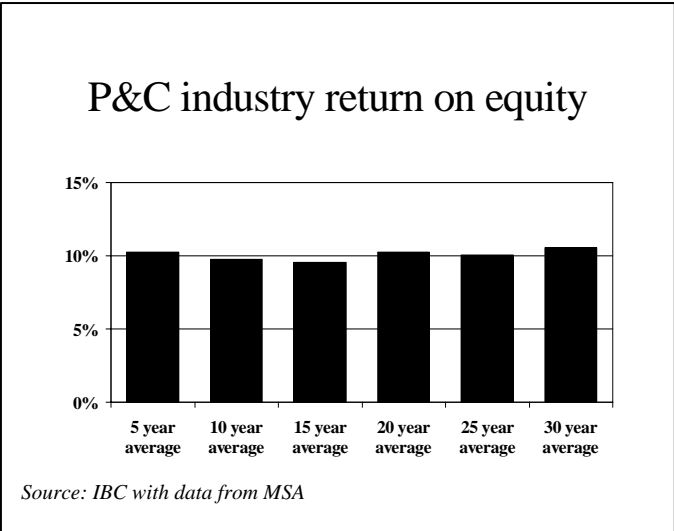
In preface to our recommendations to the Board, we will present evidence regarding the key elements of the rate formula that are central to determining an appropriate profit benchmark for the purposes of the annual adjustment process.

Estimate of future claims cost

Actuaries begin the process of pricing insurance by forecasting the future costs of claims. This involves looking at the expected frequency and severity of future claims. Current claim trends and the outlook for claims costs vary significantly across insurers based on the make-up of the individual insurers’ customers. This is, by far, the largest, most volatile portion of the pricing equation. Changing future claims costs is the primary reason for movements in prices. Differences in expected claims cost trends are the primary driver for price differentials from one insurer to the next. The importance of claims costs greatly exceeds all other factors.

Profit provision

Return on Equity (ROE) is a ratio that measures earnings compared to invested capital. It is measured after the fact. This is a different concept than Cost of Capital (COC). COC is the expected return required by investors to cause them to place their money at risk for the year ahead. COC is a forward looking measure. These are related, but different, concepts. We suggest that the COC is the more appropriate measure for the AIRB to use in rate regulation.



Every product in every industry requires a certain amount of capital for production to occur. For many industries that we are commonly familiar with – drilling for oil, farming or ranching – we can picture the capital investment. It comes in the form of plants, machinery, equipment, rigs and barns. Insurance also requires capital investment, but not in the hard or physical capital sense. While the production of a barrel of oil requires a rig, each insurance policy sold requires cash in the bank (or invested in secure investments) to back it up, or it cannot be sold. Finding the correct balance between the risk and the rewards of

different investments is the tool by which the economy allocates capital across the range of investments required to make a modern society function normally.

The global market for capital is intensely competitive. Insurance competes with other investments for capital; capital can be reinvested in insurance markets or it can be invested outside insurance. In a similar vein, Alberta competes with other jurisdictions as insurers make choices about where to invest their scarce capital resources. The choice to invest in the Alberta auto insurance marketplace depends on the prevailing business environment relative to the alternatives. The question for the AIRB is what is the right profit provision to attract “enough” different types of capital into Alberta’s auto insurance marketplace to offer consumers choice, innovation and consistency in supply.

Over the past 30 years, the average return on equity for P&C insurers operating in Canada has been 10%. This is the average over the past 5, 10, 15, 20, 25 and even the past 30 years. When looked at over a longer period, which accounts for some of the cyclical results for both P&C insurance and comparative industries and firms, we see that Canadian property and casualty insurers in aggregate returned relatively less to all of their investors than many other enterprises including a number of businesses that most consumers encounter in the normal course of daily life such as the grocery store, the bank and the hardware store.

It is important to understand that over time, all-industry average ROE is not an appropriate benchmark for regulatory purposes. In the first place, the industry’s long-run average return on equity includes years when profitability was higher than 10% as well as years where profitability was lower than inflation. Were the AIRB to limit the cost of capital provision in the pricing equation to a maximum of 10 %, then only those insurers with an actual cost of capital of 10% or less would be able to attract capital to this province on a long-term basis.

