



SUBMISSION TO THE

**ALBERTA AUTOMOBILE INSURANCE
RATE BOARD**

**PUBLIC HEARING
NOVEMBER 2006**

By

MELOCHE MONNEX INC.

TABLE OF CONTENTS

TABLE OF CONTENTS	2
PREAMBLE	3
INTRODUCTION	4
I. AN INDUSTRY-WIDE RETURN ON EQUITY TARGET	5
Public Policy Goals vs. Outcomes	5
Insurance Industry Results	7
Comparing Industry Results	7
II. RECONCILING THE PROFIT PROVISION AND ROE	11
Premium to surplus ratio	11
Invested rate of return expected on policyholders' funds	12
Invested rate of return expected on surplus	13
III. CALCULATION TECHNIQUES OR MODELS TO CONSIDER IN CONVERTING TARGET ROE TO AN UNDERWRITING PROFIT PROVISION.....	13
IV. POTENTIAL IMPACT OF CHANGES TO INSURANCE FINANCIAL REPORTING.....	14
CONCLUSION.....	15
APPENDIX.....	16
Return on 3-Year Government Bonds	16
Conversion Calculation	17
Changes in financial reporting	18

PREAMBLE

Founded in 1949, Meloche Monnex is a member of the TD Bank Financial Group, one of the most respected financial services organizations in Canada. Meloche Monnex is the largest direct response insurer and one of Canada's top four property & casualty insurers in personal lines, serving more than 1.5 million policyholders and with a total of \$1.8 billion in written premiums in 2006. Meloche Monnex now employs more than 3,000 people across Canada, with offices in Alberta, Ontario, Québec, Nova Scotia and New Brunswick.

Home and auto insurance services are provided under two major brands, TD Meloche Monnex and TD Home and Auto, and are underwritten by wholly owned insurance companies: Security National Insurance Company, TD General Insurance Company, TD Home and Auto Insurance Company (formerly Liberty Insurance Company of Canada), and Primmum Insurance Company.

The Meloche Monnex business model is direct response, meaning that service is provided directly to clients, without using third-party intermediaries. The processes and technology that we use allow us to provide quality services in a timely and efficient manner.

We are now the third largest auto insurer in Alberta, with over 200,000 auto policyholders and \$314 million in written auto premiums for 2006. The number of Meloche Monnex clients has more than doubled in the last five years, and we're still growing. Our offices in Calgary and Edmonton now employ over 500 personnel dedicated to serving Albertans. Meloche Monnex remains committed to the Alberta market.

INTRODUCTION

Meloche Monnex is pleased to make this submission to the Alberta Auto Insurance Rate Board (“The Board”) as it deliberates on issues related to automobile insurance profits.

In its notice to the industry, the Board asked for specific comments on several technical questions related to the relationship between a profit provision (expressed as a percent of premium) and the target and actual Return on Equity (ROE) that the industry and investors use to measure profitability.

We will take a broad look at auto insurance and comment on the economic implications of imposing a standard profit target (however measured), notwithstanding the regulatory structure that requires the Board to set a uniform premium level annually. The initial notice of the Board’s intent indicated that the profit issue is “complex and calls for a considerable amount of attention.” The Board felt that “a separate and more comprehensive hearing” was warranted. We agree and therefore must communicate our continuing concerns about an industry-wide ROE target and indeed, a uniform premium. Implementation issues are also addressed, as it is not at all clear how ROE targets would be imposed and then maintained with respect to the industry as a whole.

“Staying the course” with the current system of industry-wide price regulation is likely to have negative effects on competition and availability. As one of the largest auto insurers in Alberta, we have an obligation to our policyholders, shareholders, and financial regulators to uphold a sound and stable insurance system. We will continue to make our views known to government officials as the new auto insurance regulatory regime develops further.

The Board has indicated its recognition that a sufficient level of profit is necessary to attract and retain capital to the insurance industry. We are pleased to see this fundamental issue addressed. An undercapitalized industry will not be able to grow and serve Alberta drivers. Given the inordinate level of risk that auto insurers face as compared with other industries that routinely achieve ROEs between 15 and 20 per cent annually, it is clear that P&C insurers must seek a competitive ROE level or risk capital flight to other industries.

