This submission is made on behalf of The Dominion of Canada General Insurance Company ("The Dominion") by Steve Whitelaw, Vice President, Product Development and by Doug Hogan, Senior Vice President and Chief Financial Officer.

Incorporated in 1887, The Dominion is a 100% Canadian-owned insurer operating only in Canada. At The Dominion, we work hard to achieve profitability, consistency, stability and transparency at all levels and for all stakeholders. We focus on the long term and, therefore, seek to maintain consistency in our practices and seek to make decisions using good judgement and common sense. Decisions are directed at 'doing the right thing' – a term heard a lot around The Dominion. 'Doing the right thing' means we will faithfully meet our coverage obligations to policyholders. It also means writing business we want to keep, making decisions that stand up well to the scrutiny of our brokers and policyholders, and making those decisions as close to both the policyholder and broker as possible. It also means that our management team is not distracted by short-term rewards. Our performance is measured across a cycle and based on building the value of the business.

We insure more than 70,000 drivers in Alberta. As all of our business is in Canada, and Alberta automobile insurance comprises 8.9% of our annual premiums, the decisions of the Alberta Automobile Insurance Rate Board ("AIRB") are of great importance to our shareholder. We appreciate this opportunity to comment on this critical issue.

With respect to the AIRB's review of profit level for automobile insurance, we offer the following input:

ISSUE # 1: AN APPROPRIATE TARGET LEVEL OF ROE FOR AUTOMOBILE INSURANCE WRITTEN IN ALBERTA

Consumers should experience competitive, stable prices over time. Price volatility and steep price increases have practically nothing to do with return on equity ("ROE") pricing assumptions. ROE assumptions tend to be stable over time. ROE pricing assumptions are not producing volatility or steep price increases.

If the industry's recent high profits are the underlying concern, the following points are worth noting:

- ROE assumptions used in premium rates are not what generate the more profitable years within a cycle. Nor do ROE assumptions account for periods of high premium increases.
- The predominant factor affecting underwriting profit and price volatility is claims costs. When claims costs accelerate beyond expected trend levels, premiums must catch up. Since claims costs are difficult to predict, premium increases sometimes overshoot the required level, resulting in more profit than assumed. But this happens in both directions. Insurers sometimes do not achieve their assumed profit levels due to actual claims costs exceeding expectations. Therefore, maintaining sound legislation and regulation over claims costs is essential to managing price stability and moderating the insurance cycle.
- When profits reach above average levels in a competitive market, prices will inevitably stabilize or decline. Competitors adjust their pricing assumptions

downward in light of better than expected claims experience and invest in product and customer service initiatives to better service and grow their customer base.

- In most years and on average overall, auto premiums do not cover claims, expenses and profit margins. Premiums are subsidized by insurers' investment income. Investment income is a major component of profit and a significant cause of volatility in the industry's profits.
- Underlying the foregoing point, due to competitive pressures, insurers often file for proposed rates that are below the actuarial indicated rates, to maintain their business.
- As long as price competition is fostered (through the allowance of flexible company-specific pricing assumptions), consumers and their brokers are not at the mercy of any particular insurer. They will find a more competitively priced insurance product. An insurer that risks losing its policyholders because of excessive prices will be motivated to reduce its ROE assumption implicitly, by filing a rate below indications.

We suggest the AIRB not set a profit target or cap, but permit each insurer to select its own ROE assumption for pricing purposes.

The appropriate ROE for auto insurers in Alberta differs by individual insurer. Each insurer's target ROE should be commensurate with the risk profile of its unique book of business and business strategy.

The appropriate ROE for each insurer is what it can reasonably expect to earn in a sufficiently competitive market. We believe that maintaining a market that is sufficiently

competitive is the most efficient manner of achieving appropriate premium rates and profit levels.

We wish to emphasize that the ROE target should be a relatively long term expectation and yet, it should be understood that actual annual results will vary. It is not realistic to expect ROEs to achieve a target in most years, given the cyclical nature of auto insurance results. The insurance cycle and price volatility will always exist due to three main factors: (i) claims costs are estimated years before they are known: (ii) premiums are subsidized by investment returns which fluctuate over time; and (iii) the cost of claims has been allowed to escalate. Intervention by governments and regulators is not always achieved on a timely basis. Through the course of each insurance cycle, higher than average returns are necessary in some years to compensate for the substandard returns of other years.