Secondly, the industry average masks the considerable diversity that is at play within the P&C insurance market. In addition to diversity in corporate strategies and corporate risk profiles, there are differences in firms’ relative levels of success and their success over time. Within a given market segment, some corporate strategies are “winners” and others are “losers”, and, over time, successful market approaches come to replace less successful strategies.

Thirdly, this traditional book-value measure, as noted above is only loosely related to the forward looking market-value based measures that truly reflect cost of capital.

An important implication of the competitive, diverse marketplace that characterizes the Alberta auto insurance market is that there is not “one” business strategy, there is not “one” risk involved in investing in this market, but in fact many business strategies, involving many varied degrees of risk. As a result, there is no “one” cost of capital and no “one” return on equity. Each firm takes its unique combination of management expertise, marketing, sales, investment, underwriting and claims strategies to capital markets and looks for their willingness to take a chance on the enterprise. In exchange, they offer a return commensurate with the risks involved relative to other potential investments.

To further illustrate this point, the following table provides actual financial results for insurers that provide the majority of auto insurance to Alberta’s drivers. The average industry return since 1991 has been approximately 10 %. However, in any given year actual insurer performance varies dramatically. Some firms are very profitable, while others lose significant amounts of money.

Alberta’s Auto Insurances – Overall Financial Results

Year	Average ROE* (%)	Range of ROE reported by companies (lowest to highest)	
		Lowest ROE (%)	Highest ROE (%)
1991	12.4	-23.2	53.0
1992	8.1	-7.8	26.2
1993	10.5	-4.3	32.5
1994	3.7	-24.2	20.5
1995	11.4	-3.1	29.0
1996	16.1	5.3	42.4
1997	17.4	1.3	30.9
1998	12.0	1.0	33.0
1999	7.2	-5.3	21.9
2000	7.7	-1.9	21.4
2001	1.8	-20.4	12.6
2002	-5.6	-52.1	20.4
2003	3.1	-41.3	23.2
2004	18.7	-0.7	41.6
2005	22.0	10.2	38.6

Source: IBC based on data from MSA- Companies writing 80% of Alberta auto

A fourth consideration in establishing a target profit provision is illustrated by a recent study from the Georgia State University’s Center for Risk Management and Insurance Research, which found that insurers that demonstrated a “real on-going commitment to ethical business practices” show better financial performance including a higher return on equity and more efficient use of capital.⁸ This should not be surprising, since retained earnings from profits are the most important source for investments in enhancing “best practices” and innovation among insurers.

IBC believes that the AIRB’s practice of using 5 cents per premium dollar has no basis in analysis or market research. In fact, the 5 % figure originates from a 1921 National Convention of Insurance Commissioners (NCIC) Fire Insurance Committee. The report of this committee found that “5 % is the minimum percentage which can be regarded as ‘a reasonable underwriting profit’”. The report also recommended that 3 cents per premium dollar be added to protect against catastrophes. No statistical support has ever been provided for the selected level. McCullough (1948) provides an in-depth analysis of the 1921 NCIC deliberations and an update of the issue through 1947.

⁸ Robert W. Klein and Martin Grace, “The Economic Consequences of Voluntary Certification Programs, August 2006, www.imsaethics.org

IBC recommends that the 1921 figure is simply not relevant to the 2007 Alberta auto insurance marketplace. Originally a figure used for fire insurance, it was never intended to be applied to auto insurance. Moreover, the financial literature has evolved to the point that this rule of thumb is no longer relevant. Actuaries did not discount claims reserves in 1921. Today they do. This would likely change this figure. The Government of Alberta started to levy corporate income tax in the 1940's, reflecting the introduction of corporate income tax increases, increasing the required profit margin by approximately 3 points. The original 5 % number was also related only to the underwriting function and was not understood to apply to the investment component of insurance operations. The 5 % rule of thumb is not regulatory best practice but an historical artifact that should be set aside in the consideration of current technology for dealing with these issues.

