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3 AUTOMOBILE INSURANCE RATE BOARD
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6 PROFIT REVIEW SESSIONS
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10 Before Board Panel:
11 Alfred H. Savage - Board Chairman
12 Harry Gough - Vice-Chair
13 Ted Zubulake - Board Member
14 William Moore - Board Member
15 Harry Gough, QC - Board Member
16 Lewis Klar, QC - Board Member
17 Merle Taylor, CMA - Board Member
18 David White - Board Member
19 Susan Steeves - Board Member
20
21 HELD AT:
22 McDOUGALL CENTRE
23 Calgary, Alberta
24 November 8th, 2006
25 DAY 1 OF 3

1 APPEARANCES

	Name		Representing
2	Jack Donahue		)Board Counsel
3	David Simpson		)Facility Association
4			
5	Norma Nielson		) self
6	David Chan		)
7			
8	Diane Brickner		)Peace Hills Insurance
9	Jamie Hotte		)
10	Melvin Yellowbird		)
11			
12	Grant Miner		)Aviva Canada
13	Chris Townsend		)
14			
15	Steve Whitelaw	(np)	)Dominion of Canada
16	Doug Hogan	(np)	)General Insurance
17			Company
18			
19	Frank Bomben	(np)	)Co-operators General
20	Katie Suljak	(np)	)Insurance Company
21			
22	Chris Daniel	(np)	)TD Meloche Monnex
23	Rick Evans	(np)	)
24	Craig Alexander	(np)	)
25	Francois Faucher	(np)	)

1 APPEARANCES (Con't)

Line	Name		Affiliation
2	Jim Rivait		)IBC
3	Jane Voll		)
4	Grant Kelly		)
5	Richard Phillips		)
6	Sharon Tennyson		)
7	Richard Derrig		)
8	Richard Gauthier		)
9			
10	Shawn DeSantis	(np)	)Royal SunAlliance
11	Saskia Matheson	(np)	)
12	Thomas Little	(np)	)
13	Brad Hardie	(np)	)
14	Merle Taylor	(np)	)AIRB Consumer
15			)Representative
16			
17	Jetse de Vries	(np)	)ING
18	Martin Beaulieu	(np)	)
19	Don Fox	(np)	)
20	Bill Premdas	(np)	)
21			
22	Derek Tupling	(np)	)Allstate
23	Ajay Pahwa	(np)	)
24	Doug Young	(np)	)TD Newcrest
25	Joel Baker	(np)	)MSA Research

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1 --- Upon commencing at 9:16 a.m.
2
3 THE CHAIRPERSON: All right. Good
4 morning all. It's the first morning of the Alberta
5 Automotive Insurance Rates Board review of profit levels
6 for the automotive industry in Alberta. We have some
7 changes in the schedule this morning. I understand that
8 Aviva is still on the deck in Edmonton trying to get off.
9 What, is it foggy up there or something this morning?
10 Out of the generosity of their heart, the
11 Facilities Association has agreed to go first. And I am
12 going to ask Bill to introduce the board.
13 But before that, this is a meeting held in
14 public, it is not a public meeting, so all questions will
15 be addressed through the chair. And we'll not really
16 cross-examination but we'll ask the Board if there is any
17 questions to clarify your presentation.
18 Bill, would you introduce the Board.
19 MR. BILL MOORE: I'm sure you all know
20 our Chair, Alf Savage. And on my left Harry Gough, who
21 is the Vice Chair; Lewis Klar on my far left; David White
22 to Alf's right. Merle Taylor is our consumer
23 representative. Susan Steeves is -- she's a manager in
24 the -- and part of the Board staff, the one who really
25 knows what's going on. And Ted Zubulake on the right

1 from Mercer Barro -- Mercer Oliver Wyman.
2 THE CHAIRPERSON: And Jack. Don't forget
3 Jack.
4 MR. BILL MOORE: Sorry, Jack. Jack
5 Donahue, of course, yes, our legal counsel.
6 THE CHAIRPERSON: And Bill is a member of
7 the Board but he's on a bit of a leave of absence to
8 become our acting director at the moment. So he's
9 filling, officially, as acting director and on the other
10 hand he's still a member of the Board, so, he's very
11 active both ways.
12 So, gentlemen, I'll ask you to go ahead.
13 I think you're on page 3 of our book with the modern
14 mathematical formula at the top, which I have never got
15 modern math down yet.
16
17 (BRIEF PAUSE)
18
19 THE CHAIRPERSON: So, go ahead.
20
21 PRESENTATION BY FACILITY ASSOCIATION:
22 MR. DAVID SIMPSON: Thank you very much,
23 Mr. Chairman. We've tried to keep the mathematics in our
24 presentation to a minimum knowing that you'll have a
25 whole amount of it throughout the day.

1 Good morning, my name is David Simpson.
2 I'm President of the Facility Association and with me
3 today is Norm Seeney, Vice President of Finance and CFO.
4 Forgive me, I'm just struggling through my
5 first cold of the season. It's a little bit...
6
7 (BRIEF PAUSE)
8
9 MR. DAVID SIMPSON: We appreciate -- we
10 do appreciate the opportunity to be here this morning and
11 discuss residual market issues that the Board may wish to
12 consider as you reflect on appropriate automobile
13 insurance profit levels. We will speak only from the
14 perspective of residual markets as obviously there's sort
15 of an impressive roster of people here today to talk to
16 you from other perspectives.
17 I'll try and keep up with the slides as I
18 go. Our written submission deals much more
19 comprehensively with how the residual markets work and
20 their authorization. We went into that in some detail at
21 the hearing in June and we will not cover that ground
22 again today.
23 In our presentation today we will focus on
24 how the risk sharing pools can impact profit levels, how
25 the traditional residual market can impact profit levels,

1 and provide a brief snapshot of where we are now with
2 respect to the risk sharing pool volumes and financial
3 results; essentially an update on information we shared
4 with the Board in June.
5 So just by way of reminder though, we
6 administer two (2) types of residual markets on behalf of
7 the automobile insurance industry in Alberta, two (2)
8 risk sharing pools for private passenger vehicles and a
9 residual market segment for non private passenger
10 vehicles, and a tightly defined high risk segment of
11 private passenger vehicles.
12 Risk sharing pools are typically an
13 industry response to an industry-wide requirement that
14 individual companies must accept business that they
15 believe to be inadequately priced. They act as an
16 industry-wide reinsurance mechanism that allow companies
17 to mitigate the risk of having to accept business they
18 believe to be inadequately priced.
19 In Alberta we have, of course, two (2)
20 risk sharing pools: one (1) to accommodate the policies
21 subject to the maximum allowable premium under the grid,
22 known colloquially as a grid risk pool or the grid pool,
23 and another to accommodate business that companies must
24 accept under the take-all-comers provision of the law.
25 All business ceded to both pools is

1 written at company rates as mandated by the grid or as
2 approved by this Board. However, while the risk sharing
3 pools exist to mitigate the risk of the grid premium with
4 the take-all-comers rule at the company level, they do
5 result in companies having a generally higher risk
6 profile than they would if they had discretion and
7 control over their underwriting and pricing practices.
8 As we highlighted in June, the financial
9 results of the risk sharing pools can be volatile and
10 very difficult to predict in advance. And, particularly
11 because of the size of the risk sharing pools in Alberta,
12 that volatility is, of course, of material importance and
13 concern to insurance companies conducting business in the
14 province.
15 And that volatility arises from a number
16 of factors. We're still, from an insurance entity
17 perspective, just about two (2) years old, so that's
18 still a very immature, if you will, mechanism. We're
19 still basing our -- our actuaries are basing our numbers
20 on industry derived estimates.
21 It will be some time before they're able
22 to use pool experience predominantly to drive the
23 financial results. They do use the pool experience as a
24 reasonability check on the financial results but it's
25 still very much on the basis of industry estimates and

1 that's simply an actuarial necessity in the absence of
2 real experience.
3 There's still some general uncertainty of
4 the impact of product reform, although our actuaries
5 continue to reflect the emerging experience of the
6 product reform in the marketplace, and, of course,
7 company decision on pool use. And this is something that
8 is simply in the nature of the pools. Companies can take
9 a different view of how they will use the pools at the
10 individual company level and those company decisions can
11 change all the time. So there's an inconsistency, if you
12 will, in terms of what's coming in -- into the pool and
13 coming out of the pool through time that you wouldn't
14 see, for example, at an insurance company.
15 So numbers, I hope everybody can see them
16 fairly clearly. As we highlighted for the Board in June,
17 at that time, for 2006, we were starting to see a shift
18 in how companies were using the pools in the sense that
19 we were seeing less of a volume coming into the grid risk
20 pool and more of a volume coming into the non-grid pools.
21 So, in terms of private passenger written
22 exposures, year to date as at the end of September, we
23 were at a hundred and fifty-eight thousand (158,000) plus
24 in '05 and a grid pool of a hundred and twenty-two
25 thousand (122,000) this year; a fairly considerable drop.