We believe an ROE reference point is problematic for auto insurance rate making in Alberta for a number of reasons cited in this submission: economic, market stability, and administrative. However, should an ROE expectation be linked to rate making, it should not be a fixed number, but a range that is competitive with ROE performance in the financial services industry in Canada. A competitive range will attract sufficient capital to support market availability and those insurers that choose to invest in improving efficiency and performance.

I. AN INDUSTRY-WIDE RETURN ON EQUITY TARGET

The Board is charged with annually reviewing the level of premium set for basic auto insurance and adjusting it to match conditions in the market. It arrives at a view of marketplace conditions by considering the comments of insurers, consumers and other stakeholders, as well as the Board's own actuaries. We recognize that under this system—and it is worth remembering that the system is still in its infancy and may require changes—the Board is currently mandated to use some figure for profit in its calculation of the overall premium.

So the question now before the Board is: “what is the appropriate level of ROE for automobile insurance written in Alberta?” However, as we have stated in hearings and elsewhere, this is a self-defeating question if the goal is to achieve a market that provides affordable, accessible insurance protection over the long term.

PUBLIC POLICY GOALS VS. OUTCOMES

TD Meloche Monnex shares the public policy goals expressed by the Alberta Government and, in implementing the auto insurance regulatory system, the Board. We all recognize the need to maintain a system that delivers protection to the public from the risks associated with driving an automobile. That protection must be affordable, reliable, accessible and transparent. This is important not only because of the critical role that insurance plays in a smoothly functioning economy, but also because auto insurance is a product that government requires drivers to purchase.

As the Board has pointed out, Alberta has chosen a private insurance system, one that employs capital—at regulated levels—to create products and services. There is a cost to attract and retain the capital that investors provide. Capital is mobile and will be deployed wherever the risk-return equation is most favourable. This is true of every industry but auto insurance, unlike other financial services, is uniquely volatile.

The high risks of providing auto insurance are well documented: the true cost of providing the product won't be known until several years into the future; continually rising claims and associated costs, such as administrative and legal expenses; and regulatory changes and variations across jurisdictions often lead to higher operational expenses, to name several. In order to attract capital to a higher-risk operation, higher returns are required. Investors choosing among activities that are equally profitable will choose the one with lowest risk.

Keeping insurance affordable and available is clearly in the public interest. The implied rationale of an “appropriate” ROE is related to both price stability and public sentiment about “unfair profits”. But the market won't work this way. If insurers cannot achieve a rate of return that attracts and retains investment capital, then they will not be able to

grow, and ultimately some insurers may seek to withdraw from the market. Fewer insurers equal less competition.

The notion of an “appropriate” or “fair” rate of return for the industry is regrettable and based on economic fallacy. Ultimately, if the selected ROE is too low in relation to the inherent risk, the result will be adverse public policy consequences in the form of less competition, less innovation, and availability problems.

The need to maintain sufficient capital clearly is of concern to financial regulators as well as companies. The insurance industry must be adequately capitalized to ensure market stability and to keep long-term promises to policyholders. A mandated ROE, and certainly a mandated ROE that is set too low, means that auto insurance companies will not be seen as attractive investments. The prescribed ROE runs counter to the public policy goal of a well-capitalized, stable industry.

If the Board decides on an “appropriate” industry-wide ROE, it is not clear how this decision would be implemented. ROE fluctuates constantly. It is a snapshot of a company’s performance at a certain time, not a fixed signpost.

It is also not clear whether the target ROE would be applied to individual companies or to the industry as a whole. If it is used to cap individual company profits, then there would be no incentive for companies to exceed the expectations of investors. It would no longer be possible to reward superior performance; both good and bad performers would have the same flat opportunity. There would be no reason to aim for greater efficiency or to compete on price or service levels. It would be difficult to persuade investors to keep their capital in auto insurance instead of shifting it to more lucrative and/or safer investment opportunities.

Yet if the ROE target is applied at the industry level, there will be similar negative effects over a longer term. Although superior performance could still be achieved by companies on an individual basis, over time there would be an industry-wide disincentive to compete. Because with rising individual company profits, the average industry ROE could rise, leading to greater Board scrutiny and possibly a cut in the ROE target the following year. In effect, competitive behaviour would be systematically penalized.