There is no practical need for establishing a target or maximum ROE for auto insurers. The industry has generated a reasonable - but not excessive - average annual ROE over the last 28 years and during each of the four insurance cycles in that period. Allowing insurers to select their own ROE assumptions has not resulted in excessive profits. See Appendix 1 for the industry's historical results.

The profit assumption that the AIRB selects in its price equation for the determination of the maximum price adjustment for mandatory coverage will not change the cost of capital nor will it affect actual ROEs. It has the potential to impact the price-cost balance which, if negative, may serve to destabilize the competitive marketplace.

ISSUE # 2: THE APPROPRIATE VALUES OF THE COMPONENTS OF THE RECONCILIATION BETWEEN THE PROFIT PROVISION AND THE ROE.

ROE is net income, divided by average capital and surplus. The profit provision (after tax) is net income divided by premium.

Capital is a key assumption reconciling ROE to a profit provision (as a percent of premiums). The level of capital assumed in pricing can be expressed in relation to premium volume using the premium to surplus ratio (premium divided by capital and surplus). Therefore, the two measurements, ROE and profit provision can be expressed together as follows:

Profit provision = ROE divided by the premium to surplus ratio.

The other key reconciling components are assumptions for projected claims costs, reinsurance costs, expenses, return on investments and tax rates. The table below expresses these components as a percent of premiums and, therefore, shows them as components of the profit provision. For illustration, the following table is populated with The Dominion's total company average annual values for the last full insurance cycle (1997 to 2004).

Dominion's average 1997-2004

	$ millions	% of Premium
Gross premiums earned	716,859	1.00
Less reinsurance expense	(23,224)	(0.03)
Net premiums written	693,635	0.97
Claims	(504,105)	(0.70)
Expenses	(219,395)	(0.31)
Underwriting income	(29,865)	(0.04)
Investment income and gains	82,381	0.11
Less income taxes	(17,528)	(0.02)
Net income	34,988	0.05
Average capital & surplus	360,058	0.50
Premium to surplus ratio	1.99	1.99
Return on equity	9.7%	9.7%

The Dominion's average values for the last full cycle show:

- a combined ratio of 104.3% (claims and expenses divided by net premiums [0.70 + 0.31] / 0.97);
- an after tax net income of 5% of premiums (profit provision);
- which equated to a 9.7% ROE.

Note that The Dominion's achieved average ROE of 9.7% was lower than the target ROE used in all of The Dominion's Alberta rate filings throughout that whole period.

The Dominion's average ROE of 9.7% equates to an average of 5% of premiums. Investment income provided six to seven cents, after income tax, to bring the underwriting loss of about 2.5 cents, after income tax, to a five cent average annual income for each premium dollar earned.

Capital

An important component reconciling the profit provision and ROE is the size of capital the insurer holds in support of Alberta auto business.

The size of an insurer's capital will vary with the risk profile of the insurer's total book of business, with the riskiness of its investments and with the insurer's approach to capital management. Differences in these risk factors warrant different rates of return. Therefore, applying the same premium to surplus ratio assumption to each auto insurer would not be fair to individual insurers. Actual capital ratios differ for legitimate reasons.

Since insurers need relatively little working capital, the role of capital is to provide a risk buffer against threats to the insurer's ability to pay its obligations to policyholders. How much risk buffer is required to be invested by the owners of an auto insurer to adequately protect Alberta auto policyholders? Despite the respectable rigour in prevailing theories and models of risk measurement (e.g. Capital Asset Pricing Model), the reality is that this question is essentially answered by solvency regulators who define and police capital levels of insurers. In Alberta, as in most of Canada, solvency is predominantly managed by the federal regulator.

Shareholders are naturally inclined to minimize their invested capital. A lower capital level (higher leverage) could generate a relatively higher return at less risk to the shareholder. In contrast, the mandate of the solvency regulator results in a much higher level of capital to ensure there is sufficient buffer to cover the risks which threaten an

insurer's ability to protect policyholders. As a result, it is safe to say that the capital carried by most P&C insurers in Canada is the level they each believe is necessary from a regulatory point of view. There is no motivation to carry significant excess capital in a heavily regulated and risky entity. Unless an insurer is on the solvency regulator's "watch list," it is implicit that an insurer is carrying the level of capital that is acceptable to the regulator.