1 It's almost been -- been balanced off, if
2 you will, by a rise in the use of the non-grid pool, from
3 twenty-three thousand, nine hundred (23,900) exposures to
4 fifty-three thousand, five hundred (53,500) in 2006, year
5 to date as at September.
6 The total though still leaves us with, as
7 of nine (9) months, a hundred and seventy-six thousand
8 (176,000) exposures written through the risk sharing pool
9 in a private passenger market that is, and we still have,
10 of course, three (3) months to go in the year, private
11 passenger market that is on the order of 1.8 and 1.9
12 million, as we discussed in June.
13 It's a -- it's a large residual market
14 mechanism by virtually any standards, certainly by
15 Canadian and North American standards, generally.
16 In terms of where are we now, the most
17 recent analysis done by our actuaries reflects, by and
18 large, an improving picture. And, just to reiterate,
19 their methodology is based largely on -- is based
20 entirely on industry estimates with pool experienced used
21 a reasonability check.
22 But for accident year 2004 where the
23 volume is really quite small, because we started the
24 business in October of '04, we're seeing an improvement
25 in the loss ratio of fifteen (15) points, twelve point

1 six (12.6) for accident year 2005, seven (7) for accident
2 year 2006 for the -- that's all for the grid pool.
3 For the non-grid pool, a jump of twenty-
4 five (25) points. Just to point out, that's a very small
5 volume of business in the non-grid pool, in the latter
6 part of '04, just in the startup phase, relatively; six
7 hundred thousand dollars ($600,000). So you're going to
8 see a lot of volatility on a base that -- that that is
9 that small.
10 One ten (110) for '05, an improvement of
11 twenty (20) points, about a five point five (5.5) in the
12 non-grid pool for '06, an improvement of fifteen (15)
13 points. So, still on the wrong side of a hundred (100),
14 certainly in the non-grid pool, and -- but an improving
15 picture there and that is reflective, of course, of an
16 improving industry picture overall for private passenger
17 auto in Alberta.
18 In terms of the risks that the risk
19 sharing pools pose to the member companies in the
20 marketplace, and that's all the -- all the automobile
21 insurance companies, we would suggest that the -- the
22 difficulty of determining the overall financial
23 performance of the pools in advance increases the risk of
24 companies participating in the marketplace, and it
25 increases the risk associated with doing business in the

1 province. And we think that is of note or worth
2 consideration as you look at the overall profit level on
3 an industry-wide level.
4 As well, there is an additional level of
5 difficulty at the company level in determining how a
6 company's business that it cedes to the pool will perform
7 vis-a-vis the pool itself.
8 It's tough to predict how the pool's going
9 to perform. A company that chooses to use the pool has
10 to make some judgments about how their business will --
11 that they're ceding to the pool, will perform vis-a-vis
12 the overall pool.
13 So there's -- there's risks that are on an
14 industry-wide level and at a company level that are there
15 had we not -- did we not have risk sharing pools.
16 And so we've not tried to quantify that;
17 there's lots of mathematical people that can assist the
18 Board with that. What we're just trying to say, from a
19 subjective standpoint, there is an additional element of
20 risk in the marketplace caused by the existence of the
21 risk sharing pools, and to the extent that a return
22 should be commensurate with level of risk; now that's
23 something worth the Board's consideration.
24 Moving over to the residual market and as
25 I talked about, this is the -- what some people think of

1 as the farm or the traditional facility association that
2 we administer for non-private passenger vehicles that are
3 very tightly defined in regulation segment of private
4 passenger vehicles.
5 It exists, a guarantee that anybody
6 authorised to drive can buy insurance; that's our
7 statutory mandate. Insurance is provided at -- at rates
8 either approved by this Board or its predecessor and the
9 results are shared amongst all -- all companies based on
10 their market share in the province.
11 Not only are the -- the results of the
12 residual market activity, the bottom line results shared
13 by the member companies, but they must share other
14 amounts as well. We're simply an administrative office
15 that says, here's the residual market volume and company;
16 here's the amount of premium you have to book, here's the
17 losses you have to book, here's the expenses; Company B,
18 here's your share.
19 And when they get that information,
20 because we are not an insurer, they take that and they
21 book that into their own books as if it's their own
22 business acquired through their own efforts, and that
23 impacts them financially in the same way. They have to
24 pay the premium taxes, they have to pay the health
25 levies.

1 They also have to -- and because they have
2 to book that top line number, they have to book the
3 premiums on their own books. The solvency regulators
4 view that as their own premium and they have to maintain
5 capital to support those premiums. And that capital,
6 like all capital, of course, no one gives away money for
7 free, any -- you know, that I've ever heard about, that
8 has a cost.
9 And the cost of the capital that's
10 required to support residual market rates, and it is a
11 requirement of the solvency regulator, can be covered off
12 in two (2) ways.
13 1. It can be put in the residual market
14 rates or companies can include a loading in their own
15 rates through -- in their voluntary market rates to make
16 sure that they maintain enough capital to -- to cover off
17 the cost of the capital that they need to have to -- to
18 support those rates.
19 It's our belief that a cost of capital
20 provision should be included in the residual market for
21 two (2) main reasons.
22 1. The people that purchase insurance
23 through the residual market, a large number of them
24 commercial enterprises, should face the same cost
25 elements as somebody buying insurance in the voluntary

1 market. If they don't there is an implicit subsidy
2 there.
3 And from a marketplace standpoint, we all
4 want the residual market, I think, to be as small as
5 possible. My standing line that I inherited from my
6 predecessor is that I'm the only CO in Canada that wants
7 to shrink his marketshare and is doing a good job when
8 that happens. So we want to keep the marketplace small.
9 If our rates don't include a cost of
10 capital provision and our member companies' rates do on
11 their voluntary business, there is the very real risk
12 that the residual market rate is in competition with the
13 voluntary market rate and that's inappropriate. In
14 effect, our members are competing against themselves in
15 the marketplace. It's simply inconsistent with our roles
16 in marketplace of -- of -- of last resort.
17 And that's really what we had to say this
18 morning. Our written submission has a lot more detail
19 and it's -- we just would ask that the Board, and I know
20 you're going to hear it some companies, you may want to
21 ask them their views on these matters, but we just wanted
22 to come in and highlight the additional risk posed to
23 companies by their participation -- compulsory
24 participation in the residual markets.
25 And, to the extent that that generates a

1 higher level of risk for business activity in the
2 province, presumably to the extent the risk is
3 commensurate with return, that might drive the allowable
4 return -- or would likely drive the allowable return
5 higher than would otherwise be the case.
6 And that concludes our presentation.
7 Thank you, Mr. Chairman.
8 THE CHAIRPERSON: Thank you. Quite a
9 brief presentation in relation to the amount of paper you
10 gave us.
11 MR. DAVID SIMPSON: Well, we had some
12 informal dialogue with Board staff prior and I think
13 where we arrived at was that the written submission, of
14 course, should stand on its own in the context of this
15 Hearing.
16 THE CHAIRPERSON: Yeah, we appreciate
17 that. I was being facetious. But I appreciate that
18 because we have a lot of paper and we're going to take
19 some time to get through it all, in fact.
20 MR. DAVID SIMPSON: You didn't -- Mr.
21 Chairman --
22 THE CHAIRPERSON: Are there any questions
23 for clarification on this end? On this end?
24 Ted...?
25

1 QUESTIONS BY BOARD:
2 MR. TED ZUBULAKE: Just one (1) question.
3 Are you suggesting that the -- there is no profit
4 provision in the rates for the risk sharing pool or --
5 MR. DAVID SIMPSON: No, we're not.
6 MR. TED ZUBULAKE: -- or are you just
7 referring to the --
8 MR. DAVID SIMPSON: No, those --
9 MR. TED ZUBULAKE: -- the farm.
10 MR. DAVID SIMPSON: Just referring to the
11 farm, the traditional residual market.
12 MR. TED ZUBULAKE: Okay. And that's
13 relatively small in Alberta?
14 MR. DAVID SIMPSON: On the private
15 passenger side, certainly. Yeah, it is very small.
16 THE CHAIRPERSON: Anything further?
17 MS. MERLE TAYLOR: I know you haven't
18 given estimates, but for a company what percentage of
19 their business would be Facility Association? Like, is
20 there a range like --
21 MR. DAVID SIMPSON: In terms of --
22 MS. MERLE TAYLOR: Like ballpark --
23 MR. DAVID SIMPSON: -- this --
24 MS. MERLE TAYLOR: -- what -- what -- you
25 know, what, when you say that this market has an impact

1 on their profitability, I'm just trying to get a sense,
2 like, is this, like, 1 percent, 10 percent?
3 You know, what's -- what slice of their
4 whole business is ceded to the pool?
5 MR. DAVID SIMPSON: In terms of
6 individual companies, in terms of premium volume, last
7 year we were at 22 percent ceded to the risk sharing
8 pool. So it's -- it's a fairly big -- big amount and in
9 terms of the -- how that impacts our profitability
10 levels, the real answer is, I don't know.
11 MS. MERLE TAYLOR: Yeah --
12 MR. DAVID SIMPSON: But I would encourage
13 you to ask the companies as they're here over the next
14 day or two (2) to respond to that. The residual market
15 segment, because of its size, somewhat less of an impact
16 relative to their overall business.
17 MS. MERLE TAYLOR: Okay. Thank you.
18 THE CHAIRPERSON: Yes, Ted?
19 MR. TED ZUBULAKE: Just a little follow-
20 up question. You're stating that -- that the risk
21 sharing pools are losing money, the amount to be
22 determined -- the latest figures show some improvement,
23 still losing money though.
24 But would you not agree that, at least in
25 theory, the way the process works in Alberta through the

1 industry-wide adjustment that there should be enough
2 money in the entire system, if you will, to provide for
3 any losses suffered by the risk sharing pools?
4 MR. DAVID SIMPSON: To the -- I'm sorry
5 to say I'm not familiar with the detail in terms of the
6 overall rate adjustment process, but to the extent that
7 business that's ceded into the pool is -- is based on
8 premiums approved by the Board and -- you know, it's
9 priced on a direct basis --
10 MR. TED ZUBULAKE: Right. But --
11 MR. DAVID SIMPSON: -- then it has the
12 potential to be rated adequate. Whether it is or not, I
13 don't know.
14 MR. TED ZUBULAKE: Right. I mean, maybe
15 this -- the projections may be off this -- that -- but in
16 theory, if you will, the industry-wide adjustment
17 includes all business written in the province, including
18 the residual market business, both the losses incurred
19 and the premiums that are paid into the pools.
20 So, I would think, in theory, that
21 overall, while the pools may be losing money to be
22 determined, the system as a whole has enough money to
23 provide for any losses suffered by the pool?
24 MR. DAVID SIMPSON: Potentially that's
25 true.

1 MR. TED ZUBULAKE: Yeah. Okay.
2 MR. DAVID SIMPSON: And certainly at a
3 company level though it's a different game.
4 MR. TED ZUBULAKE: Right.
5 THE CHAIRPERSON: All right. If there is
6 no further questions then we'll thank you very much for
7 your presentation and look forward to hearing from you, I
8 guess, the next time in the next year when we do the
9 rates.
10 MR. DAVID SIMPSON: We'll be here. Thank
11 you, Mr. Chairman. I appreciate the --
12 THE CHAIRPERSON: We may hear from you in
13 the meantime and if we need further information I'm sure
14 we can contact you.
15 MR. DAVID SIMPSON: It would be our
16 pleasure.
17 THE CHAIRPERSON: Thank you very much.
18 MR. DAVID SIMPSON: Thank you.
19 THE CHAIRPERSON: Okay. We will take
20 five (5) minutes while we set up. Who is next?
21
22 (BRIEF PAUSE)
23
24 THE CHAIRPERSON: All right. So we're
25 all set.

