Allstate Canada Group of Companies

Submission to the Alberta Automobile Insurance Rate Board
Review of Profit Level for Automobile Insurance

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On behalf of the Allstate Canada Group of Companies (ACG), which includes Allstate Insurance Company of Canada, Pembridge Insurance Company and Pafco Insurance Company, please accept the following submission for the Alberta Automobile Insurance Rate Board (AIRB) review of profit level for automobile insurance.

ACG is a multi-channel producer and distributor of home and auto insurance products, which are accessible through our community-based agents, our broker representatives, directly on-line, and our Customer Contact Centre at 1-800-ALLSTATE.

Allstate Insurance Company of Canada has 53 agents across Alberta and was the 20th largest insurer in the province with over $60.7 million in Direct Written Premium in 2005. Pembridge Insurance, which is in the midst of repositioning itself in the market as a result of the introduction of the grid system, has 12 broker partners across Alberta and had over $2.8 million in Direct Written Premium in 2005. Pafco Insurance Company is an alternative market for high-risk drivers has not yet been launched in the Alberta market.

ACG appreciates the opportunity to participate in this debate and provide perspective on this very important issue as it will have an impact on the Alberta marketplace in the years ahead. Overall, ACG is optimistic about the tremendous potential for growth in a stable and competitive Alberta market and ACG looks forward to continuing to provide Albertans with high-quality products and exceptional customer service in the years ahead.

Over the past two years, the financial results and earnings of insurance companies has generated a significant amount of debate and received a healthy dosage of criticism. Therefore, it is necessary to provide some background information and historical perspective on the issue of financial results, including Return on Equity (ROE), as it relates to the broader insurance industry and specifically the results of ACG.

Doing so will provide the foundation to support ACG's position on the matter under review and it will respond directly to the specific issues raised by the Board.

By way of conclusion, it is important to provide some perspective and outlook on the future of auto insurance in Alberta.

The insurance industry was healthier, more competitive and more stable in 2005. Rates continued to fall, voluntarily in most cases, and more new products, services and discounts were introduced. The current marketplace in Alberta and right across Canada is an environment where both consumers and insurers are benefiting.

The reforms introduced by the Klein government are achieving their primary objective of reducing rates for consumers. While ensuring that consumers are charged a reasonable and appropriate auto insurance rate is important, it is equally important that companies have the flexibility to operate in a competitive market. When coupled together these factors help create a marketplace that can achieve the long-term sustainability that insurers and government want and that consumers deserve.

Rates were down again in 2005 and according to the Insurance Bureau of Canada (IBC) more than $1.8 billion has been put back in the pockets of Canadians including nearly $300 million in Alberta.

As the Board will know, ACG's auto rates are down on average by nearly 15% across Canada. In Alberta, ACG's auto rates are down by more than that, on average by 21%, and since 2003, customers in Alberta have received almost $6.5 million back into their pockets as a result of premium reductions.

Not only have consumers benefited from increasing stability in the marketplace in the past couple of years, but so too has ACG and the industry. However, it wasn't that long ago when consumers and insurance companies were struggling to keep up in a system that was failing.

It has been noted by the Insurance Bureau of Canada, that over the past 27 years there have been no fewer than 4 distinct earnings cycles. The latest which began in 1998 has yielded the lowest return for the insurance industry of any previous period. What is important to note is that the insurance industry is a cyclical business and the last six years provide an excellent snapshot of the highs and lows that consumers and insurers face.

Beginning in 2000, there were serious concerns as to whether companies were willing to put their capital at risk in such an unstable environment. For example, ACG's ROE was 5.5%, some 10 points below what shareholders were expecting on their return.

In 2001 it dropped by further 10 points to a negative return of -4.5% and in 2002, ACG's ROE fell again to its lowest point in the history of the company to -9.6%.

Put another way, for every $1 ACG collected in premium in 2001, $1.10 was incurred in claims and expenses. In 2002, the situation deteriorated further as for every $1 collected in premium $1.13 was incurred in claims and expenses. ACG was on the verge of going out of business in Canada. But once the ACG hit bottom the only place to go is up.