There have been a number of advancements in the academic literature concerning estimating target levels of profitability for an investment. An underlying principle of all of these approaches is that returns for investors should increase as the riskiness of the investment increases. Over time, academics have brought increasing complexity to defining and measuring risks.

What risks?

Here are some of the risks that international solvency regulators consider when setting regulatory capital requirements.

1) *Credit risk*. Credit risk is the risk of loss if another party fails to meet its obligations or fails to perform them in a timely fashion (i.e., non-payment by reinsurers).

2) *Market risk*. Market risk includes the risks that arise from fluctuations in values of, or income from, assets or in interest or exchange rates.

3) *Liquidity risk*. Liquidity risk is the potential that an insurer may be unable to meet its obligations as a result of a timing mismatch between asset and liability cash flows.

4) *Operational risk*. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

5) *Insurance risk*. Insurance risks include underwriting risks and reserving and claims risk.

Source: International Association of Insurance Supervisors.

The most common academic models to assess required returns are:

Capital Asset Pricing Model (CAPM):

CAPM has been a most popular model used by regulators in charge of establishing adequate and reasonable insurance rates. The general idea behind CAPM is that investors need to be compensated for the time value of money and for risk. The time value of money is represented by a risk-free rate and compensates investors for placing money in an investment over a period of time. The risk component calculates the amount of compensation the investor needs for taking

on additional risk. This is calculated by taking a risk measure (beta) that compares the returns of the asset to the market and to the market premium. The CAPM has come under attack with respect to insurance because it does not take into account the chance of insolvency or firm size. Despite its limitations, however, CAPM remains the underlying foundation for more advanced approaches to estimating cost of capital.

Discounted Cash Flow (DCF):

A DCF is a valuation method used to estimate the attractiveness of an investment opportunity. DCF analysis projects future cash flows and discounts them at the weighted average cost of capital to arrive at a present value. If the value arrived at through DCF analysis is higher than the current cost of the investment, the opportunity is a good one. The usefulness of the DCF model in the insurance context is arguably limited due to its reliance on earnings forecasts and growth rates. Analysts' forecasts are typically only available for large publicly traded firms, making the sample of companies that can be analyzed using this method small. Also, the method does not incorporate the breakdown of the cost of capital by line of business, which is crucial in the context on auto insurance.

Fama-French Three Factor (FF3F):

The FF3F model retains the CAPM risk-premium component but adds risk premiums for two additional factors to capture the effects of firm size and financial distress. The size factor controls for the tendency of stocks with small market capitalization to have higher costs of capital than large capitalization stocks. The financial distress premium is used for firms with low growth and low earnings to book equity ratios. Typically, high growth firms have a lower cost of capital than firms with low growth prospects. Supporters of the FF3F model argue that reliance on the CAPM overlooks significant common risk factors that play a role in determining returns. Hence, reliance on the CAPM is likely to lead to inaccurate cost of capital estimates, which can be improved using the FF3F model.

Full Information Beta (FIB):

The FIB method is used as an add-on to the CAPM or FF3F model. Instead of using industry-wide beta values, the FIB seeks to determine the appropriate values of Beta to use by establishing cost of capital estimates of the line of business composition of the firm. These estimates can be used to approximate the cost of capital by line of insurance for divisions or subsidiaries of conglomerate firms. The FIB rationale implies that the firm's overall market beta is a weighted average of the beta coefficients of its separate divisions or business lines. The weight on each divisional or line of business beta is the percentage of its sales to the sales of the firm as a whole.

The major implication for the AIRB of the evolution in the academic research on this issue is to give pause to consider policy responses based on older techniques which it is now well understood tend to understate the cost of capital for individual firms. The implications of understating the cost of capital – or setting too low an ROE target, or of setting a single ROE target for all – have been discussed at length. Stable availability and affordability of insurance in the province of Alberta are best served by allowing the marketplace work to determine the right profit factors required by investors and to ensure that the industry structure that promotes competition is maintained. IBC encourages the Board to give due consideration to this analysis and the implications of its findings.