1 THE CHAIRPERSON: Good morning, Dr.
2 Nielson.
3 DR. NORMA NIELSON: Good morning.
4 THE CHAIRPERSON: We're looking forward
5 to your presentation.
6 DR. NORMA NIELSON: Oh, I --
7 THE CHAIRPERSON: It was yours that had
8 all the formulae here that I accused them of having this
9 modern mathematics. It was yours.
10 DR. NORMA NIELSON: Tongue in cheek.
11 Tongue in cheek, I'm sure.
12 THE CHAIRPERSON: Yes, I think you saw
13 all the introductions, so I think we can just go ahead
14 with your presentation. We've been looking forward to
15 it.
16
17 PRESENTATION BY DR. NORMA NIELSON:
18 DR. NORMA NIELSON: That would be fine.
19 I am Dr. Norma Nielson. I'm a full professor in the
20 Haskayne School of Business, the University of Calgary,
21 and hold the chair in insurance and risk management,
22 coming up on -- jeez, this is my tenth year, folks, if
23 you can believe that.
24 The -- the work that -- that you're going
25 to see this morning was developed with -- with a lot of

1 help. My colleague at -- from Willford Laurier, Dr. Mary
2 Kelly, has certainly been instrumental in the
3 intellectual part of the -- of the process.
4 And David Chan, who is joining me here
5 this morning, is integral in making -- getting all the
6 numbers into the computer and getting some of the numbers
7 back out of the computer. So he and his computer are
8 both here as -- as backup and as a resource to answer any
9 questions you might have.
10 I was reflecting this morning on the fact
11 that I think this is literally the second anniversary,
12 like to the day, of some similar hearings in
13 Newfoundland, where it was the first time I was pulling
14 some of these concepts and -- and research approaches
15 together. And things have made some progress in that two
16 (2) year period but we don't have all the answers yet.
17 So that is a -- as a preface to the rest of my -- of my
18 proposal here.
19 As the previous presenters did, I'm going
20 to just, sort of, hit the highlights and make myself
21 available to answer any questions you might have, but I'm
22 not going to suffer you through the minutia of some of
23 the -- some of the methodology.
24 We -- Mary and I started out with an
25 overview of the Alberta market, because she's in Ontario,

1 for one thing, although she's pretty familiar with most
2 of Canada's auto insurance markets. We do use data
3 that's filed with OSFI and then purchased and resold and
4 reformatted through MSA Research.
5 So we had a total of sixty-six (66) firms
6 that we have in that MSA data that sell auto insurance in
7 Alberta, at least that had a positive premium. There's a
8 couple of anomalous numbers in that data set; companies
9 that are going out of business or transferring a block of
10 business to another firm and they really, I don't think,
11 contribute much to the analysis except confusion, so they
12 are -- they're not included in most of our stuff.
13 We started with looking at the top ten
14 (10) and, again, that was a way for us to prioritize if
15 we're going to be able to add a company and who would be
16 the most important ones to add in. And that's one of the
17 reasons you'll see, as we got further down, we added the
18 UK companies first because they were in the top ten (10)
19 and the Netherlands or Spain or Finland were not.
20 So, as we -- we went through that list of
21 top ten (10) which collective sell about two (2) out of
22 every three dollars ($3) worth of insurance in Alberta;
23 the other one-third of the market being taken up by the
24 other fifty-six (56) companies.
25 The Alberta market, forty-nine (49) of the

1 companies selling here are publicly traded; they're stock
2 companies in one (1) -- one (1) exchange or another
3 around the globe. We -- the work that we are able to do
4 and the methodology that we're using only works for those
5 forty-nine (49) companies. The other seventeen (17); the
6 ten (10) that are mutuals like Economical and State Farm,
7 and the seven (7) that are something else, Alberta Motor
8 Association and Lloyds is -- we can't include those in
9 some of our analysis.
10 To be honest, mutual companies,
11 historically probably don't have as good a handle on
12 their own cost of capital as the stock companies do. So
13 I don't think we're -- we're not doing something that
14 they are leaps and bounds ahead of the world on by
15 leaving them out, but it's just a matter of that -- not
16 being able to gather any data on what the market thinks
17 their firm would demand as cost of capital.
18 We looked at -- we found a great deal of
19 diversity in the Alberta market which I would think the
20 Board or the political entities charged with making sure
21 there's coverage available would be very pleased to see.
22 We saw companies from the very large to the very small;
23 companies very specialized in auto to very much
24 specialized in something else and doing a little bit of
25 auto, almost as a sideline.

1 We looked across Canada at the companies
2 and saw some geographically concentrated ones, some
3 geographically diverse ones. We get into fun things like
4 Herfindal Indexes which -- the numbers are in the -- in
5 the written testimony but, essentially, there's a -- what
6 you'll see across many of these dimensions that we
7 examined is that there is a great deal of diversity.
8 Different kinds of companies are here. People who want
9 to buy from a small company can do that. People who want
10 to buy from a specialty company can do that.
11 That, I think, is a signal -- we took that
12 as a signal of a healthy market, the fact that there was
13 this much diversity here. We looked at diversity, again,
14 the Herfindal Index, across lines of business, across
15 geographic spreads, those kinds of things.
16 We looked at loss ratios and, again,
17 you'll see the distribution. We even have a couple of
18 bell curves in here for you to show where the -- where
19 the companies fall in -- in a couple of those dimensions.
20 There's a -- we put in, for your
21 information, some data on customer satisfaction that the
22 Financial Services Commission of Ontario has developed.
23 Many of the companies writing in Alberta are also writing
24 in Ontario. They're the two (2) largest private markets
25 in the country so it makes perfect sense.

1 The companies tend to have the same
2 management and the same operational structures in place.
3 There's no glaring reason to believe that if a company's
4 customers are happy in Ontario they'll be grumpy in
5 Alberta or vice versa. So I think that should transfer
6 across provincial lines reasonably well.
7 Claims satisfaction ranged from 70 to 95
8 percent, an average of 86. Those -- it's a -- it's a
9 balance in terms of both designing a product and in your
10 -- in the charge that this Board has, helping design a
11 marketplace for insurance to keep all of those things
12 working. You don't want low prices and terrible claims
13 service, so you have to -- I don't -- I think I said
14 last year, I don't envy you that job.
15 But the -- the focus of most of the work
16 that's been done at the Risk Study Centre of the
17 University of Calgary has been -- in the last two (2)
18 years has been to develop the funding for and then the
19 data and the analysis to go along with understanding
20 better the role of capital and the cost of capital in an
21 insurance market.
22 As you know, most of the companies selling
23 in Alberta are Federally regulated companies that receive
24 their solvency oversight from the Office of the
25 Superintendent of Financial Institutions, a Federal

1 entity.
2 Most -- some of them, the minimum capital
3 test, the MCT, is the benchmark that the regulator looks
4 at for them. Others are set up as branch offices in
5 Canada and they have a separate but comparable type of
6 ratio that's -- that's examined for those.
7 The minimum acceptable ratio -- so
8 there's, again, the mathematics have become more
9 sophisticated. I believe the MCT came in in 2002 or
10 2003; in just the last few years.
11 The regulator gives you a number that's
12 minimum. You have to have 150 percent of that minimum,
13 which, kind of, sounds like a minimum. But the
14 terminology can be a little confusing. But most
15 companies wouldn't dream of running at the hundred and
16 fifty (150). They tend to run between a hundred and
17 seventy (170) and two ten (210), is the target they've
18 told OSFI they're -- they're aiming to maintain.
19 So the capital is not only desirable in
20 this industry, it's mandated by, not always a provincial
21 body of government, but in many cases the Federal
22 Government. Again, some companies are provincially
23 regulated, some are Federally regulated.
24 The markets say risk require -- greater
25 risk requires greater return and that's, again, the focus

1 of what we're talking about here today. The market moves
2 up, the market moves down. The standard analysis that's
3 done in financial markets is a beta. It's -- comes
4 straight out of regression formulas a long, long, long
5 time ago when these things were new.
6 But a beta of one (1) means that's what
7 the whole market does. If you have -- if a company has a
8 beta of one (1) it moves up when the market up and it
9 moves down when the market moves down, and it moves in
10 exactly the right -- the same speed in exactly the same
11 amount.
12 So we -- one of the things you do to
13 examine the riskiness of an industry or of a company is
14 to look at the beta and see how it moves with the market
15 or not. And there's a few -- there are a few examples
16 here on page 9 of the written filings.
17 The Bank of Nova Scotia is a point two
18 eight (.28), it's much less. It moves with -- up when
19 the market moves up and down when the market moves down
20 but not nearly as much; only about a quarter as much of
21 the move.
22 Maple Leaf Foods was similarly low.
23 Rogers Communication has a beta of just
24 over one (1). So it tends to move up with the market but
25 a little more, and move down with the market but a little

1 more.
2 Nortel is a three point six (3.6). It
3 moves a lot more than the market.
4 So those -- that's just a measure that has
5 been developed and is used in the financial and economics
6 academic communities for twenty (20) or thirty (30) years
7 now, pretty regularly.
8 As we look at the beta of the insurance
9 companies, we generally find they're in the point
10 eight/point nine (.8/.9) range; a little below the
11 market, but well above that big bank I cited a moment
12 ago. So that's consistent with the literature that comes
13 at us from out of the US, from around the world; that's
14 generally the market we're in. Not nearly as risky as
15 Nortel but it's riskier than being a bank in Canada.
16 So that, again, the beta statistics and a
17 bit of the distribution where the Company -- I think
18 that's what the bell curve is. Figure 2, which is on
19 page 14 shows, a frequency distribution for the beta of
20 insurance companies writing auto. They're at the back.
21 And you'll see them clustered right around
22 the point eight/point nine (.8/.9) range. But some are
23 very low, likely the big Canadian banks that also sell
24 insurance, if I might speculate, and one (1) or two (2)
25 of them are considerably higher.