The long road back was not a smooth one for consumers or insurers. The insurance environment in 2001 and 2002 produced much tighter underwriting criteria and forced companies to limit exposure in an effort to recover and achieve the reforms in markets across Canada.

2003 proved to be the beginning of the turnaround as ACG's ROE bounced back to 14.2%. 2004 and 2005 also produced healthy ROE's at 30% and 32.9% respectively. However, a few years of moderate success does not erase a decade of instability and sub-par financial results. Despite the positive recovery in the past couple of years, ACG's average ROE over the past six years was a modest 11.4%. More importantly, the returns earned by ACG in the past two years are not sustainable. Just as the competitive market drove ROE up, it will drive ROE down as well.

By comparison, ACG's average ROE between 2001 and 2005 was 12.6% and below;

- Canadian Banks at 13.8%;
- McDonald's at 14.4%
- RBC at 16.5%; and
- Loblaws at 17.6%.

Over the same period, the ROE for the entire industry was only 10.3%.

When ROE's fluctuate so too do rates. In 2002, when ACG's ROE was at its low point auto rates were at their peak. It was noted during the annual rate adjustment hearing this year, that between 2000 and 2004 Allstate's auto rates in Alberta increased on average by approximately 12% per year. As ROE improved over the course of 2003, 2004 and 2005 auto rates have fallen dramatically in Alberta and right across Canada.

Make no mistake; this is not the type of market environment that ACG is interested in operating in. The goal is to continue to keep auto insurance rates at an appropriate level in an open and competitive Alberta market, and to continue to earn a fair and reasonable return for our shareholders. ACG is better prepared to sustain the inevitable hardening of the marketplace with an entrenched underwriting discipline and a commitment to remain on the leading edge of product development. These goals are not mutually exclusive and ACG is committed to helping create and sustain the type of marketplace that both consumers and insurers have benefited from over the past three years.

The financial results outlined above for ACG illustrate how volatile and unpredictable the insurance industry can be. More specifically, it provides the foundation which supports ACG's position on the question of an appropriate target level of ROE.

First though, it is extremely important to outline what components make up insurance company profits. There are three general categories of income, or loss, that coupled together, determines the financial results for an insurance company.

The first is underwriting profit or loss which consists of the difference between the premium collected and the amount paid out in losses and expenses. Second, is investment income on insurance operations which is the investment income earned while holding the premiums collected from customers before having to pay losses and expenses. Finally, the last component is the investment income on shareholder provided funds or equity. This is the investment income earned on the money supplied to us by shareholders.

What is an appropriate target level of ROE for automobile insurance written in Alberta?

The insurance industry is no different from the pharmaceutical industry, retail stores, grocery stores or banks. While the products that are sold and the services that are offered may be similar in a particular field, every company or organization is run differently. In addition, companies can operate in specialized or niche markets which cater to specific needs. How companies operate and deliver the products and services that are offered is what distinguishes them.

Every company is unique. No two insurance companies are exactly the same and there are a number of factors that set companies apart. For example, the type of insurer (ie. mutual or stock); the products that are offered (ie. personal lines or personal and commercial); geographic concentration; risk appetite; use of reinsurance; customer service; and claims handling are the primary examples which differentiate one insurer from another.

These factors are an integral component in an organizations' effort to attract consumers by delivering a high quality product, and to achieving a ROE that shareholders demand as a result of the risk of the operation. Thus, no one single target or range will meet the expectations of every insurer.

Furthermore, insurance as a product is unlike any other. Policies are sold for a premium before knowing the actual costs associated with it. Auto manufacturers as an example, know exactly what it costs to manufacture and deliver a vehicle to a customer down to the penny, before a sale is made.

The unique nature of the insurance product creates an inherent risk and volatility for insurers as the cost of any one policy will not be known for years. There may not be any losses incurred or there could one claim worth millions of dollars. There are many techniques and methods for estimating the cost with accuracy. But even with sophisticated techniques, there is considerable volatility. Companies require flexibility to respond to situations based on the nature of their operation and in the best interests of their customers.