These issues affect everyone, not just insurers. Capital flight to other industries or jurisdictions would be a real prospect, with implications for product availability and service, as well as industry employment.

If a target ROE is determined for the industry, it will be very important not to impose that same target on individual company filings. Every company has different risk exposures, asset mixes and business strategies and should be allowed to use the target ROE that matches its particular circumstances.

INSURANCE INDUSTRY RESULTS

An insurance company's total rate of return 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 premium and reserves).

Over a recent twenty-year period (1984-2004), the Canadian P&C insurance industry achieved underwriting profits in only two years. In the eighteen other years, investment income was used to offset underwriting losses.¹ That places greater importance on the return on investment assumptions discussed in Section II.

Insurance industry results are cyclical over time. To assess profits in a meaningful way, it is necessary to examine the average ROE over the length of the cycle. Reacting to a peak year is shortsighted and counterproductive. Cutting the peak-year ROE means that the average ROE will be lower too. In effect, an industry-wide ROE that is set at an unsustainably low level will leave the cyclical valleys in place, but not the peaks, ultimately jeopardizing the viability of the industry. Historically, P&C industry returns have been both volatile and low relative to the risks of the business. It does not make sense that average returns have been lower than many utilities and other, less risky, competitors for capital in the financial services industry.

That profits attract political attention is undeniable. Profits that spike in a year or over a few years are perceived by the public as bad or unfair. This ignores the reality of the insurance cycle. Both the industry and government have the responsibility of educating consumers about insurance—how the products work, how risk should be reflected in price, and how profits (and losses) are generated in an auto insurance system. There has to be a better understanding that headline-making profits don't mean much unless the average over the cycle is examined as well. There also has to be a better understanding of the extent to which regulation shapes the product and its price.

We believe that the Board can play a valuable role in communicating these issues to the public. Other rate boards have begun this effort, actively working to educate consumers. In the long run, this should benefit everyone by leading to better public policy choices, because unfortunately, making policy decisions based on public concern over profits won't change the economic outcomes of those decisions.

COMPARING INDUSTRY RESULTS

¹ Insurance Bureau of Canada, Facts of the General Insurance Industry in Canada, 2005, p. 7.

As part of the Board's 2005 annual review, the Mercer, Oliver, Wyman (MOW) report used the equivalent of a 10.1% return on capital assumption. However, we have found no economic analysis supporting this number.

In a free-enterprise market, shareholders should have the ultimate say on what constitutes an adequate return on investment. This is why ROE fluctuates over time. Fluctuations in value are part of the normal functioning of the market. However, should the Board decide to establish an industry-wide ROE target, it should be based on economic principles that reflect the risk associated with the industry, as observed through the volatility of the profit levels that are generated.

As a comparative illustration, we have included the rates of return that have been granted to various public utilities by regulatory authorities in different Provinces in recent years.

Public Utilities	Allowed Return on equity	Decision Date
Alberta Utilities ¹	9.50%	November 2004
Fortis BC	9.43%	May 2005
Manitoba Centra Gas	9.56%	July 2003
New Brunswick Power	9.50%	May 2003
Newfoundland Power	9.75%	June 2003
Nova Scotia Power	9.55%	March 2005
Terasen Gas	9.42%	February 2003
TransCanada Pipelines	9.56%	April 2005
Union Gas	9.62%	March 2004

¹ Altgas Utilities Inc.; Altalink Management Ltd.; Atco Electric Ltd. (Distribution), Atco Electric Ltd. (Transmission); Atco Gas; Atco Pipelines; Enmax Power Corporation (Distribution); Epcor distribution Inc.; Epcor Transmission Inc.; Fortis Alberta (formerly Auquila Networks).

Utilities are conservative, safe investments. Following are some of the factors that make a utility less risky than an automobile insurance company:

- Utilities generally have a monopoly in the markets in which they operate and do not risk losing market share to competitors.
- In a number of cases, utilities defer variances in specific costs with the variances included in the determination of future rates. This has a stabilizing effect and almost guarantees a rate of return to an investor over a certain period of time. In the automobile insurance industry, any fluctuations in the rates of return are being absorbed by the companies.

