The Co-operators Group Limited

The Co-operators written submission to the
Alberta Automobile Insurance Rate Board

Review of Profit Level for Automobile Insurance

October 19, 2006

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The Co-operators is pleased to participate in the AIRB's consultation process regarding profit levels. We remain committed to working with the government of Alberta to achieve common objectives that will benefit consumers. This submission will focus on the following issues as outlined in the AIRB notice of August 9, 2006:

- An appropriate target level of ROE for automobile insurance written in Alberta;
- The appropriate values of the components of the reconciliation between profit provision and the ROE;
- Calculation techniques or models to convert target ROE to an appropriate underwriting profit provision; and
- The impact of impending changes in insurance financial reporting.

The Co-operators philosophy regarding the delivery of the automobile insurance product to the consumers of Alberta is based on the following fundamental guiding principles:

- **Security**: At its most basic level, insurance provides peace of mind. To provide peace of mind, auto insurance must provide adequate coverage for treatment and compensation for the most seriously injured accident victims and at the same time ensure that those responsible for personal injury accidents have an appropriate measure of financial protection.
- **Affordability**: Auto insurance must be affordable for a compulsory insurance system to work. In recent years, auto insurance has become less affordable because claims costs are increasing at a pace several times that of inflation.
- **Availability:** Insurance consumers have the right to expect reasonable access to a variety of providers who can meet their coverage needs.
- **Simplicity:** Insurance consumers have a right to understand the product they are purchasing and the benefits to which they are entitled if they are injured.

ABOUT THE CO-OPERATORS

The Co-operators is a group of Canadian companies focusing on insurance. As a co-operative, our members are 33 co-operatives, credit unions and like-minded organizations, representing a combined membership of 4.5 million Canadians. Our Alberta members include Agrifoods International Cooperative Ltd., Credit Union Central of Alberta Ltd., Lilydale Inc., United Farmers of Alberta, and Wild Rose Agriculture Producers. For the past three years The Co-operators was listed among Canada's "50 Best Employers" in *Report on Business* and listed among Canada's "Top 100 Employers" by *Maclean's* magazine.

The Co-operators has deep roots in western Canada. From humble beginnings, a group of farmers, who sought insurance protection that the market would not provide, came together to form what is today known as The Co-operators.

In Alberta, 99 agents independently own offices in communities across the province. They create employment, they volunteer their time, and they help fund community initiatives. The organization employs 486 people in locations throughout Alberta. Over 181,000 private passenger vehicles are insured by The Co-operators Group in Alberta.

Company	Staff/Agents/Brokers	Private Passenger Vehicles insured
Co-operators General Insurance Company	99 agents 377 staff	171,209
Coseco Insurance Company	10 staff in Calgary	10,000

We take great pride in our co-operative structure. It enables us to contribute to the Alberta economy and through our co-operative approach to doing business, has ensured that the economic and social benefits of our enterprise remain in the local communities where we operate.

COMMITTED TO ALBERTA COMMUNITIES

The Co-operators and its agents have contributed over $879,250 to Alberta charities and community organizations since 2000. Our community commitment and involvement grows year over year. In addition, $156,200 has been contributed to Alberta co-operatives through The Co-operators Development Program since 2000.

Sponsorships in Alberta:

- As a national sponsor of the Safe Communities Foundation, The Co-operators supports Alberta's 10 designated Safe Communities that work to make safe living an integral part of every day life
- As the national sponsor of 4-H, we provide scholarships as well as the time and financial support of many of our Alberta agents
- Each year, The Co-operators provides $10,000 to support the United Farmers of Alberta Rural Safety Camps
- Through the efforts of several agents, we help to support DARE (Drug Awareness Resistance Education) in the province
- We distribute approximately 8,000 Safe Seniors Calendars in Alberta each year
- We have distributed approximately 1,000 fire safety games to help teach children about fire safety basics

Beneficiaries of Corporate Donations and Community Economic Development in Alberta	
The Goldeye Foundation (Education)	Calgary Immigrant Women's Association
Alberta Children's Hospital Foundation (Calgary)	Edmonton Community Loan Fund Society
Stars Foundation (Safety)	Mennonite Central Committee Employment Development
Alberta Adolescent Recovery Centre	Canadian Worker Co-operative Federation(Calgary)
Fire Fighter Burn Treatment Society, Edmonton	Multicultural Health Brokers Co-operative (Edmonton)
Students Against Drinking and Driving	Children's Wish Foundation
United Way of Calgary and Area	
United Way of Central Alberta (Red Deer)	
United Way of Alberta Capital Region (Edmonton)	