1 So this is just a -- a distribution of the
2 risk that the companies writing insurance in Canada face
3 when they face the investors in the capital market. I
4 like that chart. Okay.
5 So when I was here last year, in a classy
6 northeast hotel room, as I recall, the -- we were
7 presenting primarily research coming out of the US. I've
8 summarized that for you on page 10.
9 The Cummins & Phillips work that I was
10 citing was based in the US. It's based on data up to the
11 year 2000. I -- we've come a long way in one (1) year
12 because, not only are we talking about that work, you
13 have one of the authors of that work meeting -- is coming
14 to speak with you later this afternoon. I believe
15 Richard Phillips is in -- is among the people who will be
16 seeing you later this afternoon.
17 So I would encourage you, if you have any
18 questions -- nagging questions that have been bothering
19 you since this time last year that take the opportunity
20 to ask Dr. Phillips those questions this afternoon.
21 The -- the bottom line of those results,
22 the equally weighted CAPM cost of capital in that study,
23 again US based, the year 2000, was about twelve point six
24 (12.6). The value weighted -- so the equal weighted is
25 counting a little company the same as a big company. The

1 value weighted is counting the big companies more. It's
2 more market share weighted than number weighted. It goes
3 down a little bit because size matters.
4 The bigger companies sometimes can -- can
5 get their capital a little cheaper than -- so we came up
6 with a CAPM estimate of ten (10). But the work coming
7 out of the US showed that two (2) other factors were --
8 were very, very important and employed a relatively new
9 methodology, the Fama/French three (3) factor method, to
10 estimate what the size factor was in the market and as
11 well as what some of the author's was calling financial
12 distress model, which I think is -- sometimes adds more -
13 - that naming sometimes, I think, adds more confusion to
14 the discussion than it adds clarification.
15 But at any rate, we came up with costs of
16 capital during that timeframe in the US that were, again,
17 between 17 1/2 and about 20 1/2 percent based on those
18 additional factors being included.
19 I remember vividly one of the commissions,
20 two (2) years ago in Newfoundland, saying, Well, that's
21 all very well and good but we really need it for Canada.
22 And I -- I said to her, Well, that will take two (2)
23 years and fifty thousand dollars ($50,000), and we'd love
24 to do that for you. Well, as it turns out we -- we've
25 had our two (2) years, but we haven't had the fifty

1 thousand dollars ($50,000) for two (2) years. But we
2 have gotten a grant to do that kind of work. It helps --
3 helps David make his computer run.
4 And that's what we're here to tell you a
5 little bit about this morning. We did get the 2005 data,
6 so we have Canadian data up through the year 2005. The
7 2005 data was released in late May --
8 MR. DAVID CHAN: Yes.
9 DR. NORMA NIELSON: -- early June. So
10 we've had June, July, August, September -- yeah, four (4)
11 months, maybe, to try and pull some of these things
12 together.
13 We are -- we were, by October 20th, in the
14 written submission, able to pull together data on fifty-
15 three (53) publicly traded companies that operate in
16 Canada and are in the MSA data set -- excuse me, fifty-
17 three (53) groups. That includes a hundred and fourteen
18 (114) insurance companies because some companies they
19 bought -- bought another firm and not changed its name or
20 they have a different incorporated entity operating in a
21 different province for -- for other reasons.
22 So a hundred and fourteen (114) insurance
23 companies, fifty-three (53) groups.
24 What we've been able to include so far are
25 the ones traded on the Toronto Stock Exchange, the New

1 York Stock Exchange, the NASDAQ and the London Stock
2 Exchange. Again, we really -- the big crunch we made for
3 October 20th was to get London in so we could have AVIVA,
4 the last of the top ten (10) companies in our group.
5 So about forty (40) of the insurance
6 companies in this sample sell insurance in Alberta to the
7 tune of about $1.3 billion in 2005. We didn't give you
8 ten (10) years worth of history there. We figured just
9 so -- you're in the market today, that the data from
10 today would be good enough.
11 But we have gathered data from 1991
12 through 2005, so two (2) to three (3) times the length of
13 the period in the Cummins & Phillips study. At this
14 point we were analysing a hundred and five thousand
15 (105,000) data points; daily stock price changes, that
16 sort of thing.
17 We did compute a traditional CAPM to make
18 sure the model wasn't giving us wonky results and we came
19 up with a beta of point eight two (.82) and that lovely
20 chart in Figure 2.
21 So, this is not the end of our work, but I
22 want to thank the Board for letting -- letting us, at
23 least, have a little more time to be able to present some
24 of the work to you this morning.
25 We have, on page 12, the P&C insurance

1 groups; there are fifty-three (53) of them. And if we do
2 the same type of analysis for those companies that are
3 doing business in Canada that cover the period through
4 2005, a CAPM type of cost of capital historical is about
5 ten point six (10.6). If you look at the thirty-seven
6 (37) companies, and I'm sorry I've got a little bit of a
7 typo there, it's not thirty-eight (38) but I'm sure it
8 would have -- it makes it much harder to read, about ten
9 point four five (10.45).
10 So only about fifteen (15) basis points in
11 the Canadian sample when you take out companies that
12 don't write auto insurance at all. And it does take out
13 quite a few companies but it doesn't change the cost of
14 capital.
15 In part that's because auto's a big --
16 such a big chunk of the Canadian market. It's going to -
17 - it's going to weigh heavily on the industry average, so
18 -- so you can't -- as long as you're keeping a big chunk
19 of it it's not going to move very much.
20 We were able, this week, to do a value
21 weighted -- like, is about 1 percentage point higher than
22 that, eleven point five, two (11.52). The Fama/French 3-
23 Factor, what we were able to add in at this point we
24 haven't -- we haven't got the data sufficiently cleaned
25 and -- and working to add the Canadian factors.

1 But if we -- so if we take -- of the three
2 (3) factors, we Canadianize the first one and keep the
3 other two (2) the way they showed up in the US study.
4 There -- my instinct tells me that one of those will be a
5 little higher and one will be a little lower so that the
6 net won't be too far off in the end in Canada. We end up
7 with a sixteen point five (16.5), sixteen point six
8 (16.6) value weighted of seventeen point seven (17.7).
9 In the 16/17 percent range is what the companies have
10 been paying investors in the market historically.
11 Now, that said, that's not your job, is to
12 look backwards. Your job is to try and look forward.
13 One size does not fit all. The big company and the
14 little company, the company that specializes and the one
15 that doesn't, those diversity measures that are good from
16 the consumers' availability point of view often have
17 different costs. They're different elements of risk in
18 running those companies.
19 Even a company that's in all the same
20 markets is going to make different decisions about how it
21 finances its operations, about how much capital it
22 carries, about how it invests its assets in the time it
23 holds them between when premiums come in and claims go
24 out. All of those things affect the company's overall
25 risk. We don't have a monopoly situation here and I

1 think in Alberta we probably don't want one.
2 So what we did -- what I did to recognize
3 that what we're doing may be useful to you but is not the
4 same thing as you may need, I took that distribution of
5 the cost of capital that we've seen historically, I
6 chopped off both 5 percent tails, and the 90 percent
7 range was from fourteen point three (14.3) to eighteen
8 point two, six (18.26) using the Canadian cost of capital
9 with the two (2) adjustments from the US, chopping off
10 the tails.
11 So that's, again, how far we've been able
12 to get with only a hundred thousand (100,000) data
13 points. We probably need to get up to about five hundred
14 thousand (500,000) data points before we're done here
15 with this whole project and get the other twenty (20)
16 some companies included -- from eight (8) countries?
17 MR. DAVID CHAN: Ten (10).
18 DR. NORMA NIELSON: Ten (10) other
19 countries and stock exchanges and interest rate markets
20 and things like that.
21 So it's a big project. The -- the two (2)
22 years and fifty thousand dollars ($50,000) that I pulled
23 off the top of my head was extremely close; that's about
24 how much and what it's going to take in terms of time and
25 money.

1 And we hope to have that completed -- more
2 complete by next year, but we are able to give you data
3 that includes only Canadian companies and data that
4 includes up to the year 2005. So that's what we're able
5 to contribute, I think, this morning to help you with
6 your difficult task.
7 I'm delighted to answer any questions you
8 might have.
9 THE CHAIRPERSON: Thank you, Dr. Nielson.
10 The only thing that I noted that I dispute with you is
11 the people in -- in Ontario aren't as happy as people in
12 Alberta or vice versa, and I think Alberta's happier.
13 DR. NORMA NIELSON: Oh, okay. They're --
14 they're happier with their claims handling.
15 THE CHAIRPERSON: I think they're happier
16 just living here.
17 DR. NORMA NIELSON: Yeah, okay. I -- I
18 have no -- no indications that there's a statistically
19 significant difference.
20 THE CHAIRPERSON: Questions on this end
21 of the table? Yes, Bill?
22
23 QUESTIONS BY BOARD:
24 MR. BILL MOORE: Dr. Nielson, the -- I
25 think Figure 2 deals with the -- the frequency

1 distribution of the risk measure, the beta, and I presume
2 those are -- those are the averages over fifteen (15)
3 years or --
4 DR. NORMA NIELSON: Yes.
5 MR. BILL MOORE: -- each of the
6 companies?
7 How stable are those beta measures within
8 any one (1) company?
9 Is there -- is a company consistently
10 higher risk or lower risk or is it pretty much a -- of a
11 random variable over the fifteen (15) years? I guess
12 the --
13 DR. NORMA NIELSON: That is a fabulous
14 question.
15 MR. BILL MOORE: Okay. All right. I
16 think probably the graph answers the question. But --
17 but I think from the point of view of what the Board
18 does, the question really is: Does a -- does a
19 particular company consistently need a higher cost of
20 capital or must it reflect that higher cost?
21 DR. NORMA NIELSEN: Well, the -- the
22 actual cost of capital in the market are everywhere from
23 -- over the fifteen (15) year period, not the betas but
24 the cost of capital; that happens to be a listing I
25 looked at yesterday --