- The earned rates of return for utilities are usually very close to their allowed rates of return. In the automobile insurance industry, the final cost of the product is only known a number of years after the product is sold when all claims are settled.
- Since the automobile insurance industry derives a larger portion of its earnings from investment compared to the public utilities, there is an additional source of volatility.

Because of these strikingly different market conditions, it is not appropriate to cap insurance industry ROE at levels acceptable for stable and low-risk utilities.

Similarly, the major banks have typically provided returns around 15-20% in recent years. Yet banking is a much less risky enterprise than providing auto insurance. In addition to the expectations of shareholders, it must be remembered that insurers need higher levels of capital to operate than other financial services, such as banking, and other industries. Because P&C insurers have to be ready at any moment to pay claims that are ultimately unknown (although they are estimated, with reserves set aside to cover them), P&C companies require more equity relative to liabilities.

We have outlined the economic, market stability and administrative reasons that cause us to be concerned about an ROE reference point. However, should the Board decide to link an ROE expectation to rate making, it should not be a fixed number but a range. In her June 2005 testimony before the Board focusing on the role and cost of capital for auto insurers, Dr. Norma L. Neilson stated her view that an ROE range would be preferable to a single target ROE.

We strongly recommend that the AIRB allow the marketplace to function to the fullest extent that is consistent with its mandate. That statement emerges from one of the most consistent messages in our review of the literature—that basing prices on industry-wide costs of capital is likely to be value-destroying for the average firm in the industry. As regulators your perspective includes not only the need to examine the price of mandatory auto insurance coverage but also the need to ensure conditions that encourage companies to make it available. In order to balance both of these needs, it is preferable to establish an acceptable ROE range for P/L insurers who underwrite automobile insurance in Alberta, rather than trying to develop a single (maximum) ROE target which could end up being too low for the average (typical) auto writer.²

Any range that the Board adopts should be seen as competitive with ROE performance in the financial industry in Canada. A competitive range will ensure sufficient capital to

² Presentation by Norma L. Neilson, Ph. D., developed in conjunction with Gilles Bernier, Ph.D., to the Alberta Automobile Insurance Rate Board, June 9, 2005, pp. 14-15.

support continued market availability and foster innovation by insurers that invest in improving efficiency and performance.

Finally, it is clear that the 5% profit provision currently being used is inadequate and will lead to financial difficulties by more and more companies. While some may believe this problem is addressed by having a company-by-company process for appealing the rate adjustment decision, we do not think that this is satisfactory. More and more companies will file for recognition of “exceptional difficulty”, leading to a system that is bogged down and inefficient.

The rate regulation regime should be reviewed now that the extremely difficult market conditions that led to the Government’s reforms have passed. The goals of accessibility, affordability and stability are still paramount, but it would be useful to examine how best to achieve those goals over the long term. We question whether the current industry-wide review and adjustment process produces systemic benefits sufficient to override the potential negative economic outcomes. Annual review of individually filed rates would provide a stable system, but also provide the ability to recognize individual insurer circumstances.

Recommendations on Issue #1:

- **There should not be a profit provision or ROE reference point in rate making.**
- **If the Board sets a target ROE, it should be a range rather than a fixed number, to encompass varying insurer risk profiles and operations. The range should be competitive with the financial industry performance to ensure long-term market availability and incentives for insurers to improve efficiency and performance.**
- **Any ROE reference point adopted by the Board should be implemented as a guideline for individual filings as other jurisdictions do, rather than integrated into the rate making process.**
- **The Board should undertake outreach and education efforts to increase public awareness of important auto insurance issues, including the cyclical nature of industry results.**
- **The Government should review the regulations governing rate approval to ensure that the original reform goals are being met and it is possible and practical to implement decisions of the Board. More specifically, we recommend eliminating the requirement that the Board set uniform industry rates, while maintaining the Board’s approval role for**

II. RECONCILING THE PROFIT PROVISION AND ROE

Notwithstanding our strong reservations about the Board adopting a profit provision and corresponding ROE reference point, following are Meloche Monnex's comments on the technical reconciliation questions raised by the Board.