The Office of the Superintendent of Financial Institutions ("OSFI") uses the Minimum Capital Test ("MCT") as a main measurement of capital adequacy. The MCT is a respectable measure of capital required and effectively discriminates between insurers based on their individual risk profiles. A 2003 study commissioned by the Insurance Bureau of Canada indicated that Canada's MCT resulted in capital requirements that rank among the highest in key global markets.

The MCT calculates risk margins for balance sheet assets, for policy liabilities, varied by line of business, for catastrophe exposure, for reinsurance acquired from unregistered reinsurers (not under the jurisdiction or control of Canadian solvency regulators) and for off-balance sheet exposures. These margins are summed to comprise "capital required." Capital required is compared to "capital available," which is mainly the book value of capital plus adjustments for the market values of investments. Capital available is divided into capital required to result in the MCT ratio.

It is important to note that OSFI does not blindly apply the MCT, nor is the same MCT ratio expected to be achieved by each insurer. OSFI "negotiates" individual minimum

MCT results for each insurer, based on qualitative factors that the MCT does not fully address for each individual insurer (e.g. management's performance, line of business or geographic concentration). Also, OSFI assigns a "composite risk rating" to each insurer in its jurisdiction based on its examinations. This includes qualitative factors such as the quality of governance practices, management experience and demonstrated performance and other qualitative factors. All of these regulatory practices converge to affect the level of capital the insurer carries.

In our view, the actual capital carried by most insurers is the appropriate capital for each insurer's profile. (In the case of an undercapitalized insurer, it would instead be the minimum capital that the regulator is requiring the insurer to achieve.) The insurer's actual capital level is appropriate because competing forces optimize it. Shareholders seek to minimize capital; the solvency regulator seeks to maximize it, within reason, and insurers generally carry the capital they believe will satisfy the regulator.

Therefore, we conclude that the appropriate premium to surplus ratio to be used in rate-making should be based on the insurer's <u>actual</u> premium to surplus ratio.

From a shareholder's perspective, the insurer's prices should take into account the actual risks assumed by the insurer in providing protection to policyholders. From the policyholder's perspective, the price paid should fairly compensate for the risks that the policyholder is transferring entirely to the insurer.

This leaves the question of how to determine the premium to surplus ratio attributable to Alberta auto. There are many methods for allocating capital. A method consistent with our line of reasoning is to calculate a notional MCT "capital required" amount for the insurer's assets and liabilities attributed to Alberta auto. The insurer's actual total MCT ratio would then be applied to the Alberta auto "capital required" to determine the actual capital allocated to Alberta auto. (This is premised on the reasonable assumption that "capital available" is allocable *pro rata* to all "capital required.") Alberta auto premiums would then be divided by the capital attributed to Alberta auto to yield the premium to surplus ratio to be used by that insurer in its Alberta auto rates.

For pricing assumption purposes, an adjustment may need to be made to reflect the insurer's assumptions for expected future claims costs, significant changes in policy counts, or a change in future investment return. In other words, pricing assumptions look forward; the assumption for leverage must adjust historical experience to reflect expected experience.

In summary, we argue that:

- Shareholder capital in a P&C insurer is mostly a buffer to protect policyholders from the insurance and investment risks that threaten the insurer from meeting its obligations to policyholders.
- The appropriate capital for a particular insurer is the amount that sufficiently covers the risks associated with its insurance and investment exposures.

- In Canada, OSFI's main tool for monitoring capital adequacy, the MCT, makes a reasonable measurement of capital for an insurer based on its individual risk profile.
- OSFI's application of the MCT and its supervisory practices result in capital requirements that are appropriate, with reasonable discrimination by line of business and investment profile.
- Insurers generally do not carry significant excess capital. They carry the capital they believe satisfies the regulator. Therefore, most actually carry the capital that is appropriate to their individual risk profile.
- The MCT's "capital required" calculation can be used to determine the appropriate capital of an insurer that applies to its Alberta auto business. Adjustments may need to be made to reflect prospective expectations that differ from recent experience. The resulting capital amount can be converted back to a premium to surplus ratio for pricing calculation purposes.