1 MR. BILL MOORE: Hmm hmm.
2 DR. NORMA NEILSON: -- across the years
3 go from negative something to plus thirty (30), the --
4 the cost of capital, the return in the market, anybody
5 who has investments knows -- knows that there are good
6 years and bad years, the -- they are all over the map and
7 this is an average of those across years.
8 I would estimate that the big company
9 that's fairly well diversified is -- is going to be
10 pretty stable.
11 The small company that was heavily exposed
12 to last year's floods in Calgary may have had a really
13 bad year.
14 So they're going -- the smaller companies
15 are going to be less stable than the big companies. The
16 more diversified companies are going to be more stable
17 than the less diversified companies.
18 But the -- the literature over the years,
19 the point eight (.8), point nine (.9), is what always
20 shows up. So I would say for the industry, it's
21 reasonably stable. For an individual company -- you
22 know, Nortel was stable at one point.
23 So, it's a -- that's a -- that's a guru
24 question.
25 MR. BILL MOORE: I think the last couple

1 of days and --
2 DR. NORMA NIELSON: Income trusts, yes.
3 MR. BILL MOORE: -- exactly. So as -- as
4 -- as the Board looks forward and -- and we -- we have
5 legislation that currently, I believe, where we have put
6 a cost of capital in that's the same for every company,
7 the range that you have suggested in the last page of
8 your paper, is that really telling us that as we look
9 forward, some companies need a higher cost of capital
10 provision than others?
11 DR. NORMA NIELSON: Certainly some do.
12 And -- and I think the Facility Association, the ones
13 that need to make more allowance for losing money to the
14 Facility Association would be one (1) example.
15 The -- the difference between the -- the
16 historical cost of capital that we've come up with,
17 looking back, and the target cost of capital that this
18 Board has to come up with, looking forward, they're
19 different animals.
20 The -- the year that the companies may --
21 that a company made 16 percent, the target might have
22 been 18. People, companies, don't hit targets exactly.
23 You tend to come in a little under your target more often
24 than you come in a little over your target. So, because
25 floods happen, you know, because of the nature of the

1 business.
2 So, the cost of capital in my mind, it's a
3 conservative thing to estimate a little high on the
4 target, knowing that it's human nature and sort of Mother
5 Nature to fall short of that target, and -- and then
6 you're probably going to be close enough that the market
7 will understand why you missed your target.
8 The companies are free to set lower
9 targets than the ones put in the -- the grid or the
10 maximum rates. If they have access to cheaper capital,
11 that will make them more competitive in the market place.
12 That's -- that's some -- that's a dynamic that I would
13 expect the Board would want to function.
14 So, to the extent that you've set a higher
15 target, you're saying competition will sort out some of
16 these things more; to the extent you set a lower target,
17 you're just sort of keeping competition from working at
18 the mar -- at a bigger margin. That it's -- they're --
19 everybody's rates are not going to go up if this target
20 rate goes up. The markets are competitive.
21 80-something percent of the people are not
22 on the grid and their rates are not set based on what the
23 Board decides.
24 So, a higher target cost of capital is a
25 way of sort of moving toward competition and encouraging

1 competition; a lower cost of cap -- a lower target cost,
2 looking forward, is a way of sort of impeding
3 competition, if you want to look at it that way.
4 But it's the diff -- it's an important
5 difference between the historical cost of capital and the
6 target cost.
7 THE CHAIRPERSON: Thank you. Ted -- or,
8 sorry, you have a question?
9 MS. MERLE TAYLOR: Yeah, I had a
10 question.
11 MR. TED ZUBULAKE: I'm last, so go ahead.
12 MS. MERLE TAYLOR: Okay.
13 THE CHAIRPERSON: That's not, Ted.
14 MS. MERLE TAYLOR: Okay. Dr. Nielson, as
15 I'm sure you're aware, Dr. Calliman presented to the New
16 Brunswick Board last year and his recommended --
17 DR. NORMA NIELSON: Yes, we had the
18 pleasure of being in the same room in Newfoundland, so.
19 MS. MERLE TAYLOR: Newfoundland, too,
20 okay. Out there, out east somewhere.
21 DR. NORMA NIELSON: Yeah.
22 MS. MERLE TAYLOR: Can you kind of
23 describe -- like, his methodology came up with a -- a
24 much lower target return on equity than -- than your
25 analysis.

1 Can you critique his approach or give us
2 some kind of insight as to what different assumptions you
3 used.
4 DR. NORMA NIELSON: I don't remember his
5 approach so well as I remember his criticisms of my
6 approach.
7 MS. MERLE TAYLOR: So it --
8 DR. NORMA NIELSON: He was coaching
9 counsel from the sidelines. The -- he -- I -- he was
10 saying things, I must confess, I never thought I would
11 hear a finance professor say.
12 He was commenting that regression was
13 really an untried and untested technology. And, I mean,
14 everybody taking a medication in the room is basing that
15 on regression analysis and statistical significance and
16 things like that, because that's how the drug got
17 approved in the first place.
18 The -- he was criticising the authors of
19 the Cummins & Phillips paper which has now been
20 published. It was -- it was a forthcoming article. It
21 was just accepted for publication when I was doing this
22 first event two (2) years ago.
23 It was published in 2005 in the Journal of
24 Risk in Insurance, which is a peer-reviewed, highly
25 respected academic journal. It was -- received an award

1 in the August 2006 meeting of the association that
2 publishes that journal, presented by the Casualty
3 Actuarial Society as the single most important
4 contribution of the year in insurance research to the --
5 the field of casualty actuarial science.
6 So, I -- I found almost all of his
7 critiques and criticisms to be red herrings, frankly.
8 MS. MERLE TAYLOR: Okay. But at the same
9 time, he did come up with different numbers.
10 DR. NORMA NIELSON: I don't recall his
11 methodology --
12 MS. MERLE TAYLOR: Okay.
13 DR. NORMA NIELSON: -- quite as well.
14 MS. MERLE TAYLOR: Okay, thanks.
15 DR. NORMA NIELSON: I remember vividly
16 the conversation we had on cross-examination. I don't
17 remember exact -- how he came up with those numbers.
18 MS. MERLE TAYLOR: Fair enough.
19 DR. NORMA NIELSON: They were, I guess,
20 one kind of thing you could say was, old school.
21 THE CHAIRPERSON: Thank you. Ted...?
22 MR. TED ZUBULAKE: Yes. I just have a
23 few questions. Dr. Nielson, first just to clarify, the
24 range of 14.31 percent to 18.26 percent, as a going forth
25 target plus the capital, that would be an after -- after

1 tax or...?
2
3 (BRIEF PAUSE)
4
5 DR. NORMA NIELSON: I don't think so.
6 MR. TED ZUBULAKE: Maybe you could check
7 that out.
8 DR. NORMA NIELSON: Yeah. I --
9 MR. TED ZUBULAKE: I would think it is.
10 I think that --
11 DR. NORMA NIELSON: Okay.
12 MR. TED ZUBULAKE: I'm a little bit
13 confused. Your table on page 12 which shows the -- the
14 results of your analysis using the Canadian data, fort
15 the -- at least one (1) of the three (3) factors.
16 I believe you describe this as the
17 historical cost of capital over that period, 1991 to
18 2005.
19 DR. NORMA NIELSON: That's correct.
20 MR. TED ZUBULAKE: A couple of questions.
21 Then these are not -- you're not saying that this is -- I
22 guess -- let me ask this: What is the difference between
23 a cost of capital and a --
24 DR. NORMA NIELSON: Cost of --
25 MR. TED ZUBULAKE: -- return on equity?

1 DR. NORMA NIELSON: This is a cost of
2 equity capital.
3 MR. TED ZUBULAKE: Cost of equity capital
4 versus -- how is that different from any return on
5 equity?
6 DR. NORMA NIELSON: Historically, they're
7 the same. I mean, a historical cost of capital and
8 return on equity --
9 MR. TED ZUBULAKE: Okay, so --
10 DR. NORMA NIELSON: -- historical --
11 return on equity and a cost of equity would be the same.
12 MR. TED ZUBULAKE: Okay, so this is where
13 I get a little confused.
14 Are you saying that these numbers on page
15 12 are the return on equity achieved by these P&C
16 Insurance groups over that 1991 to 2005 period?
17 And, if so, why are they -- why would --
18 to me, return equity, there's only one (1) number, how
19 could we have your range of return on equities --
20 DR. NORMA NIELSON: Well, if you're --
21 well, no, there are -- certainly is more than one (1)
22 number, because if you -- if you had the number -- you
23 have one (1) number for each company, but how you combine
24 fifty-three (53) or thirty-seven (37) --
25 MR. TED ZUBULAKE: I'm sorry, I meant why

1 there's a different number under the cap-end versus the -
2 - the FF-3F method?
3 DR. NORMA NIELSON: No, we're --
4 MR. TED ZUBULAKE: I guess I --
5 DR. NORMA NIELSON: -- trying to -- we're
6 trying -- what we're trying to do is model the cost of
7 equity that the markets required, and you try to
8 calibrate it to the market but it's not exactly the
9 market.
10 MR. TED ZUBULAKE: I could understand you
11 saying that based on the -- this period of time, looking
12 back, this is what the cost of capital needs of the
13 company -- of the P&C companies should have been or
14 were. But I don't think these are --
15 DR. NORMA NIELSON: Ten (10 --
16 MR. TED ZUBULAKE: -- the returns of
17 equities that the companies dispute --
18 DR. NORMA NIELSON: Ten (10) -- ten (10)
19 -- ten point six (10.6), ten point four five (10.45),
20 those are the returns that the market would have given
21 them based on the risk of the companies involved.
22 MR. TED ZUBULAKE: Okay. So -- but it's
23 not their actual --
24 DR. NORMA NIELSON: We're calibrating the
25 model as opposed to --

1 MR. TED ZUBULAKE: Okay.
2 DR. NORMA NIELSON: -- providing you with
3 actual. The companies in the IBC themselves are better
4 able to tell you actual.
5 MR. TED ZUBULAKE: Okay, that I
6 understand. And --
7 DR. NORMA NIELSON: So we're trying to --
8 we're trying to tease out what the market's rewarding
9 them for and what the market is penalizing them for.
10 MR. TED ZUBULAKE: Right.
11 DR. NORMA NIELSON: And the ten point
12 five (10.5), plus or minus, is what the market's
13 rewarding them for taking the risk of being in the auto -
14 - or in the insurance business.
15 MR. TED ZUBULAKE: Okay. So this -- this
16 performance over this period of time, this is what the
17 market would have asked --
18 DR. NORMA NIELSON: Would have said they
19 deserved.
20 MR. TED ZUBULAKE: Said they deserved,
21 okay.
22 DR. NORMA NIELSON: Okay. Is that
23 better?
24 MR. TED ZUBULAKE: That's better.
25 DR. NORMA NIELSON: Yeah, okay.