Profit provision as a percent of premium can be calculated as follows:

$$CR * ROE / (1 - ITR) - CR * LS$$

where

$$CR = 1 / PS$$

and

CR: capital required as % of premium

ROE: after-tax return on equity

PS: premium to surplus ratio

ITR: income tax rate

LS: investment income on surplus

PREMIUM TO SURPLUS RATIO

Federal supervision of financial institutions includes monitoring of insurers' capital to ensure solvency. The Office of the Superintendent of Financial Institutions (OSFI) uses the Minimum Capital Test (MCT) to assess the financial health of Canadian insurers. Insurers must typically maintain a capital level in the range between 165% and 180% of the MCT, and it has to be approved by their boards. This translates approximately to 200% premium to surplus ratio. It is important to emphasize that this is the *minimum* capital required for all lines of business combined.

The question is what should be the premium to surplus ratio for automobile basic coverage in Alberta? Capital allocation by line of business should be based on the relative risk and volatility of each line. One significant component of the MCT calculation is the loss reserve. The ratio of loss reserve to premium for automobile basic coverage is significantly higher than for the total of all lines of business on a countrywide

basis. Therefore the capital required per dollar of premium should be higher for automobile basic coverage. The premium to surplus ratio should be significantly less than 200%.

OSFI sets high standards for capital adequacy in order to protect the public with respect to insurer solvency. If the Board chooses a higher premium to surplus ratio for rate setting, this will inevitably negatively impact accessibility.

By way of comparison, Dr. Basil A. Kalymon, in his June 20, 1988 pre-filed testimony before the Ontario Insurance Board's hearing on the cost of capital, estimated the following premium to equity ratios by sub-line for Ontario automobile insurance:

- Third party liability: 124%
- Accident benefits: 145%
- Collision and Comprehensive: 314%

Furthermore, FSCO uses a premium to surplus ratio of 200% for all-lines of business combined.

We recommend that the Board adopt a premium to surplus ratio of 150% for automobile basic coverage in Alberta.

INVESTED RATE OF RETURN EXPECTED ON POLICYHOLDERS' FUNDS

Insurers invest the premiums that they receive from their policyholders for the period of time until such funds are required for the payment of expenses and claims. Because of the quasi-fiduciary responsibility that an insurer has with respect to the premiums it receives from its clients, funds should be invested for durations that correspond to the timing of these payments. For Meloche Monnex, the average corresponds to approximately three years. Appropriate matching of assets and liabilities will ensure that the insurer has sufficient liquidity to meet its financial obligations to its claimants on a timely basis while minimizing the risks associated with the impact of interest rate volatility on bond market values.

Meloche Monnex strongly recommends that the selected rate of return on investment assumption be based on the current yield of a 3-year Canada bond. This is in line with the expected payments for automobile insurance.

We should also note that discussions of this issue frequently use interest rate assumptions that are overly optimistic. A chart showing historical 3-year government bond yields with a projection over the next few years is provided in the Appendix. The main point here is that history will be a poor guide to the future level of yields, as there has been a sustained decline, reflecting lower and more stable inflation.

INVESTED RATE OF RETURN EXPECTED ON SURPLUS

As opposed to the investment of premium funds, the investment of an insurer's own capital funds may reflect a broader range of criteria as to the mix and duration of the portfolio. As a diversified public financial institution, the Toronto Dominion Bank Financial Group has a rigorous approach to capital management. We believe that the purpose of capital is to provide financial protection to our clients against unforeseen extraordinary events. Although this kind of event would have a relatively low probability of occurring, capital funds must be sufficiently liquid and their value sufficiently certain to ensure their availability in a time of crisis.

Because of the nature and term of the financial obligations underlying our insurance portfolio, we estimate that under adverse scenarios, capital funds would be required within a relatively short period of time. Hence, we consider that the appropriate investment of these funds requires the use of high-quality liquid investments with a short to mid-term maturity.

III. CALCULATION TECHNIQUES OR MODELS TO CONSIDER IN CONVERTING TARGET ROE TO AN UNDERWRITING PROFIT PROVISION

In order to convert the target ROE to an underwriting profit provision, it is first necessary to understand the various shifting components that contribute to an insurer's results. For example, how much of that return will be achieved from underwriting? The company's payout patterns, expected return on investments, and underwriting results all must be known. To estimate these components, insurers rely on assumptions. (The detailed calculation is found in the Appendix.)

