Alberta Automobile Insurance Rate Board

Consumer’s Input on Profit

What are the concerns of consumers?

Certainty

Consumers like reasonable certainty. They react negatively when premiums increase by 20-30% in one year.

Mandatory Product – Profits should be reasonable

Third party liability insurance is a mandatory product for anyone that owns and operates a vehicle. Consumers are resentful when insurers make significant profits on a product that they are obliged to purchase. In Alberta, most people need a vehicle in order to get to work so owning and operating a vehicle is viewed as a necessity.

The insurance industry announced a return on equity for 2005 of 20.2% just prior to my meetings with consumers in the Spring. Consumers were appalled at such a high level of profit. Reported profits for the first 6 months of 2006 are 19.6%--still excessive in the eyes of consumers.

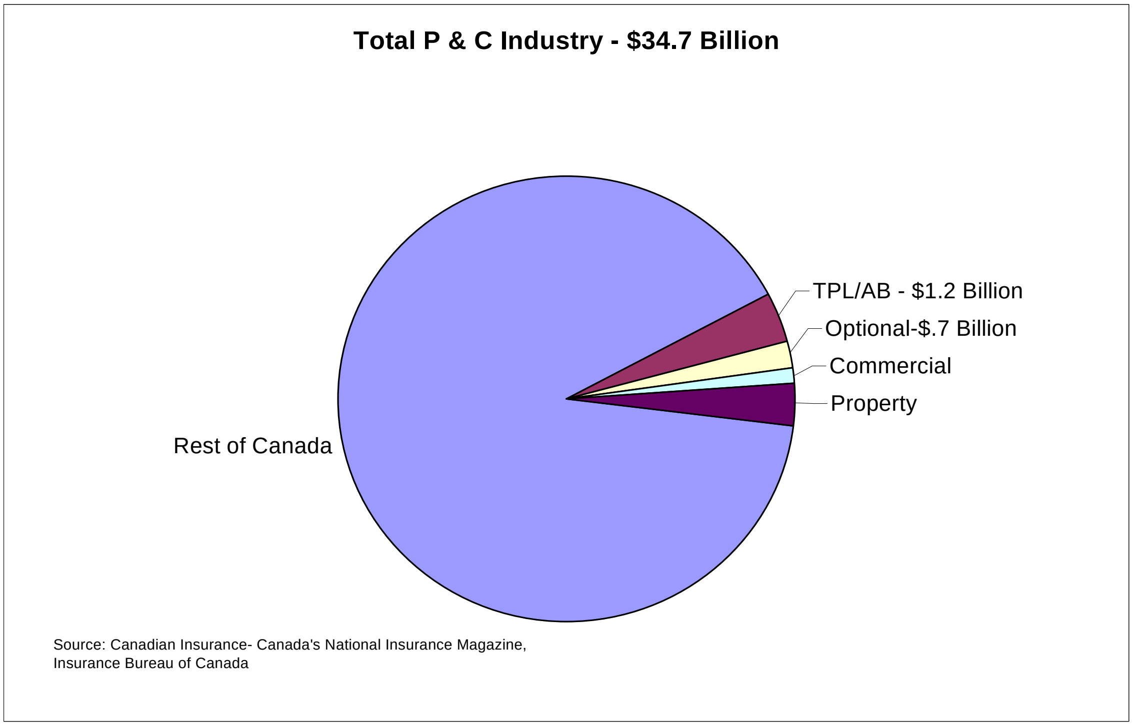
Availability

Consumers need to be able to obtain insurance. Many of the complaints from the hard market several years ago were related to the inability of consumers to obtain automobile insurance from a standard carrier. This is the counterbalance—profits must be adequate to ensure a healthy market that provides consumers with choices for auto insurance.

Complexity of the Issue

Lack of Relevant Data

The AIRB is asked to rule on a level of allowable profit for mandatory automobile insurance. Industry is unable to provide data that dissects the profitability of mandatory insurance in Alberta. It is therefore not clear which line of business is making the largest contribution to profit. Is mandatory insurance a break-even proposition? Or are consumers being unfairly taxed to support other lines of business such as commercial insurance, optional automobile coverage and property insurance that are less profitable.
Are Alberta consumers contributing a greater amount to the overall profitability of the insurance companies than other provinces? We really don’t know. The following chart illustrates the small slice of premium revenue that is affected by decisions of the Alberta Auto Insurance Rate Board. Alberta premiums for third party liability and accident benefits account for $1.2 billion, which while significant, is only 3% of the total premiums for the property and casualty industry in Canada.



Difference Between Profit and Return on Equity

We understand underwriting profit to be:

Premium Revenues
MINUS: the accrued amount of TPL claims and accident benefits
MINUS: an allocated portion of administrative costs and income taxes.

Return on equity includes the return on investment income in addition to underwriting profit.

By the nature of the product, insurers collect premiums in advance of providing any service to the consumer. In some cases, if the consumer is never involved in an accident, they may never receive any service. As a result, a significant aspect of the insurance business is the investment of premium revenue. The return on these investments can significantly affect the Return on Equity.