1 MR. TED ZUBULAKE: Now --
2 DR. NORMA NIELSON: Simplifying sometimes
3 has its --
4 MR. TED ZUBULAKE: Okay.
5 DR. NORMA NIELSON: -- has its risks,
6 too.
7 MR. TED ZUBULAKE: That -- given that,
8 and I know you went back to 1991, but I think if you go
9 back even further in time, the insurance industry, the
10 P&C insurance industry, does not -- has not achieved
11 anything close to an average of 14 to 18 percent return
12 on equity; closer to 8, 9, 10 percent, I believe. I'm
13 sure the IBC will have the actual numbers.
14 But why would it be that the markets are
15 not achieving the targets that you say can go to --
16 markets, okay they should be --
17 DR. NORMA NIELSON: Again, it's the
18 difference between make -- setting target and hitting a
19 target are two (2) different things.
20 MR. TED ZUBULAKE: But they're so far off
21 the target. They're -- they have eight (8) points off
22 the target; eight nine (8/9) points off the target.
23 DR. NORMA NIELSON: Well, I must confess
24 that a number of people sometimes have scratched their
25 head about that; why companies even stay in this business

1 if they can't --
2 MR. TED ZUBULAKE: But they are staying
3 in this business.
4 DR. NORMA NIELSON: -- make a better
5 return.
6 MR. TED ZUBULAKE: So if they stay in the
7 business and returns are much less than the targets
8 you're recommending here, doesn't that say something
9 that, maybe they don't need 14 to 18 percent, or has
10 something changed that caused them now to need 14 to 18
11 percent whereas before ten (10) was fine.
12 DR. NORMA NIELSON: Well, one of the
13 things that definitely has changed is the international
14 nature of Canadian's insurance -- Canada's insurance
15 markets.
16 So, this is the two-thirds (2/3's) of the
17 companies that are operating in Canada --
18 MR. TED ZUBULAKE: Right.
19 DR. NORMA NIELSON: -- that are traded in
20 Canada, US, and UK.
21 The -- there's another one-third (1/3) of
22 the market that has parent companies in France and Spain
23 and Switzerland and Italy and Germany and Japan, and on
24 ad infinitum.
25 One of the things that has changed over

1 the time that we're talking about here is the increasing
2 movement of those multi-national companies into Canada,
3 and until we get the other twenty (20) some companies
4 into our sample, we won't know if that moves this up or
5 down.
6 My guess is it will move it. The fact
7 that one of the things that has changed in the real world
8 is the internationalization, the globalization of
9 Canada's insurance market, and so that one of the reasons
10 this number may be off is that it does not yet include
11 those global companies. And those are big players --
12 MR. TED ZUBULAKE: So you say that they--
13 DR. NORMA NIELSON: -- that make come --
14 it may push it back down some more.
15 MR. TED ZUBULAKE: So, it may be the case
16 that we have a ten (10) percent made, then -- fine and
17 sufficient return for companies over the last ten (10)
18 years, but going forward, because of the changes you've
19 just discussed, that just isn't good enough.
20 DR. NORMA NIELSON: Well, it may be that
21 the 10 percent is sufficient for companies that are
22 traded on the TSX. But it may not be sufficient to get
23 companies from other countries to come and to stay in the
24 market.
25 MR. TED ZUBULAKE: Now -- yes --

1 DR. NORMA NIELSON: I -- I -- so again,
2 the -- we're looking at partial results here and --
3 MR. TED ZUBULAKE: Yes.
4 DR. NORMA NIELSON: -- and part -- and so
5 I can't tell you how this is going to change.
6 I can tell you that the market has changed
7 in the last fifteen (15) years, we have far more multi-
8 national companies in it, and that could move this number
9 up or -- it will move it up or down. It could move it
10 down to the -- to the range that you're suggesting is --
11 is closer to what's being observed in the market.
12 MR. TED ZUBULAKE: The betas that you've
13 discussed that are the, kind of the -- both the CAP "M"
14 and the FF-3F methods --
15 DR. NORMA NIELSON: The CAP "M" is one 1)
16 of the three (3) factors --
17 MR. TED ZUBULAKE: Oh, one (1) of the --
18 okay.
19 DR. NORMA NIELSON: -- in the three (3)
20 facts, so they're not --
21 MR. TED ZUBULAKE: All right.
22 DR. NORMA NIELSON: -- it's one (1) step
23 along the way, and there's two (2) more after that. It's
24 not that they're completely separate --
25 MR. TED ZUBULAKE: And --

1 DR. NORMA NIELSON: -- approaches, that -
2 - I'm not saying this for you, I'm saying it for the non-
3 actuaries on that --
4 MR. TED ZUBULAKE: No you're --
5 DR. NORMA NIELSON: -- side of the table.
6 MR. TED ZUBULAKE: -- saying it for me,
7 too, I believe.
8 But the -- but the beta, you found, was
9 about point eight (.8) for the insurance --
10 DR. NORMA NIELSON: That's an unweighted
11 average, yes.
12 MR. TED ZUBULAKE: Unweighted average,
13 right.
14 Now what -- first of all, how is that --
15 that's a measure of the volatility of the stock prices of
16 these P&C, or these insurance groups, versus the -- the
17 market stock prices?
18 DR. NORMA NIELSON: Yes.
19 MR. TED ZUBULAKE: Okay. And the point
20 eight (.8) means what; that it's better than average,
21 less risky than average or --
22 MR. DAVID CHAN: Less risky than the
23 market. The market is always one (1).
24 DR. NORMA NIELSON: So it -- it moves up
25 with the market -- it's a positive number so it means

1 when the market goes up the insurance stocks go up. When
2 the market goes down insurance stocks go down. But they
3 tend to only go up 80 percent as much.
4 MR. TED ZUBULAKE: Right.
5 DR. NORMA NIELSON: If -- if the market
6 goes up ten (10) points -- 10 percent the insurance stock
7 will probably only go up eight (8). But it doesn't go up
8 quite as fast, it doesn't go down quite as fast, but it
9 generally goes up and down with the market.
10 MR. TED ZUBULAKE: But -- but we're using
11 that -- that measurement as a -- as a measure of risk, I
12 guess, and so are we saying -- are we saying that --
13 DR. NORMA NIELSON: One (1) -- one (1)
14 dimension of risk; the -- the riskiness of investing in
15 this -- this particular venture versus an oil sands
16 versus a healthcare company.
17 MR. TED ZUBULAKE: So -- but does the
18 point eight (.8) mean -- call it point eight (.8), that
19 overall the -- the insurance industry, the companies in
20 this study, are less risky than the market -- than the --
21 DR. NORMA NIELSON: They're a little less
22 volatile than the market.
23 MR. TED ZUBULAKE: And how do cycles come
24 into play because I've got to believe that insurance
25 stock prices vary widely with -- with the cycles --

1 insurance cycles.
2 DR. NORMA NIELSON: The underwriting
3 cycles.
4 MR. TED ZUBULAKE: Underwriting cycles.
5 How -- how is that considered in this analysis?
6 DR. NORMA NIELSON: To the extent there
7 have been cycles since 1991 they're in the data.
8 MR. TED ZUBULAKE: Well, have you looked
9 at your -- that -- that data -- the range that you looked
10 at to see what's -- how many cycles were included in that
11 period, if any at all?
12 DR. NORMA NIELSON: There was a small
13 down-cycle in the '90s and there was a big whopping one
14 in 2001 after 9/11. So there should be some pretty good
15 representation of up and down cycles in the market in
16 that -- in that data period.
17 MR. TED ZUBULAKE: All right. So that's
18 why you -- why you hadn't picked that particular period,
19 '91 to 2005. But did you consider --
20 DR. NORMA NIELSON: We would -- we would
21 take more if it were available; that's as much data as we
22 can buy.
23 MR. TED ZUBULAKE: All right. I was just
24 wondering if --
25 DR. NORMA NIELSON: I mean that -- I

1 mean, is very pragmatic that -- who -- who was saying we
2 go the pragmatic approach. It's a very pragmatic reason;
3 we can't buy any more than that. We'd have to go look up
4 two thousand (2,000) stats to add --
5 MR. TED ZUBULAKE: No, I understood. But
6 my question is to the extent there were partial cycles,
7 big cycles in that period, the analysis may be biassed,
8 distorted somewhat because of this --
9 DR. NORMA NIELSON: Well, one of the --
10 one of the reasons I thought it was important to do this,
11 the Cummins & Phillips study ended at the year 2000 and
12 2001 was a very important year for the insurance
13 business. So having -- having that extra five (5) years
14 of data that included the World Trade Centre, the 9/11,
15 the reinsurance crunch, the terrorism exclusions and,
16 sort of, bouncing back from that I thought was very
17 important.
18 I was reassured, frankly, to find that our
19 numbers -- their numbers from the US, ending in 2000,
20 were twelve point six (12.6) and about ten point five
21 (10.5), they're in the same ballpark; they're not very
22 far -- they didn't move a lot.
23 It was -- and to the extent they did move
24 they -- it was very logical to me. They moved down a
25 little bit because we've added years when interest rates

1 were lower. They should move down with the -- as risk
2 free interest rates are down, those rates should go down
3 and they did. So I'm very comfortable with those kinds
4 of results.
5 MR. TED ZUBULAKE: Now, your
6 recommendation of the range of 14 to 18 percent, you just
7 touched on this now, would that be your recommendation
8 for the next year, or are these numbers that have to
9 change each and every year as the -- as interest rates
10 change and how do these relate to the risk change --
11 DR. NORMA NIELSON: They would move up
12 and down with interest rates. As interest rates are
13 moving up that would push these numbers up.
14 MR. TED ZUBULAKE: So what kind of -- is
15 there a formula that you could recommend to the Board to
16 -- to work with going forward, as opposed to having to re
17 -- re-analyse profit -- you know, appropriate returns
18 each and every year?
19 Is there a way the Board can --
20 DR. NORMA NIELSON: Of...?
21 MR. TED ZUBULAKE: Is there relationship
22 between the risk free rate and what you're recommending?
23 DR. NORMA NIELSON: The risk free --
24 there is and there isn't, okay? It's the risk free rate
25 plus the beta times the market's equity premium.