In the overall calculation, the net present value of premiums and investment income on surplus should be equal to the net present value of claims, expenses, taxes (on premium and income) and profit.

- The net present value cash flows should be evaluated using the investment rate of return expected on policyholders' funds.
- Investment income obviously depends on the type of investments chosen and the term. As stated previously, we have advised the Board that investment returns should be estimated conservatively, based on three-year Canada bonds.

- Claims can be estimated by relying on an analysis of the company's payout patterns.
- Expenses are constantly monitored, and may change with new regulatory requirements, rising wage rates, and other developments external to the company. This is true of taxes as well, although they tend to be more stable.
- The mathematical equation to determine the appropriate underwriting profit provision can be solved using the calculation shown above, and detailed in the Appendix.
- Again, we must emphasize that the calculations are straightforward, but are specific to each company.
- Given that some of the assumptions underlying the calculation of the appropriate underwriting profit provision vary significantly by coverage, it is recommended that these calculations be done for each coverage separately.

Recommendations on Issues #2 and 3:

- **The premium-to-surplus ratio is a critical element in converting the profit provision to target ROE. We recommend implementing a premium-to-surplus ratio of 150% for basic automobile insurance.**
- **The current yield of 3-year Canada bonds should be the basis for the return on investment assumption.**
- **Recognizing the industry's need for liquidity, it is critical to be realistic about assumptions used regarding the rate of return on investments.**
- **The calculations should be done on a line of business basis.**

IV. POTENTIAL IMPACT OF CHANGES TO INSURANCE FINANCIAL REPORTING

The shift to Fair Market Value accounting of assets has attracted a great deal of attention, with questions raised about potential increased volatility in P&C insurer financial statements and possible related impacts in terms of investment strategy.

The new standards (CICA 3855 Financial Instruments – Recognition and Measurement) require that companies measure the fair value of all non-derivative financial assets except for loans and receivables and held-to-maturity investments, which should be measured at amortized cost. This will apply to all companies for the annual period beginning on or after October 1, 2006. Meloche Monnex's quarterly reporting for the period ending January 31, 2007 will incorporate the changes required by CICA 3855.

We do believe that CICA 3855, which is detailed further in the Appendix, will present challenges for the P&C industry and for Meloche Monnex. It will have an impact on P&C reporting and will increase the volatility of results.