While a purely competitive market-based approach to the cost of capital variable is the industry's strong preference and, in our view, the approach that best serves consumers, we appreciate that the Board is interested in "a number". For this reason, we have summarized the most recent approaches to estimating the average cost of capital for an industry – FF3F and FIB. Although we do not support the use of averages or single figures for the industry as a whole.

In addition, IBC informs the Board that the use of more modern technologies such as the Fama French 3 or the Full Information Beta approach in and of themselves is not sufficient for addressing the question at hand. These techniques can be employed to estimate average COC. In order to establish an effective ceiling price, the Board would need to use the top-end COC parameter of insurers operating in the marketplace coupled with other conservatively estimated variables within the pricing equation to produce an effective ceiling price.

Premium to Equity Ratio

This is sometimes also called the gearing ratio, and it describes how much insurer capital is required to support that premium that will be written. A common rule of thumb for P&C insurers across all insurance lines is that a 200% average blended premium-to-equity leverage ratio is appropriate. Canadian insurers face the most conservative solvency regulation framework in the G7. Experience for 2005 under OSFI's Minimum Capital Test (MCT), which regulators use to monitor the health of Canadian insurers, indicates that insurers (at the all Canada all-lines level) must maintain a 175% level on the MCT.

In their last analysis the AIRB's actuaries used a 200% as the premium to equity ratio. While this may be a reasonable value for this average blended leverage ratio for Canadian insurers at the all-Canada all-lines level it is not appropriate for the AIRB to use in its deliberations. This is because an insurer needs more surplus to support the underwriting of coverages where the ultimate value of claims becomes known, on average, long after the date when the premium is earned. Given the longer claim duration for the mandatory auto product, the most significant portion of which is third party liability, IBC recommends that the AIRB use a conservative Premium-to-Equity Leverage Rate in the annual adjustment to reflect this reality. To arrive at our final recommendations, we assume a leverage ratio between 1-to-1 and 1.3-to-1. When the AIRB determines this ratio we recommend that the AIRB consult with OSFI on the appropriateness of this factor.

Return on investment (ROI)

P&C insurers use investment income to offset premiums. The higher the expected return on investment the lower the required premium for drivers.

The federal Office of the Superintendent of Financial Institutions regulates the investment practices of insurers using the prudent person rule. Assets that are reasonably liquid are necessary for insurers given claims payout patterns.

There is considerable diversity of investment strategies employed by insurers across the industry. Some insurers have more conservative investment portfolios. They take the view that the risk inherent in the liability or insurance side of their balance sheet (i.e. mainly the unpaid claims and unearned premiums) is enough risk. They are unwilling to take on additional risk in connection

with how they invest. Other insurers have a larger appetite for risk on the asset side of the balance sheet, and are willing to invest their equity or surplus more aggressively (within limits permitted by the regulator), with the expectation of earning a higher return on equity.

The more conservative insurers match the duration of their investments with the average duration of the claims payout. Other companies deliberately “mismatch” by investing for a longer duration, while maintaining sufficient liquidity, in order to attain higher yields. The individual insurer’s portfolio affects the selection of the discount rate for unpaid claims (bond book yield).

The key part of investment income within the pricing equation is that it is forward looking. The actuary is estimating future investment performance rather than relying solely on past performance. In our opinion, an appropriate expected return on investment for cash flow from underwriting should not be greater than (and perhaps somewhat less than, since insurers need to retain some level of cash float) that which would be expected by investing cash flow from underwriting after front-end expenses (i.e. the provision in the premium for claim costs) at current rates in risk-free Government of Canada bonds reasonably matched by duration to the claim liabilities. Based on a survey of our members, IBC estimates that the average duration is approximately 2.67 years. Were the AIRB to assume higher investment returns than this conservative investment strategy, they would be placing the more conservative insurers at a disadvantage relative to their peers – a questionable competitive outcome given that some consumers may prefer to deal with an insurer with a risk-averse approach to pricing, reserving and investing.