1 MR. TED ZUBULAKE: Right.
2 DR. NORMA NIELSON: As -- as investors
3 love and hate the market, that equity premium -- how much
4 you have to pay me to get a -- take a bigger risk changes
5 with, sort of, the psychology of the market. So, yes and
6 no.
7 I would say in terms of if you wanted to
8 look forward one (1) to two (2) years, I know you have a
9 gentleman from TD Waterhouse scheduled sometime over the
10 next couple of days, they should have a very good handle
11 on the yield curve and whether -- what it indicates rates
12 are -- interest rates might be a year or two from now, so
13 there probably is a way to adapt.
14 I don't know what some of the other
15 analysts are doing but we have a spent -- essentially a
16 spot price for you --
17 MR. TED ZUBULAKE: Yes.
18 DR. NORMA NIELSON: -- and how to turn
19 that spot price into a -- a price that'll make sense one
20 (1) year from now which, on average, is the middle of
21 your two (2) year timeframe or something like that.
22 I would ask the gentleman from TD
23 Waterhouse what the yield curve looks like a year out
24 from now because I've --
25 MR. TED ZUBULAKE: But what --

1 DR. NORMA NIELSON: -- been busy with
2 other stuff.
3 MR. TED ZUBULAKE: And one (1) final
4 question. In the front of our binder there is an
5 Appendix A which -- which deals with, sort of, the pros
6 and cons of the CAPM pricing model; is this part of your
7 presentation?
8 DR. NORMA NIELSON: No, it's not.
9 MR. TED ZUBULAKE: Oh, it's not.
10 DR. NORMA NIELSON: That's probably one
11 of the academics that'll be here this afternoon.
12 MR. TED ZUBULAKE: Okay. But you're
13 obviously familiar with the weaknesses of the CAP "M" --
14 DR. NORMA NIELSON: Well, that's why the
15 three (3) -- why it's going from a one (1) factor model
16 to a three (3) factor model is people trying to measure
17 and address the -- the weakness.
18 MR. TED ZUBULAKE: And we'll -- of
19 course, we'll ask this of Dr. Phillips later, but -- but
20 in your opinion does the -- the additional of -- the
21 addition of the two (2) factors completely overcome the
22 disadvantages or the deficiencies in the CAP "M" model or
23 is it just kind of getting us closer to a better model
24 but we're not quite there yet?
25 DR. NORMA NIELSON: It's closer. There's

1 -- there's another -- another paper I was reading last
2 week that was looking at the Canadian stock market
3 generally and coming up with a four (4) factor model. So
4 you --
5 MR. TED ZUBULAKE: Four (4) factors --
6 DR. NORMA NIELSON: -- you can look
7 forward to the -- the momentum factor being added in --
8 in. You know, five (5) years from now there will be a
9 four (4) factor model.
10 The -- the bottom line of what we look at
11 when we build these models there's -- there's one (1) of
12 the -- one (1) or two (2) statistics you can look at that
13 tell you the percentage of the movement around the data
14 point that's being explained by the model; an R-squared
15 for the -- or an adjusted R-squared for the
16 mathematically inclined in the room.
17 So if the model -- you can -- and there
18 are other tests to make sure it's statistically
19 significant, that the odds are under -- under 2 percent
20 or 1 percent, that it's not -- that this is -- that
21 there's something else going on that's not being pict --
22 drawn in this picture.
23 So if the R-squared is point six (.6) that
24 means that 60 percent of the movements are being
25 explained by that one (1) factor. And if you can add two

1 (2) more factors and move it up to point eight (.8) then
2 you've improved the model.
3 You'll always have a lower explanatory
4 power with one (1) model that -- or with one (1) factor
5 than you get by adding more relevant factors.
6 You're never going to get to 100 percent
7 because weird stuff happened in some of these stocks that
8 has nothing to do with the market. It has to do with,
9 you know, the President and CEO of the company being
10 arrested on the front page or something. It's never
11 going to be 100 percent. It's the market driving things.
12 MR. TED ZUBULAKE: Thank you very much,
13 Doctor.
14 THE CHAIRPERSON: Jack, I think you had a
15 question.
16 MR. JACK DONAHUE: Dr. Nielson, just a
17 clarification, the figures that you use in the table, you
18 talk about them -- the distribution of beta and risk
19 management for companies writing insurance -- auto
20 insurance.
21 Does that chart dealing just with their
22 auto insurance book or is that the entire book, property
23 and casualty --
24 DR. NORMA NIELSON: That's the entire
25 book. We -- we're trying --

1 MR. JACK DONAHUE: So you use property
2 and casualty --
3 DR. NORMA NIELSON: Property, casualty,
4 yes. And this -- and this includes TD --
5 MR. JACK DONAHUE: Right. So --
6 DR. NORMA NIELSON: -- as TD Meloche
7 Monnex. As I say, RBC is down probably at the lower end
8 of that.
9 MR. JACK DONAHUE: Not being an actuary,
10 but I would think that if you were to isolate just the
11 auto insurance --
12 DR. NORMA NIELSON: That's what we were
13 trying to get to work this weekend and it didn't.
14 MR. JACK DONAHUE: If you isolate just
15 that portion -- well, the frequence of the variation of
16 beta would be much narrower than the casualty. The auto
17 insurance industry doesn't have floods, fires and 9/11's.
18 DR. NORMA NIELSON: Actually they do have
19 floods. But --
20 MR. JACK DONAHUE: Well -- but I mean,
21 maybe I'm --
22 DR. NORMA NIELSON: Cars washing down the
23 river are covered by the auto insurance, so.
24 MR. JACK DONAHUE: But would it narrow
25 the beta?

1 DR. NORMA NIELSON: It should. We are --
2 the next step, and we -- we worked -- David worked very
3 hard over the weekend to try and have it for today and it
4 just didn't happen. It's something called the full
5 information beta that tries to break out the type of
6 business the company is in and look at if the beta is
7 point five (.5) how much of that is contributed by --
8 what -- what would be the beta just for different types
9 of business it's in so that when you weigh it and you
10 come up with a point eight (.8). That's --
11 MR. JACK DONAHUE: And --
12 DR. NORMA NIELSON: -- the next step and
13 we just -- we got a -- we got a model that told us ipods
14 are two thousand dollars ($2,000) and plasma TV's are two
15 hundred (200) so we know it's not working yet.
16 MR. JACK DONAHUE: So if you were to
17 narrow that down to just the auto insurance --
18 DR. NORMA NIELSON: We're -- we're
19 working in that direction, we're not there yet.
20 MR. JACK DONAHUE: -- you would get a
21 different beta number and you would -- you would likely
22 then get a different equity target too?
23 DR. NORMA NIELSON: Yes. I would say
24 auto -- again -- but again, in Canada auto insurance is a
25 big chunk of the total, so it's not going to move as far

1 from the mean as you might think; plus or minus 1
2 percentage point.
3 THE CHAIRPERSON: Thank you. Any further
4 questions?
5 MR. BILL MOORE: Dr. Nielson, did not the
6 Cummins & Phillips work illustrate that when you did
7 isolate using the full information and beta approach the
8 -- the automobile business was, in fact, riskier than the
9 -- than the company as a whole or the --
10 DR. NORMA NIELSON: In general I think
11 they did. Yeah, they were slightly above. But then
12 they're suing each other in the US too, so.
13 MR. BILL MOORE: Fair enough. Yeah.
14 DR. NORMA NIELSON: So I -- I -- I can't
15 -- I would say it would be plus or minus one (1) percent.
16 Probably the one (1) -- probably plus one (1) but that's
17 just an instinct at this point not a -- not a research
18 result.
19 MR. BILL MOORE: Thank you.
20 THE CHAIRPERSON: Hearing no more
21 questions, I want to thank you and ask you if you do hone
22 that out we certainly would enjoy receiving it.
23 DR. NORMA NIELSON: All right.
24 THE CHAIRPERSON: It would be beneficial
25 to us. But we will --

1 DR. NORMA NIELSON: Well, we're working
2 on spending that grant money.
3 THE CHAIRPERSON: We will -- you can
4 appreciate the amount of material we have so we aren't
5 going to reach our conclusions tomorrow.
6 DR. NORMA NIELSON: Right.
7 THE CHAIRPERSON: So it would certainly
8 be helpful to us. So thank you very much
9 DR. NORMA NIELSON: Very well.
10 THE CHAIRPERSON: -- for your
11 presentation and we look forward to hearing from you
12 again.
13 DR. NORMA NIELSON: Full information
14 beta, yeah, got it.
15
16 --- UNDERTAKING NO 1: Dr. Norma Nielson to clarify
17 to Board when isolating,
18 using the full information
19 and beta approach, the
20 automobile business was
21 riskier than the company as a
22 whole.
23
24 THE CHAIRPERSON: All right. That will
25 give us a few minutes here to get sorted out. Aviva has

1 arrived.
2
3 --- Upon recessing at 10:20 a.m.
4 --- Upon resuming at 10:32 a.m.
5
6 THE CHAIRPERSON: Everybody here now?
7 Good morning.
8 MR. GRANT MINER: Good morning.
9 THE CHAIRPERSON: You finally made it,
10 did you?
11 MR. GRANT MINER: Yes. I certainly
12 apologize.
13 THE CHAIRPERSON: We've all flown back
14 and forth. We know what it's like.
15 MR. GRANT MINER: They pulled away from
16 the gate at the right time and then we sat on the --
17 Peace Hills and I sat on the airplane for close to two
18 (2) hours while we waited to be de-iced. And we joked --
19 Jamie and I were joking they turned the heat up so much
20 on the plane I thought they were trying to de-ice it from
21 the inside.
22 However, we made it.
23 THE CHAIRPERSON: Well, thank you very
24 much. Go ahead with your introduction and start.
25

1 PRESENTATION BY AVIVA CANADA:
2 MR. GRANT MINER: Okay. Yes, first of
3 all, I'd like to -- I'd like to thank the Board for the
4 opportunity for Aviva Insurance Company, Aviva Canada to
5 be presenting.
6 My name is Grant Miner, Senior Vice
7 President for Western Canada for Aviva and based out of
8 Edmonton. Also, we have Chris Townsend and Chris, if
9 you'd just like to introduce yourself?
10 MR. CHRIS TOWNSEND: Sure. I'm a Fellow
11 of the Canadian Institute of Actuaries and my current
12 role is as corporate actuary so in that role I'm
13 responsible for, sort of, managing the adequacy of Aviva
14 Canada's capital which hence my interest in the return on
15 equity on that capital.
16 MR. GRANT MINER: Okay. We're going to
17 start off with -- with just some introduction. You have
18 our presentation but I'll walk through quickly some --
19 some slides.
20 My part of the presentation is to give
21 you a -- a more robust and rounded understanding of what
22 Aviva Canada is and how the companies are set up. I will
23 not dwell on this because I'm sure you want to move into
24 the financial component of our presentation fairly
25 quickly.