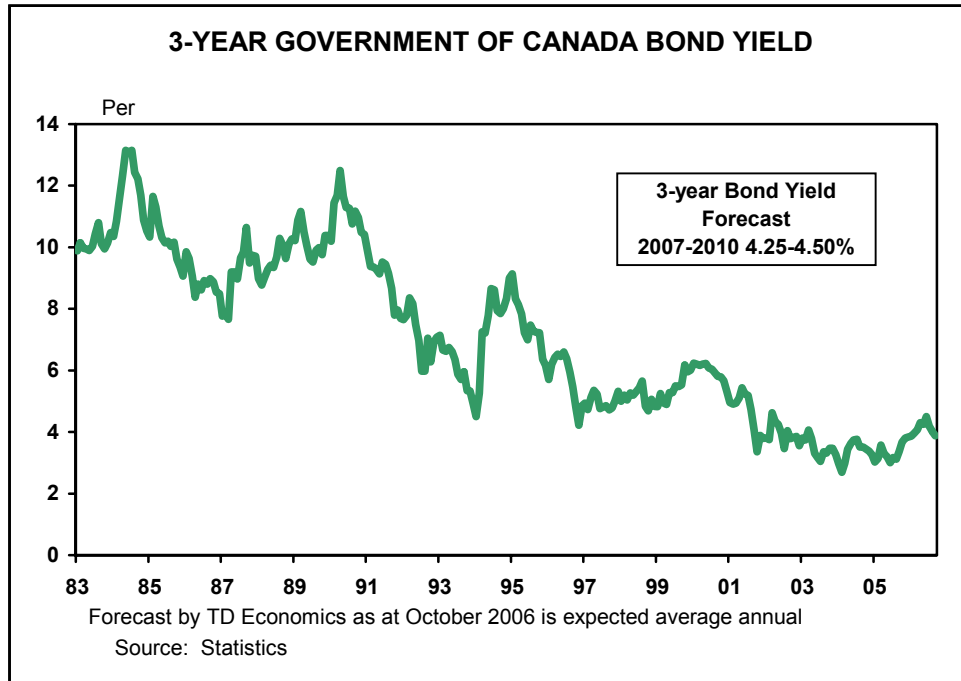
CONCLUSION

Meloche Monnex appreciates the opportunity to provide comments on automobile insurance profits. We hope that the Board will opt for the least intervention in the marketplace possible and: 1) consider eliminating the profit provision and need for corresponding ROE calculations and reference; 2) consider eliminating uniform industry rates; and 3) if ROE is to be used as a rating reference point, recognize that the current profit provision is too low, and ROE needs to be in a competitive range to support a healthy industry.

More broadly, we recommend that the Government undertake a review of the regulations governing rate approval to ensure that original reform goals are being met and to address ongoing policy and implementation issues. Meloche Monnex is committed to serving Alberta drivers and will continue to work with the Government to achieve a stable, sustainable auto insurance system.

APPENDIX

RETURN ON 3-YEAR GOVERNMENT BONDS



CONVERSION CALCULATION

The following equation indicates that the net present value of premiums and investment income on surplus should be equal to the net present value of claims, expenses, taxes (on premium and income) and profit.

$$\begin{aligned} & m * (1 + lp)^{-Dm} + (1 - m) * (1 + lp)^{-Db} + (ls / PS) * (1 + lp)^{-1} \\ & - C * (1 + lp)^{-Db} - (T + Ei + Mi) * (1 + lp)^0 - (Et + Mt) * (1 + lp)^{-0.5} - L * NPV \\ & = ((ROE / (1 - ITR)) / PS) * (1 + lp)^{-1} \end{aligned}$$

has to be solved for L

and

$$1 = C + T + Ei + Et + Mi + Mt + A + L$$

has to be solved for A

where

m: proportion of policies on monthly pay

Db: average delay for annual premium to be remitted

Dm: average delay for monthly premium to be remitted

PS: premium to surplus ratio

ROE: after-tax target rate of return on equity

ITR: income tax rate

ls: investment rate of return on invested surplus

lp: investment rate of return on policyholders' funds

C: commission rate

T: premium tax rate

Ei: operating expenses at issue

Et: operating expenses over term

Mi: other miscellaneous expenses at issue

Mt: other miscellaneous expenses over term

NPV: net present value factor based on claim payout pattern evaluated using lp

A: appropriate underwriting profit provision

CHANGES IN FINANCIAL REPORTING

Meloche Monnex will review its overall investment strategy with the goal of reducing volatility. The first step of this strategy is to segregate the investments supporting the unpaid claims liability provision and the investments supporting the remainder of the balance sheet and the equity.

The investments supporting the equity and the remainder of the balance sheet will be designated as Available for Sale (AFS—see Appendix) and will be accounted for accordingly, i.e., will be recorded at fair value on the balance sheet with the difference between the fair value and the market value recorded directly to equity or comprehensive income. Fluctuations in fair value will create volatility in equity, but will not influence the net earning.

The investments supporting the unpaid claims liability provision will be designated as Fair Value Option (FVO) with the unrealized gain or loss on investment recorded directly into net income. By designating that portion of the investment portfolio as FVO, management expects to significantly reduce the mismatch caused by the fluctuation of the discount rate from period to period. The duration and composition of the FVO investment portfolio will also have to be reviewed to better match the unpaid claims liabilities provision composition in order to mirror the fluctuation of fair value fluctuation on both sides.

This exercise will necessitate a major commitment from Meloche Monnex's perspective, since matching the unpaid claims provision liabilities and investment portfolio is easier said than done. Both sides of the equation are moving targets. The unpaid claims provision will fluctuate based on growth, paid claims, revisions of estimates and much more.

