State Farm Mutual Automobile Insurance Company

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Automoblile Insurance Rate Board
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STATEMENT OF STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY

I appreciate the opportunity to provide comments to the Board regarding auto insurance in Alberta

The State Farm Mutual Automobile Insurance Company is the largest insurer of automobiles in North America. State Farm commenced writing auto insurance in Canada in June of 1938.

State Farm is a multiple line insurance organization serving the personal lines insurance needs of over 900,000 automobiles in Canada, of which 85,000 are in Alberta. In addition, we have about 800,000 property and casualty (P&C) policies other than automobile insurance and over 250,000 life insurance policies in Canada. State Farm has a branch office in Aurora Canada and 41 exclusive State Farm insurance agents in Alberta.

It is worth noting that the automobile insurance marketplace in Alberta is very competitive. State Farm is one of a number of insurance companies writing automobile insurance in Alberta. To illustrate the competitive environment, the company with the largest premium volume only has 17% of the market. However, since the introduction of the Risk Sharing Pool (RSP), it has more premium than any insurer. This creates significant concerns for a properly functioning competitive marketplace.

The purpose of my written submission is to provide suggestions to the Alberta Insurance Rate Board regarding the automobile insurance issues set for Hearing in November 2006.

It is important that the Board not disrupt the competitive market by adopting a rigid and uniform method that might deny insurers a fair and reasonable profit. A competitive marketplace is the best regulator of rates. A more open, competitive market will provide the insurance-buying public availability and reasonable stability of prices.

Rate of Return After Tax

The total rate of return for insurance companies includes its operating return plus the investment income on the company's equity. The operating return is the sum of the amount remaining after incurred losses and expenses are deducted from earned premium (i.e., underwriting profit or loss) plus investment income on insurance operations (i.e., investment income on reserves). With the total return approach, all investment income can be included.

The total rate of return must provide a reasonable opportunity to earn a return comparable to the returns for other industries with comparable risk. A fair and reasonable rate of return is one that reflects the cost of capital. The cost of capital is a function of risk. The greater the degree of risk, the greater the cost of capital and the greater is the fair and reasonable rate of return.

The most basic element of risk for the P&C insurance industry is the fact that it is one of the very few industries where the cost of the product is not known at the time it is sold.

The rate of return for the P&C insurance industry has significant variation, which implies higher risk.

State Farm believes a total return in the 11% to 15% range for the voluntary market is reasonable for automobile insurance overall in comparison to the current returns of other industries. However, it is not appropriate to determine a single value which can be uniformly applied to all insurers. It is important to not use rigid regulated imposed formulas, methods, and assumptions, thus allowing independent filers as much flexibility as possible in the choice of methods and assumptions not only to reflect individual insurer circumstances but also allow for potential future developments.

Auto insurance is uniquely risky in that it is subject to the pressures of the competitive marketplace and the great uncertainty regarding future product costs.

The actuarial determination as to whether a rate is not excessive, inadequate, or unfairly discriminatory is based on the costs associated with the insurance transaction which a specific insurer is expected to experience. Diversity in costs exists between insurers regarding claim loss costs, operational expense costs, and the cost of capital. The cost of capital varies from insurer to insurer because the degree of risk varies.

We suggest a rate of return greater than 15% for the purpose of determining the industrywide premium level for the basic automobile insurance coverage for the following reasons:

- the premium grid already places a ceiling on the premiums but no such limit exist on the losses.

- selecting too low of a return will likely result in prices being understated relative to the cost and this will impede the competitive marketplace

- the presence of additional uncertainty and therefore risk due to the size of the residual market and the take all comers provision

- there is more uncertainty with the cost of insurance for the mandatory coverages than the cost of insurance for the physical damage coverages especially regarding the legal challenges to the threshold for pain and suffering and the longer payment pattern for the mandatory coverages

-the establishment of the cost of capital at this level does not guarantee insurers will earn this return.

The establishment of the benchmark is intended to be a ceiling. If it is not a true ceiling, it will impede competition. Competition is the best regulator of rates.

Premium to Surplus Ratio

It is important to understand that surplus is a statutory insurance accounting term analogous to the general accounting concept of net worth. It is calculated by subtracting an insurance company's liabilities from its assets.

The premium to surplus ratio for an insurance company is one measure of potential risk of insolvency. The higher the ratio, the greater the risk of insolvency. Surplus or net worth is the difference between solvency and insolvency. The surplus provides a protection for increased liabilities, declines in asset values, supports policy growth and additional coverage for existing policyholders. The net worth of a company is the protection that stands between promises kept and promises broken.

This ratio is important in insurance ratemaking because it is used to translate a target rate of return in terms of equity to a return in terms of premium. Even though a 2:1 premium to surplus ratio may be used in ratemaking by some individual insurers, it is advisable to use the industry average premium to surplus ratio in this setting. All insurance capital is at risk. Use of something other than the actual premium to surplus ratio should be at the discretion of the individual insurer. The current premium to surplus ratio for Canadian companies is about 1.15 to 1.

It is important to note that the purpose is to establish the rate of return for the mandatory coverages. There is more uncertainty/variability in the results for the mandatory coverages than the shorter tailed physical damage coverages. Due to the additional risk, the premium to surplus ratio should be lower for the mandatory coverages compared to the premium to surplus ratio for the physical damage coverages or all coverages combined.

Again, I appreciate the opportunity to provide comments to the Board regarding auto insurance in Alberta. State Farm is committed to working with AIRB in providing a healthy auto insurance environment that is responsive, stable, affordable and sustainable at meeting the needs of Albertans.

All questions concerning this written submission should be directed to:

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Sincerely,

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