Finally, determining insurance rates is a prospective and complex process, which is driven by equally prospective and complex process to determine an insurance company's ROE. Moreover, there are numerous methodologies currently used by insurers to determine the ROE that *they* require to operate and maintain and attract capital. No one single rate or range is appropriate for every insurer.

Therefore, and respectfully, the Allstate Canada Group strongly advocates that an industry-wide ROE average or range not be implemented in Alberta.

It is ACG's position that an industry-wide ROE average or range will drastically reduce a consumer's ability to choose an insurer; it will stifle competition between companies; and potentially drive companies out of the Alberta market.

What are the appropriate values of the components of the reconciliation between profit provision and ROE? What calculation techniques or models target ROE to an appropriate underwriting profit provision?

The rate determination model used by ACG is the discounted cash flow (DCF) approach. The discounted cash flow method takes several factors and values and discounts the results to a common time period and determines the appropriate premium levels. The DCF is a methodology commonly used by insurers and while it is the preferred method of ACG it is likely not the method used by every insurer.

The components used in ACG's discounted cash flow model include premium to surplus ratio; investment returns; tax rates; estimated underlying losses; and claims expenses. It is important to provide some background on how ACG utilizes each component to reconcile between profit and ROE.

First, premium to surplus ratio is subjective and is dependant on the level of risk that comprises a company's portfolio. The higher the surplus ratio, the less capital is used to support the underlying business and lower the premium.

However, it is important to note that a company's entire surplus is available, if necessary, to support insurance operations in every province in which they do business. It is not as simple as allocating a portion of a company's surplus to Alberta because it does not limit the company's exposure to that amount.

If loss and expense payments exceed premium and investment income, the entire capital of the company is at risk to settle customer claims, no matter what line of business it is or where it happens. This is what the insurance business is all about. Whether it is a snow storm in southern Ontario, an ice storm in Quebec, or a hurricane in Nova Scotia, or a heavy rainfall in Edmonton, ACG's surplus is available to respond regardless of where it happens.

For example, in June 2005, between 50 and 400 millimetres of rain fell in various parts of Alberta and according to a government report over 12,000 claims were filed by individuals, small business owners, municipalities, First Nations and agriculture. The estimated cost of the all the claims was approximately $162 million.

If companies were limited to earning a specific return in one province it would significantly hamper an insurer's ability to fulfill its commitment to its customers. Insurers need to have the flexibility to earn a reasonable return in every province in order to be there when customers need it the most.

Coupled with premium to surplus ratio, insurers must also adhere to the "Minimum Capital Test" (MCT), which is set by the Office of the Superintendent of Financial Institutions and determines how much capital is required for every insurance company. As part of the MCT different amounts of capital are required for investments of different levels

The second component is investment returns, which are the funds generated from writing a policy to earn investment income. The funds used to underwrite a policy, which are funds supplied by the shareholder, also yield investment income. Policyholder funds are usually invested in very liquid and conservative investments to ensure that the insurer can fulfill its obligations and commitment to a customer when a loss occurs.

ACG's pricing assumptions use a risk free rate to estimate the yield earned on those investments. The duration of these investments is selected to match the duration of the expected losses.

With respect to investment returns on shareholder funds, surplus is invested in higher yield investments such as equities. ACG uses the CAPM model to estimate the expected market yield. The investment yields selected are based on prospective expected returns, and not based on the past history of the company. When a rate is calculated it is trying to project into the future and the current market rates are the best indicators of these forward rates.

Third, tax rates are used to convert the after tax profit to pre-tax basis. ACG uses the actual top marginal tax rate in each jurisdiction.

The fourth component is losses and ACG looks at the loss experience for the past five years, then applies loss development factors to determine ultimate loss costs, trends the losses to a common date, and then apply different weights to the experience to arrive at a developed and trended loss costs. In adjusting historical losses to a common date, ACG also takes into account regulatory changes in order to have a common starting point.