AN APPROPRIATE TARGET LEVEL OF ROE FOR AUTOMOBILE INSURANCE WITHIN ALBERTA

Insurers must be allowed to achieve a reasonable return on the equity invested in writing automobile insurance. A reasonable return is required for insurers to attract capital and maintain their stock values. We believe that, at a minimum, a Return on Equity (ROE) of 12% after-tax should be used. This is consistent with returns achieved by publicly traded financial institutions, and is the target return for The Co-operators.

The target level of return needs to be achieved over the long-term. Due to the nature of the insurance market, we know that there will be years when we will not achieve our target return on equity. This means that there must be years when a return greater than our target is achieved.

There is significant risk and uncertainty in selling insurance products and this should be reflected in the target ROE. Products need to be priced adequately in order to be self-sustaining. It should not be expected that one line of business will subsidize another. If an adequate level of return is not achievable for Automobile Insurance in Alberta, some insurers will move away from writing this line of business, reducing the level of competition and consumer choice.

THE APPROPRIATE VALUES OF THE COMPONENTS OF THE RECONCILIATION BETWEEN THE PROFIT PROVISION AND THE ROE

Generally, the approach we use in determining rate indications is based on a loss ratio approach. This requires the determination of a permissible loss ratio (PLR) – that is, the loss ratio that is expected to generate the expected return on equity. In the process of determining the PLR, a profit provision is calculated. We believe this profit provision is consistent with the provision that would be used when determining premiums on a Loss Cost basis. The profit provision calculation requires an ROE assumption. The formula we have historically used and its derivation are shown in the attached Appendix A.

The assumptions required to determine the PLR are as follows:

- Expenses – variable & fixed;
- Payment patterns by coverage;
- Investment yield; and
- Premium-to-surplus ratio.

Additional comments regarding assumptions about the investment yield and premium-to-surplus ratio are provided below. Also discussed is the impact on the profit margin to reflect the experience of the Risk Sharing Pool.

Investment Yields

When determining appropriate rate levels, policyholders should be credited with investment income that can be earned on the premiums that they pay between the time that the premium payments are made and losses and expenses are paid out. Investment income is incorporated in the pricing of insurance product in the determination of the permissible loss ratio (PLR). The PLR is the loss ratio needed in order to achieve the target return on equity. Coverages, such as Third Party Liability, where there is a longer payment pattern have higher PLRs. The higher PLR accounts for the additional investment income that will be earned due to the later payment of losses.

When doing the pricing analysis, appropriate future premiums are being determined. Since the premiums will be received and invested in the future, appropriate investment returns would be those that the company expects to achieve on the assets that will be used to support the liabilities coming from this business. As these funds must be invested in conservative investment vehicles, expected returns on investments such as Bank of Canada Bonds would be appropriate returns to consider, using terms that are consistent with a company's investment strategy.

In light of the upcoming changes to the financial reporting of financial instruments (discussed later in this document), this may influence the selection of an appropriate investment yield.

Premium to Surplus ratio

A company's total surplus is available to support all the lines of business that a company writes. Companies don't report surplus on a line of business or provincial basis. This may be done internally but the method of allocation could vary widely from company to company. Many analyses on Capital allocation and Premium-to-Surplus ratios have been undertaken by members of the actuarial profession and there is currently no consensus on how this should be done.

Insurance companies are highly regulated, both in the automobile insurance premiums that can be charged, as well as their financial solvency. Companies are required to maintain a minimum level of capital or risk OSFI involvement in the operation of their business. In reality, a level of capital higher than the minimum is required to ensure that a company will remain solvent in the event of adverse or catastrophic experience.

The Premium to Surplus ratio used in pricing should be based on a Company's actual Premium to Surplus ratio. An appropriate ratio for a company will vary based on a number of factors,

including the company's size, the lines of business written, market volatility, etc. A reasonable range for this ratio may vary from 1.5 to 3.0.

Risk Sharing Pool

There should be an allowance in the PLR calculation to recognize that income from the regular market needs to offset the losses from the risk sharing pool. One method to address this would be to increase the "profit provision" required.