Other components of a profit provision

Similarly, insurers' operating practices, investing policies, claims handling practices and reinsurance strategies vary significantly from each other. It would not be realistic nor fair to establish targets for these other elements making up the profit provision.

It is our view that in a market such as Alberta automobile insurance which has many competitors with differing practices, the appropriate values of the components are each insurer's own selected values, based on its expectations of claims costs, expenses, investment income and capital level.

Rather than fixing specific targets for capital levels, investment income and costs, we suggest the Board allow companies to assume in their rate filings the values that reflect their expectations for these components.

ISSUE # 3: CALCULATION TECHNIQUES OR MODELS TO CONVERT TARGET ROE TO AN APPROPRIATE UNDERWRITING PROFIT PROVISION.

The Dominion is a subsidiary of a publicly traded stock company. Shareholder expectations and the company's success are measured based on the amount made on the capital invested rather than as a percentage of revenue.

The Dominion's rate filings have followed typical actuarial approaches for calculating the indicated rate change. See Appendix 2 for The Dominion's format of deriving the permissible loss ratio.

Since we suggest the Board not mandate target assumptions for profit and its components, we suggest that the Board provide a fixed format for each insurer to use in presenting its assumptions, for the Board's review for reasonability.

For example, our typical chart deriving the permissible loss ratio based on a target ROE (Appendix 2) shows the assumed ROE ("r"), assumed premium to surplus ratio ("k"), the underwriting margin and the other key assumptions of investment return and expenses.

ISSUE # 4: THE IMPACT OF IMPENDING CHANGES IN INSURANCE FINANCIAL REPORTING.

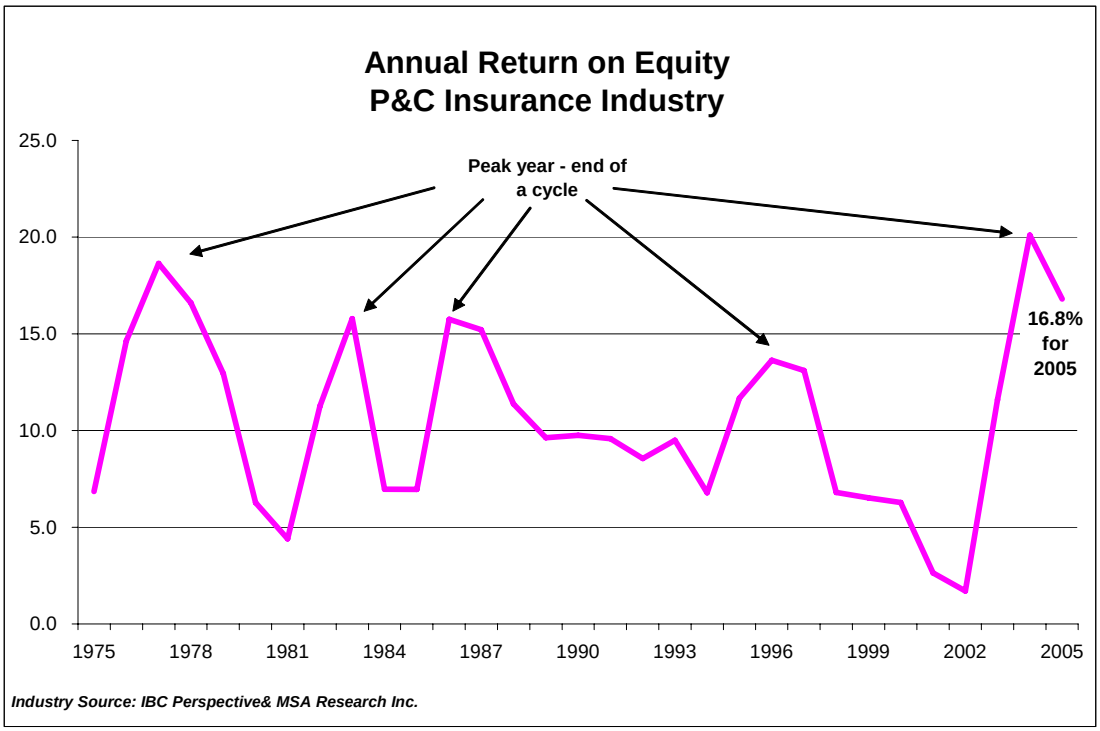
It is premature to be conclusive on the exact impact of the new financial instrument accounting rules coming into effect on January 1, 2007. This is because entities may choose, to a large degree, whether unrealized gains/losses on investments will be included in "net income" or in a new category of "other comprehensive income." We suspect that most auto insurers will follow the approach The Dominion plans to take, which is the same as what we understand most U.S. insurers do, where similar rules have been in effect for about a decade. That is, to retain today's definition of net income, largely intact, while most unrealized investment gains/losses will be reflected in the new "other comprehensive income."