Fifth, in addition to losses are underwriting expenses. Underwriting expenses are broken down into two categories; variable and fixed. Expenses that are directly related to the actual premium are considered variable such as commissions or premium taxes. Overhead costs, salaries, rent are considered fixed expenses. ACG uses the company's historical data to estimate the numbers.

The last component is claims expenses. There are essentially two categories of claims settlement expenses as well. Allocated loss adjustment expense (ALAE) and unallocated loss adjustment expense (ULAE). ALAE are expenses that can be directly attributable to a specific claim, such as a lawyer fees for a specific file. ULAE costs can't be specifically allocated to an individual claim file, for example salaries of claims personnel. ALAE is already included in the underlying losses discussed earlier, so no additional or specific adjustments need be made. ULAE is estimated based on ACG's historical information, and is usually a percentage of the losses.

These are the six components that ACG uses and considers when determining the overall rate level needed by the company to achieve the target profit. From there the discounted cash flow model (DCF) is used to convert the results in a premium. The DCF model attempts to isolate the premium required to achieve ROE. All the components in the model are adjusted for the time value of money to common date.

Each individual company must show in the development of their rate level that they have utilized an appropriate method based on its own operations and capital requirements.

Therefore, a reasonable approach for AIRB would be to enable individual companies to use accepted methodology to determine expected returns which meet the specific needs of individual companies based on their operations.

To gain a better understanding of the methodology that ACG uses to determine ROE is to provide an actual example.

Given:

- P/S = **1.5**
- Target after tax ROE = **16.93%**
- Tax Rate = **36.1%**
- Loss Cost estimated = **$100**
- Variable expense = **25%**
- Fixed Expense = **$10**
- ULAE= **10% of losses**
- Risk Free Rate = **5%**
- Market Rate = **7.5%** and
- PV factor loss time 1 = **.925**

What should the appropriate premium and the underwriting margin be? To simplify the example above:

Assume the fixed and variable expenses are paid at policy issue time period 0 and assume ULAE is paid at the same time as losses. ACG's goal is to adjust all cash flows to one year after policy inception (i.e. time = 1)

The first thing that must be adjusted is the loss cost for the time value of money. Recognizing that the losses will be paid over many years it is necessary to have a payout pattern of the losses, which is established by using historical information. Each percentage is then discounted using the risk free rate to time period 1. Assume this has been done and the discount factor is 0.925

Looking at all cash flows at time 1:

$$P \times (1.05) + P/1.5 \times (0.075) - 100 \times 0.925 - P \times (0.25) \times (1.05) - 10 \times (1.05) - 100 \times .10 \times 0.925 = P/1.5 \times [0.1693/ (1-0.361)] \quad (1)$$

The numerical equation above shows all the cash flows and the corresponding verbal explanation below shows the money left over after paying all expenses all adjusted to the same time.

The six terms are:

- The premium collected brought forward 1 year for the time value of money
- The return on surplus assigned.
- The value of the losses adjusted to one time 1
- The cost of the variable expenses adjusted to one time 1
- The cost of the fixed expense adjusted to one time 1
- The cost of the ULAE adjusted to time 1

0.1693/(1-0.361) is the required return on surplus before taxes.

Why? Our goal is that for $1 dollar of surplus at time 1 we receive 16.93 cents after taxes.

Tax rate is 36.1%:

Therefore, before taxes you receive:
0.1693/(1-0.361)= 26.49 cents

The tax is:
26.49 x 0.361 = 9.56

After tax:
26.49 – 9.56= 16.93 cents.

Going back to equation (1) there is only one unknown P.

Solving, you get for P:

P= **$169.47**
Total Loss & Expense = **$100*.925+.25 x $169.47 +$10 + $9.25= $154.12**
Discounted loss ratio= **($100*.925+$9.25)/$169.47=60.0%**
Expense ratio = **($.25*169.47 +$10)/$169.47=31.0%**
Combined Ratio = **91.0%**
Underwriting Margin = **9% (= 100%- 91.0%)**

The above example outlines our methodology in determining our premiums and underwriting margins.