Consumers are concerned when premiums increase as a result of poor investment decisions by the insurer that affect their ROE. Alternatively, consumers are pleased when an insurer is able to make good investment decisions and is able to pass on those returns to the consumer in the form of lower premiums.

Profit Level Considerations

The determination of an adequate level of profit involves a number of technical determinations that I defer to experts to assess. However, following is some data and some considerations that may be useful in guiding the decision of the AIRB.

Principles

- *Profit levels should be modest on mandatory insurance compared to other lines of insurance where the consumer has greater choice as to whether or not to purchase them.* A consideration with third party liability and accident benefits is that insurers should incur lower marketing costs in selling these products since the Government requires motorists to carry this insurance.

  At the same time, the consumers that I talk to do not make any distinction between mandatory and optional insurance. As we all know, in order to obtain financing on a new vehicle, the consumer is obliged to carry collision insurance – and anyone that has a reasonably new vehicle could not afford the repair costs of an at-fault accident. Mercers Oliver Wyman recently presented the results of their analysis of optional coverage to the Automobile Insurance Rate Board.[1] Their analysis indicates that the industry-wide average street premium for optional coverages is approximately 20-25% excessive. This amount is in addition to a provision for a reasonable level of profit.

- *While the profit level should be modest, it should not be so low that insurers are unable to meet the reserve requirements of OSFI and as a result, are unable to provide insurance in the Alberta market; or profit levels are so low that insurers are unwilling to offer the product.*

  A profit level that is too low can create an availability problem for consumers.

Benchmark Data

- The current risk-free interest rate is 4 %. This rate is significantly lower than the rate in the early 1990's. Depending on the assumptions that one uses, the risk-free rate on underwriting profit would be equivalent to an ROE of between 7-8%. It is reasonable that a business needs to earn something in excess of the risk-free rate in order to assume the risk of being in business- and automobile insurance is not considered by anyone to be a risk-free business.

- IBC data presented at the AIRB hearings in 2004 indicates that the average Return on Equity from 1975 to 2004 has averaged 11.2%, 9.9%, 10.6% and from 1998 to 2004, 8.3%. In 2005, the ROE for P&C insurance companies was 20.2%. So while industry may be suggesting that shareholders are demanding an ROE of 15-20% or higher,

[1] Mercer Oliver Wyman – Actuarial Analysis of Optional Coverages, Effective November 1, 2006, Private Passenger Automobile, prepared for the Alberta Automobile Insurance Rate Board- October 12, 2006

insurance companies have continued in business for the last 30 years at ROE's that were closer to 10%.

- The allowable after tax profit for Alberta utility companies is currently 8.9 %. It is generally accepted that the insurance industry is riskier than the utilities business – so some return on equity in excess of this rate would be reasonable.

- The Newfoundland Public Utilities Board ruled in 2005, that an ROE of 10% for for the automobile business line was acceptable. At this rate, insurers continue to operate in Newfoundland.

- Dr. B. Kalymon, a professor of finance from the Richard Ivey School of Business University of Western Ontario, presented to the New Brunswick rate board in 2005 and recommended a ROE of 8.5-9.5%. His recommendations were lower than some of other expert presenters—however, his data was based on Canadian data which indicates a lower ROE than U.S. data.
  The consumer advocate for New Brunswick recommended a rate not to exceed 10%.

- The stock market has performed at an average of 10% ROE in Canada for the last 50 years.

- Experts have presented to regulators in Alberta, New Brunswick, and Newfoundland. Their recommended target ROE's range from 9% to 16%.

- While the determination of the level of profit is an important one to the AIRB and to the insurance industry, the actual dollar impact of one percentage point to the consumer is approximately $6 on their mandatory premium.

My Recommendation

- The ROE that is allowed on mandatory insurance should be higher than the risk-free rate and higher than the allowable ROE for utilities (currently 8.9%).

- While the data may indicate that some minor adjustment to the profit level might be justified on an actuarial basis, consumers would view any increase as totally unjustified given the recently reported profit levels. From the analysis of optional coverage that has recently become available, it would appear that market forces are not working for the consumer. Since the profit level on mandatory coverage is regulated, insurers appear to have simply kept the price of collision insurance artificially high to make up for any foregone profit on mandatory insurance.

  For these reasons, I could not support any increase in the profit level for mandatory insurance ---and suggest that the AIRB seriously consider the implications of the high profit levels reported on the unregulated portion of automobile insurance. If the profit level is to be adjusted, it should be done in consideration of both mandatory and optional coverage.

Conclusion

I feel that these recommendations address the primary concerns of consumers:

- **Certainty**

  If insurers achieve a reasonable profit on an annual basis, it should not be necessary to increase premiums dramatically when losses accumulate. Clearly insurers are currently making an adequate profit on personal passenger vehicles so consumers should not be at risk of a dramatic increase in rates.

- **Reasonable profits on a mandatory product**

  Anyone who owns a vehicle is obliged to purchase mandatory automobile insurance. Like utilities, this is a product line for which profits need to be held to be reasonable.

- **Availability**

  The level of profit needs to be adequate to allow insurers to be able to continue to offer the product in Alberta. At reported profit levels, there is no indication that insurers are at risk of refusing to provide insurance in Alberta.