The new rules will allow companies to calculate two ROE's. One largely consistent with today's ROE, assuming the approach we expect most insurers to take, by excluding other comprehensive income from the income number (the numerator in the ROE) and excluding accumulated other comprehensive income from capital (the denominator in the ROE). There will also be the new all-inclusive ROE where unrealized gains/losses are included in both numerator and denominator.

Regardless, the essential impact of the new rules is simply to change the timing of when investment returns are recognized. There is no change in the underlying economic substance. Over time, the two accounting methods result in the same income since unrealized gains and losses eventually become realized.

Since the ROE target should be a mid-to-long term target, we do not believe the new rules will have an effect (certainly not a material effect) on the appropriate target ROE.

Thank you for the opportunity to provide our input on these important issues facing the Board.



During the last 28 years in Canada, there have been four insurance cycles. (We describe the terms "annual return on equity" used in this chart and "insurance cycles" on the following page.) The four cycles and their average ROEs are as follows:

- 1978 to 1983: 11.2%
- 1984 to 1986: 9.9%
- 1987 to 1996: 10.6%
- 1997 to 2004: 8.6%

This annual profit data indicates that the industry's earnings for each business cycle have been fairly steady over time. Further, it represents a reasonable return for investors, without being excessive for consumers.

Definitions:

The industry's annual return on equity, as presented in the chart on the preceding page, is a weighted average of all insurers' results, sourced from the Insurance Bureau of Canada and MSA Research Benchmark Reports. The multi-year averages for the industry, such as the average annual return on equity for each cycle, are simple averages - each year is equally weighted, for simplicity. We believe weighted averages would not be materially different since the industry is mature with volumes change moderately over time.

We define the "insurance cycle" to be the period of years beginning with the first year following a "peak" earnings year to the next peak earnings year, essentially from the top of a cyclical wave of annual results, to the next peak. A "peak" earnings year is the year with the highest earnings in a series of improving years, before subsequently deteriorating in a series of subsequent years. Another equally appropriate way to define insurance cycles is to use the combined ratio (which measures underwriting results instead of ROEs) whereby each cycle ends with the best underwriting result. The two approaches do not result in notably different definitions of cycles.

The following is a sample method of deriving the permissible loss ratio, for pricing purposes, based on a target ROE.

Permissible Loss Ratio Calculation

Variable	Description
	Pre tax return on Equity
	Tax rate
r	Target After-tax return on equity { Pre-Tax Return on Equity x (1 - Tax Rate) }
i_S	Pre-tax investment income rate on Surplus
i_O	Pre-tax investment income rate on Insurance Operations
t	Effective income tax rate
k	Premium to equity ratio.
u	Profit and contigency margin = [r - i_S x (1 - t)] / [k x (1 - t)]
e	Variable expense. (Total Expense Ratio)
d	Lag from effective date of policy to receipt of premium.
	Permissible Loss Ratio on discounted losses. { (1 - e - u) / [(1 + i_O) ^ d] }
PV	Present Value Factor (based on i_O)
PLR	**Permissible Loss Ratio. { PLR on discounted losses / PV}**
	Underwriting Margin. { 1 - [PLR + e]}

The variables may be reordered in a manner that best suits the review of the Board to compare ROE and profit as a percent of premiums.