For the purposes of generating our recommendation for an effective ceiling price, we assume a risk-free interest rate of approximate 4.25 %.

Importance of qualitative factors

We want to conclude this section with a caution to the Board against relying on purely quantitative measures in arriving at the profit factor that will be used for the annual adjustment process. They can bring false confidence in the precision of rate setting. In the real world qualitative measures such as rating agency requirements, financial analyst statements, demands from the financial press, and the profitability of competing opportunities all play important roles in determining any company’s target profit provision. As well, we caution the Board in relying too extensively upon one estimation model. There are hundreds of actuaries in Canada with years of professional education and experience including the guidance of professional codes and standards. Each company has a pricing model that reflects its unique expertise in this area. Each of these models is appropriate, arguably even more appropriate, to the company than an industry imposed uniform approach. The knowledge contained in each individual companies’ actuarial estimation processes, including its reflection of relevant cost of capital requirements, could be a very valuable asset to the Board in ensuring the integrity of premiums for drivers in the province.

Fair Value Accounting

There are important changes to Canada’s Generally Accepted Accounting Principles scheduled to come into effect for January 1, 2007. These changes impact all companies that hold “financial instruments”. This change is driven by a desire to assist users of the financial statements in

assessing the health of a company. Accountants are making a trade-off in making financial statements more relevant, but more volatile.

The Canadian Institute of Chartered Accountants has introduced a new way to account for financial instruments, like investments, that require:

- All financial instruments, including derivatives, are to be included on a company's balance sheet and measured, either at their fair values⁹ or, in limited circumstances when fair value may not be considered most relevant, at cost or amortized cost. The standards also specify when gains and losses as a result of changes in fair values are to be recognized in the income statement. These requirements will probably affect all entities to some degree.¹⁰
- A new location for recognizing certain gains and losses - other comprehensive income - has been introduced. This provides for an ability for certain gains and losses arising from changes in fair value to be temporarily recorded outside the income statement, but in a transparent manner.¹¹

IBC has worked with the Office of the Superintendent of Financial Institutions on this issue and OSFI's results guideline D10 clarifies that P&C insurers can use the "fair value option" in their financial reporting to OSFI. OSFI also requires that all financial institutions that use the fair value option have a documented risk management strategy.

Under the new rules insurers will designate all investments into 3 categories on January 1, 2007 based on their intentions when they acquired the asset. The categories are:

- 1) Held-to-maturity;
- 2) Held for trading; and,
- 3) Available for sale.

Different classifications require different accounting treatment. Some of the most important differences are included in Table Two. The primary difference is in the treatment of unrealized or "paper" capital gains.

⁹ Fair value for investment contracts is defined as the amount for which the asset could be settled between knowledgeable willing parties in an arm's-length transaction.

¹⁰ http://www.cica.ca/index.cfm/ci_id/24912/la_id/1.htm

¹¹ http://www.cica.ca/index.cfm/ci_id/24912/la_id/1.htm

Investment designation	Net Income	Other comprehensive income	Valuation of liabilities	Matching
Hold-to-maturity: assets can not be sold or entire portfolio must be revalued.	Investments amortized over life of investment	NA	Book value	Matches assets and liabilities
Held for trading:	Investments held at fair value on balance sheet. Changes in fair values recognized on income statement.	NA	Market value of liabilities	Matched assets and liabilities
Available for Sale	Investments held at fair value on balance sheet. Changes in fair values recognized on income statement only when realized.	Unrealized gains recorded as other comprehensive income.	Market value	Mismatch of assets and liabilities.

This accounting change will allow users of financial statements to have a clearer picture of the financial health of a company and allow them to make more informed decisions when assessing and comparing companies. This is the intention of this change.

In the summer of 2006, IBC surveyed insurers and asked them which investment designation they intended to choose:

- 9.5% of insurers indicated that they will use the held-to-maturity option
- 42.9% of insurers indicated that they will use the available for sale method
- 23.8% of insurers indicated that they will use a combination of available for sale and held for trading.
- 23.8% were undecided.