What will be the Impact of impending changes in insurance financial reporting?

Effective January 1, 2007, insurance companies are required to record their assets at market values rather than historically being held at amortized cost or book value. This will essentially convert unrealized capital gains / losses to capital gains /losses. Insurers are required to designate all investments into one of these three categories; Held to Maturity; Available for sale; and Held for Trading.

Held to Maturity is very similar to existing method of recording assets, however, if any assets are sold before maturity, remaining assets will have to be immediately reclassified, and any changes from amortized value of assets to market value will flow through income and balance sheets.

Under the Available for sale method, changes in assets values due to market fluctuations do not flow through regular income, rather, they are recorded under Other Comprehensive Income, while changes in claims liabilities due to changes in market rates flow directly through regular income, thereby creating volatility in results. Currently, this method is used in United States since unlike Canada, liabilities are not discounted, therefore claim liabilities are unaffected by changes in market interest rates.

The third option, Held for trading, takes market value changes of assets and flows them through regular net income, with associated impact on claims liabilities also flowing through net income. This method is to be used if it can be demonstrated to OSFI that proper matching of assets and liabilities exist, and the company has in place an effective risk management process.

ACG is currently reviewing which option best fits our business model. However, initial reviews indicate that regardless of which option is selected, ACG's equity position would increase due converting unrealized capital gains into capital gains regardless of which method is selected.

How should these issues be handled in the context of overall regulation of automobile insurance rate making?

In conclusion, the competitive market can be allowed to operate to the advantage of consumers in Alberta without an ROE target level or range. Over the past couple of years, increased competition has benefited Alberta drivers with lower rates and greater choice in the market.

For example, last year alone, Allstate and Pembridge made some 18 changes to their respective auto insurance products including new discounts and positive changes to the underwriting criteria, in an effort to make it more attractive to consumers. In addition, a number of enhancements were also made to the property line products, as well as improvements to the specialty lines products including motorcycles and snowmobiles. Introducing an ROE target level or range would hamper an insurers' ability to introduce measures such as these that obviously benefit consumers and thus provide the consumer with less choice in the marketplace.

Not only do these moves illustrate the competitiveness that exists in Alberta, but they are a strong indication of ACG's commitment to servicing consumers in the Alberta market. Consumers deserve the freedom and flexibility to find the coverage that is the most appropriate for them at the most appropriate price and insurers should have the flexibility to earn the right to be the insurer of choice for consumers.

Customers will also play a very important role in determining the health and stability of the insurance system. With a wide array of companies competing for business, customers will naturally gravitate to those providing the service and product that they feel is a good value. There are many consumers who consciously protect themselves and understand what they expect from their insurance company and they are willing to pay more for better service, better relationships and better products.

The competition for capital is global and it is stiff. Handcuffing insurers' ability to attract capital by implementing an ROE target or range jeopardizes the health and stability of the marketplace that has been evolving in Alberta since 2003. It is no secret that if equity investors do not see the potential to earn the required return on their investment, they will turn to alternative investments with returns that are appropriate. As a result, the potential for companies leaving the market because of the lack of capital to support the operation becomes a very frightening possibility.

The preceding has provided the Board with some insight into how ACG calculates and arrives at a target ROE. While the method may used by another organization, the factors that are used, the application and the outcome will be vastly different. Imposing one methodology or one target ROE on the some 60 insurers operating in Alberta contradicts the spirit of capital enterprise that has become synonymous with the province.

Therefore, and respectfully, the Allstate Canada Group strongly advocates that an industry-wide ROE average or range not be implemented in Alberta.

ACG remains committed to working with the Board and the government to prolonging the success of the marketplace that consumers and insurers have benefited from over the past couple years. More importantly ACG is committed to achieving the mutual long term goal of appropriate and affordable auto rates for consumers and earning a fair and reasonable return for shareholders.

The Allstate Canada Group of Companies would again like to thank the AIRB for its consideration and for the opportunity to add our voice to this very important issue.