CALCULATION TECHNIQUES OR MODELS TO CONVERT TARGET ROE TO AN APPROPRIATE UNDERWRITING PROFIT PROVISION

The method we use to determine the underwriting profit provision is based on the technique discussed in the paper "The Relationship of Underwriting, Investment, Leverage, and Exposure to Total Return on Owners' Equity", written by J. Robert Ferrari. Our derivation of the formula for underwriting profit provision, based on this paper, is provided in the attached Appendix A.

THE IMPACT OF IMPENDING CHANGES IN INSURANCE FINANCIAL REPORTING

We assume this refers to the accounting changes occurring October 1, 2006, related to the reporting requirements for Financial Instruments.

New Canadian accounting standards are effective for annual and interim accounting periods in fiscal years beginning on or after October 1, 2006. These new standards affect all companies, including Property & Casualty (P&C) insurance entities.

The new standards focus on the measurement of financial instruments and how the associated changes are recognized in Financial Statements. Each asset will need to be classified as either held-to-maturity, held-for-trading or available-for-sale. The classification determines how the value of the asset is established and how the unrealized gains are recognized for Financial Statement purposes.

Under the new accounting standards, it is possible that some or all invested assets that support policy liability cash flows will be measured in Financial Statements on a fair value (marked-to-market) basis. Currently bonds, the bulk of our investment portfolio, are carried in our financial statements at an amortized value. Historically, that value would tend to change gradually over time. Aside from this, the bond portfolio was only affected by changes to the portfolio (i.e. buying, selling or maturation of bonds). Moving to a fair value basis will result in greater volatility as the carried value of assets will now also fluctuate due to changes in market conditions.

A new income amount is being introduced in the financial statements, called "Other Comprehensive Income". This will result in the Financial Statements showing three income amounts – Net Income, Other Comprehensive income and Total Comprehensive Income (where

Total Comprehensive income is the sum of the other two income amounts). Depending on the insurers' asset classification, unrealized gains may be included in Net Income, Other Comprehensive Income or both. With this change, the comparison of Net Income across companies will become more difficult.

Insurance contracts are not currently recognized as "financial instruments" and are therefore not directly impacted by the new accounting standards. However, the use of a portfolio-based discount rate in the determination of the actuarial present value of the policy liabilities will have an indirect impact on these liabilities. Historically, the discount rate did not vary significantly from one reporting period to the next. This change will result in greater volatility in the discount rate, affecting the policy liabilities carried on the financial statements and directly impacting net income.

Some impacts are still unknown at this time, such as the tax implications of these changes, or how these changes will affect the assessment of insurers by rating agencies or Federal and Provincial regulators.

In summary, this accounting change is expected to result in the following:

- Multiple net income amounts shown in the financial statements;
- Greater volatility in a company's income due to changes in market value of assets;
- Increased volatility on policy liabilities, due to changes in portfolio yield affecting the discount rate ;
- Increased volatility of returns for P&C insurers; and
- It will be more difficult to compare net income across companies, since asset classifications may vary.

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Appendix A - Current Profit Allowance Calculation

This appendix summarizes the calculation of the profit allowance used in the PLR calculations for both auto and habitational ratemaking.

$$ROE = \frac{\text{Total Return}}{\text{Surplus}} = \frac{T}{S} = \frac{I + U}{S}$$

$$= \frac{I}{S} + \frac{U}{P} \times \frac{P}{S}$$

I = investment income
U = underwriting income

I / S = investment yield (IY)
P/S = premium to surplus ratio
U/P = underwriting return relative to premium

From the above, we get:

(1) $$\frac{ROE - i}{P / S} = \frac{U}{P} = \text{U/W return (at the end of the year)}$$

U/W return = [Premium received, excluding commission and premium tax, received "z" months after the beginning of the policy period

- expenses paid (assumed to be paid half-way through the year)
- discounted losses]

valued at the **end** of the year

(2) U/W return = [(1-a-t) x (1+i)^-z - (e) x (1+i)^-.5 - ((1-a-t-e-p) x Paypat DF)] x (1+ i)

where:
a = commission (acquisition) expense
t = premium tax
e = other expenses
p = profit allowance

i = investment yield
Paypat DF = payment pattern discount factor
z = delay in receiving premium

Using: (1) & (2) , solve for "p"

$$p = 1 - a - t - e + \left[(e) \times (1+i)^{-.5} - (1-a-t) \times (1+I)^{z} + \frac{ROE - i}{(P / S) \times (1+i)} \right] / \text{Paypat DF}$$