This will also change how management and the industry view results. Currently, management refers to loss ratio to evaluate underwriting decisions. In the future, the loss ratio will incorporate an additional factor in the fluctuation of discount rate. The impact of the fluctuation of discount rate cannot be mitigated; a change in 25 basis points of discount rate can have a significant impact on the company's results. However, companies like Meloche Monnex, which choose to reduce their earning volatility by designating a portion of its investment as FVO, should have the same impact in the opposite direction generated by its investment. Therefore, going forward the incurred loss and loss ratio will have to be evaluated in conjunction with the realized gain or loss on investment or else evaluated before discount.

Because of the penalty for early sale, presumably most P&C insurers will elect to categorize virtually none of their financial assets as Held to Maturity (HTM), but rather, split them between AFS and Held for Trading (HT)/FVO.

The value of surplus, being the difference between the values of assets and liabilities, should in most circumstances also be expected to be more volatile, despite the partial offset of the asset change by the liability change. This volatility will contribute to an increasingly cautious investment approach, which may negatively impact returns.

Basic rules

The basic principles of CICA 3855 require companies to designate, on an item-by-item basis and irrevocable basis, each of its financial assets into the following categories:

- Loans and receivables
- Held to Maturity (HTM)
- Available for sale (AFS)
- Held for trading (HT)

Under CICA 3855, companies must measure at fair value all non-derivative financial assets with the exception of loans and receivables and held-to-maturity investments, which should be measured at amortized cost.

Gains or losses on financial instruments measured at fair value be recognized in net income in the periods in which they arise, with the exception of:

- a) gains or losses on financial assets classified as AFS, which are recognized in other comprehensive income until the assets are derecognized or become impaired.
- b) certain financial instruments that are part of a designated hedging relationship

- **Held to Maturity (HTM)**

This category is intended for assets which the insurer plans to hold to maturity, and is potentially applicable only to invested assets which have a fixed maturity date such as most fixed income assets. Investments recorded as HTM will be carried at amortized cost on the balance sheet with the change in book value (amortization of the premium or discount) being recognized in the income statements over the term of the assets.

Investments classified as HTM will have to be held to maturity. Disposition before maturity will have serious consequences on the accounting treatment.

- **Available for sale (AFS)**

This category is intended for financial assets that the insurer does not intend to trade actively, but might sell if and when conditions are appropriate. Investments recorded as AFS will be carried at fair value (market value) on the balance sheet with the difference

between book value (amortized cost) and fair value being recognized in the Other Comprehensive Income, a portion of equity.

- **Held for Trading (HT)**

This category is intended for assets that the insurer intends to trade actively; however, any assets can be designated as HT. Investments recorded as HT will be carried at fair value (market value) on the balance sheet, with the difference between the book value (cost at acquisition) and the fair value being recognized to the income statements.

Fair Value Option (FVO) is a term introduced by OSFI. The accounting treatment of assets designated as FVO mirrors the treatment of assets classified as HT. FVO and HT are essentially synonyms. The use of FVO is only permitted when it eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognizing the gains or losses on them on a different basis.

Implications of the newly introduced investment classification

Canadian P&C insurers are required to record a provision for unpaid claims liabilities on a discounted basis on the balance sheet.

Under the Standards of Practice of the Canadian Institute of Actuaries (CIA), the actuary is required to select supporting assets, based on the expected future cash flow related to these supporting assets and how they are booked in the financial statement, the actuary must determine an appropriate expected future investment return rate to be used for discounting.

To the extent that these supporting assets are categorized as either AFS or HT/FVO (recorded at fair value on the balance sheet), this means that the investment rate will reflect the expected future market rates, rather than the current situation where the rate reflects the embedded expected return on amortized book value. This means that the net claims and adjustment expenses incurred in the income statements will reflect the change in discount rate from period to period, which will create more volatility.

Fair value accounting will create more volatility for P&C insurers, as market rates fluctuate.

**FINANCIAL INSTRUMENTS
CLASSIFICATION**

Category	Accounting Treatment	Issues
Held to Maturity	Amortized cost	Difficult to maintain Penalty for early sale (tainting rules)
Held for Trading	Fair value with gains and losses included in income (net of tax)	Can elect Ht for any financial instrument at inception (The fair value option)
Available for sale	Fair value with unrealized gains and losses included in Other Comprehensive Income Amortization of premiums\discounts included in income	Mismatch for assets backing liabilities
Loans and receivables	Amortized cost	