The new standards apply on a prospective basis (i.e. prior periods will not be restated), however, through proper notes to the financial statement and communication, results for 2007 can still provide some relation to prior period results.

This is a significant change to financial statements. The implications for actuarial standards of practice and the AIRB are not entirely clear. The CIA is working to complete an educational note for P&C actuaries that details changes to standard actuarial practice.

Given the uncertainty in the reporting and actuarial environment at this time, we are able to offer only the following cautions to the AIRB on this matter:

- If the Board intends to make reference to financial statement data, particularly for the purposes of comparing one firm's overall earnings with another, the profit or ROE calculation should be based on the other comprehensive income statement rather than net income to adjust for the differences in accounting methods from one company to the next. At the same time, IBC recommends that ex post accounting ROE figures are not relevant to the question of establishing the appropriate target cost of capital measure for the purposes of establishing the direction of rates for mandatory auto insurance in Alberta.
- If the Board intends to use financial statements to compare aggregate investment yields from one company to another, it is important to note that the reported return on investment (ROI) can differ based on the accounting method used. This is due to the larger denominator being employed when assets are carried at fair value (larger number) instead of amortized cost (smaller number). IBC recommends that an industry ex post ROI derived from financial statements is not likely the best or most relevant measure for establishing an effective price ceiling for auto insurance in Alberta.
- If the Board intends to evaluate financial statement data for the purposes of comparing company trends or industry trends over time, it is important to be aware that underwriting results are likely to become more volatile as changes in fair value of claims liabilities flow through the income statement while changes in investment income may flow through the statement of other comprehensive income. At the same time, IBC recognizes that the underwriting information, particularly that gleaned from the automobile statistical plan, and projections by individual company actuarial departments will continue to be the relevant source data for the purposes of establishing a direction for insurance prices for the mandatory automobile insurance product in Alberta.

The move to fair value accounting will further highlight the diversity of results across insurers. It is not clear how this will impact actuarial practice. The CIA will be issuing an educational brief on this issue soon. Some are suggesting that this makes the pricing actuary's job of matching investment assets supporting the premiums easier. Time will tell.

IBC's analysis suggests that there will be a one-time increase in industry equity as reported on financial statements in the transition. This will distort the normal ratios used in the pricing equation including return on equity, return on investment and the Premium-to-Equity Leverage Ratios. It will be important to revisit this issue once that industry has fully made the transition to the new reporting approach.

Summary of recommendations for the AIRB:

- a. The AIRB must recognize that the profit load that they use in the price equation for determining adjustments to the price for basic coverage will not control actual profits earned by any company or the industry as a whole. This is determined by competitive forces and company ingenuity. The Board is not responsible for or able to regulate company or industry profits.
- b. The target ROE/profit provision in the pricing equation is a cost estimate that contributes to determining the direction of prices for the basic coverage. Understating the cost of capital, results in understating costs and understating price and will eventually destabilize the marketplace, reduce competition and the supply of insurance in the Province.
- c. High ROEs are associated with high customer service, and the target permitted in the price adjustment should be consistent with providing a high level of service to Alberta drivers.
- d. A cost of capital parameter at the upper end of the range of actual cost of capital for the industry is not a guarantee that companies will earn this amount. It is recognition that some insurers have a cost of capital at this level, and it provides them with an opportunity to set prices at the level that would reflect this relatively higher cost, but at the same time, would subject them to competition with insurers with lower costs, including a lower cost of capital and attendant lower prices.
- e. If the premium regulations permitted, the AIRB would be advised to adopt a benchmark approach, using filings from all insurers to establish and track actual average market trends and permitting rates to vary from insurer to insurer by permitting variety in individual cost parameters including the cost of capital, within a set range or band. As regulations do not permit such an approach at this time, the AIRB is advised to adopt a ceiling approach allowing competitive forces to determine prices below the ceiling rate.
- f. The establishment of an effective price ceiling for basic coverage requires assumptions that reflect the higher range of costs within the industry, so that firms facing these costs will not be prevented from competing in the marketplace, albeit competing with insurers with lower cost parameters.
- g. Determining a profit margin from a ceiling cost of capital estimate involves other parameters including ROI and gearing ratio. Taking the higher end cost of capital estimate alone will not necessarily produce an effective ceiling price. We recommend that all of these factors be considered together, and a conservative approach be pursued, to ensure an effective ceiling and maximum room and scope for competition below the ceiling price.

- h. We recommend that the AIRB take the upper tier of actual target ROEs actually in force among Canadian insurers operating in Alberta auto market. Based on our assessment of member insurer target ROEs and current research, we believe this to be around 17% in current market conditions. This figure is validated by academic research in this field and capital market practice.
- i. In converting this target ROE to a profit margin, and given the longer claim duration for the mandatory auto product, IBC recommends that the AIRB use a conservative Premium-to-Equity Leverage Ratio in its Uniform Price Adjustment to reflect this reality. AIRB should also consult with OSFI on the appropriateness of this factor. Our analysis of industry practice suggests that a ratio of 1.3 to 1 or lower would be appropriate.
- j. In our opinion, an appropriate expected return on investment for cash flow from underwriting should not be greater than that which would be expected by investing cash flow from underwriting after a provision in the premium for claim costs at current rates in risk-free Government of Canada bonds reasonably matched by duration to the claim liabilities.
- k. IBC estimates that these assumptions produce a profit provision in the range of approximately 8 to 11 cents per dollar of premium.
- l. Should the Board not decide to pursue an effective ceiling price approach, including the selection of conservative parameters for all elements in the pricing equation, then IBC recommends that the Board permit Section 6 filings to include variation on all parameters in order to provide an outlet for competitive diversity.
- m. With regard to fair value accounting, IBC does not anticipate this change in financial reporting to significantly affect the activities of the Board, however, depending on the decisions made in the course of this hearing and again next year, the Board may want to be open to receiving Section 6 filings from insurers for which the factors determined in this process are significantly out of step with their post-fair-value accounting economic and reporting realities.
- n. The AIRB may wish to revisit the issue of fair-value accounting in 2008 after the impact of the move to fair value accounting is better understood and actuarial guidance on the issue is more established.

CONCLUSION

IBC appreciates the opportunity to participate in these hearings and looks forward to continuing to work with the Alberta Insurance Rate Board in the coming years, on these important issues, as part of our collective desire to develop a leading edge insurance industry in Alberta and across Canada.

The Alberta auto insurance market is working within the constraints imposed by the provincial government; it is competitive, diverse and offers a range of products, service and choice to consumers in the province. Further regulatory interventions that could disrupt the competitive marketplace should be redundant and with caution.

Industry earnings are not excessive, but are on par with peers in the financial services sector, and in fact low relative to a host of goods and services that consumers purchase in the course of day-to-day living. Consumers are the winners when performance of the insurance industry improves, through reduced rates, greater choice and increased availability.

Low ROEs generate availability problems for the market as a whole and for certain coverages within a marketplace when the firms offering those coverages cannot obtain an ROE sufficient to meet the cost of capital. Rate boards should allow companies the flexibility to select the target ROE that reflects their company's level of risk and to base prices in the Alberta auto insurance marketplace on their unique actual costs. Establishing the conditions for insurers to earn competitive rates of return ensures available, affordable insurance for Alberta drivers.

While price regulation has been a typical Canadian response to insurance cycles since the 1980s, this is not common in the rest of the world and in other industries. The global trend is towards greater reliance on market forces to determine insurance prices. Academic research and practical experiments have also uniformly demonstrated the failure of price regulation to produce greater price stability and product availability. In fact, price regulation ultimately increases volatility in insurance premiums in the long run. For this reason IBC's recommendations for the AIRB are oriented towards including room for competitive market dynamics within the regulatory system of market oversight.

Modern methods of estimating the cost of capital for this industry are increasingly in use by insurers. Traditional methods employed by regulators elsewhere tended to understate the cost of capital, and consequently contributed to under-allocation of capital, and availability problems in the marketplace. Consideration of these models and their findings is essential to ensuring long run availability and affordability of insurance in Alberta.

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