1 So, also, we'll be walking through our
2 presentation which will address the questions that the
3 Board asked us to address as well. I -- one (1) of the -
4 - the key messages that we will have is very simplistic
5 which is that we need a target ROE, return on equity,
6 that is going to attract capital in this competitive
7 marketplace and that is one (1) of the fundamental
8 messages that we will be putting in front of the Board
9 this morning.
10 So, by -- by way of -- of introduction on
11 the agenda I'll walk through a description of Aviva
12 Canada, overview of the ROE and also address the impact
13 for fair value accounting practices.
14 The -- the relevance for this slide, we
15 don't want to get too -- too pictorial here but our core
16 purpose as an organization is peace of mind and that is
17 peace of mind for both the consumers as well as for our -
18 - our shareholders.
19 Our -- our vision is to be the most
20 trusted and valued home, automobile and business insurer
21 in Canada and to be an outright winner in delivering
22 sustainable profit and growth. So it's a growth
23 orientation strategy. But clearly there's a link to our
24 shareholders and we're -- we're driven by achieving
25 sustainable profit and that is based on a track record as

1 well as future expectation.
2 This image just gives you a quick look at
3 Aviva's position across -- across the country but of more
4 relevance is, what does it mean to Alberta? Well, we're
5 a major employer in Alberta with branches in Edmonton and
6 Calgary.
7 We -- we try to contribute to the -- the
8 community through involvement with Grant McEwan and
9 provide some leadership and also maintain a pretty strong
10 -- a commitment to corporate social responsibility, a
11 high level of voluntarism and promote -- and we sponsor
12 SADD, for example.
13 So just trying to give you a quick feel
14 for -- for our presence. We have two hundred and twenty-
15 five (225) staff in these two (2) locations.
16 In Alberta itself there are four (4)
17 companies, of the five (5) that are illustrated in the --
18 in the PowerPoint, that actually trade. One (1) is --
19 the first one (1) is Aviva, which is Aviva Insurance
20 Company, Traders, which is our group, Elite, which is
21 more of a specialty product line for personal lines and
22 Scottish & York which I'll talk about and then, of
23 course, Pilot which is a personal lines company in
24 Ontario.
25 So just spend a few moments just talking a

1 little bit about each of the business entities because it
2 is important to set the stage for the discussion on the
3 financial piece that Chris will move into in a moment.
4 I'm not going to walk through all the
5 details on this but -- but basically, from Aviva
6 Insurance itself, in Alberta, we have introduced
7 innovations. They tend to be more property orientated.
8 But -- and we remain -- we remain optimistic and we're
9 committed to Alberta for -- for growing the business here
10 largely because the current state is -- is fairly solid
11 and we are, at this point, remaining optimistic that it
12 will continue to improve as far as trading and business
13 opportunities.
14 Traders is our group division and when you
15 look at the graph we did have a drop in volume from 2003,
16 2004. Basically that was a reflection of pricing action
17 that we had to take to improve results.
18 Elite, which we can call our -- our toys
19 division, focusses on -- on certain niches and I think
20 the -- I just -- the reason I wanted to put this one (1)
21 up is it addresses some needs that the marketplace has in
22 Alberta which is availability and affordability of
23 certain products. And this is -- this is one (1) of our
24 divisions that actually steps up to the plate over and
25 above just standard automobile insurance.

1 The fourth division is Scottish & York and
2 this is -- this is not that well known but we -- there
3 are two (2) parts to it. There's a specialty commercial
4 lines which, once again, is niche focussed to meet needs
5 of Albertans and the other one (1) is a corporate
6 partnership alignment for certain -- just we have one (1)
7 right now that we're just moving into -- into Alberta
8 which the Board would be familiar with.
9 So, Aviva Canada we're -- our parent is in
10 the UK which is Aviva PLC. And I'll just touch on a
11 couple of the high points here just so you can get a feel
12 for what Aviva Can -- Aviva globally looks like, once
13 again, because it is relevant to set that stage for the
14 financial view on the return on equity.
15 This slide -- all this slide is telling us
16 is one (1) thing, is Aviva globally is about 70 percent
17 life. And in -- in the UK it's largely a life company
18 whereas in Canada it is a general property casualty
19 company and we don't have any life presence in Canada.
20 This is -- this is, once again, a global
21 view on the strategy. I bring your attention to the
22 right-hand side of the slide which is -- which is
23 relevant to Canada, being the general insurance side.
24 And all we're seeing from the strategic perspective is
25 peace of mind for consumers. That's how I've summarized

1 that and it's also consistent with the vision that I put
2 up earlier.
3 The -- the focus within our strategy is
4 competition. And we have a desire to compete in a free
5 market and we also -- we know we have to compete for
6 customers and we have to compete for capital.
7 So that -- that basically gives you a
8 Reader's Digest version of Aviva globally and Aviva
9 Canada and the companies that we -- that are actually
10 trading in Alberta, Aviva Insurance company by far is the
11 largest company that does business in Alberta.
12 So what I'd like to do is pass it over to
13 Chris and he'll walk you through the components and the
14 questions that the Board are most interested in.
15 MR. CHRIS TOWNSEND: So, again, just to
16 relate to context that Grant did back to the next part of
17 the presentation, as Norma said, to do the theoretical
18 stuff you need to have histories and quoted stock prices.
19 So that takes us back to our parent
20 company. So, what I'm going to is take you through a
21 little bit of the information in terms of our parent
22 company and the historical cost of capital, future
23 looking, and sort of the pragmatic way that we end up
24 putting those together in terms of setting targets.
25 And just in terms of reminding you and

1 that -- that is all in the context of a company that is
2 70 percent life insurance internationally diversified and
3 so to get back to the question in terms of Alberta auto
4 insurance, doesn't directly answer the question but in
5 terms of how we deal things, we have to start from what
6 our parent company needs.
7 So, again, just in the historical process
8 here, we're talking for -- we, you know, not a lot --
9 don't need to know a lot of detail in the CAPM's is
10 standard method, you've got lots of other information
11 here.
12 From the point of view, again, as -- as of
13 something working from this sort of practical point of
14 view, we can look up, if you will, we don't have to do --
15 save a lot of time and effort, we don't want to spend two
16 (2) years and fifty thousand dollars ($50,000) to come up
17 with an answer.
18 We can go and look up some of these
19 numbers which makes it practical for us to use. So, you
20 know, a recent and obviously probably not today's, but a
21 recent Canadian long-bond rate in terms of a risk free
22 component of the return you're looking for, say four
23 point three (4.3) the beta for Aviva from the value line
24 source is a little bit on the higher line -- the higher
25 side of the range that Norma was giving you.

1 It's about one point-o-nine (1.09) and a
2 one (1) source in terms of the -- the market return for
3 Canada from -- from Ibbotson is five point three (5.3).
4 You put those together and you get a
5 number of around ten point one (10.1).
6 You can do the same thing for our
7 competitors and, again, we want to do that for our
8 competitors because we need to understand what their
9 costs of capital are as well, because, again, we're
10 competing for that same capital and what we find when we
11 do that is we're somewhere in the middle of the pack.
12 And just, you know, to clarify, when I --
13 we're talking of target there, that's what the formula
14 would come up with the target, that not -- is not yet
15 what we're stating to be our target.
16 The other point is, any time you're
17 applying these methods, there is a range of results that
18 come out. So it's hard to focus down right down into one
19 (1) number.
20 You know, again, in terms of trying to
21 understand these, we're not trying to write academic
22 papers but we do have to say -- have some idea of what
23 the pros and the cons are of the different approaches.
24 And so the pro is clearly, it's -- it's a
25 basic theory, it's been around for quite a number of

1 years. It's easy to get the numbers.
2 Some of the cons and, Ted, Appendix A, was
3 submitted as part of our filing, some of the cons are
4 that the -- there are some risks even in the sort of
5 risk-free rate, there's an interest rate risk, there's a
6 measurement risk.
7 The TSX itself may not be a good proxy for
8 total market risk in Canada. There's a lot of sectors
9 such as pharmaceuticals which aren't represented well in
10 the TSX, for instance, so it doesn't necessarily
11 represent the entire Canadian economy that well.
12 Historical betas may be biassed. Now, in
13 Aviva's case would be beta close to one (1), that's not a
14 material issue and when you're then taking a look going
15 from Aviva PLC down to Aviva Canada, Aviva Canada's a
16 much smaller company than our parent company.
17 We're about 4 percent of the total premium
18 and, you know, there is, historically when, again, Norma
19 was talking about different ways of coming up with an
20 average, historically smaller firms have had a higher
21 risk component to them.
22 And again, I'm just putting in an example
23 where you make some adjustments for, in particular, the
24 small size and possibly from the market risk premium,
25 taking those numbers from Ibbotson or Appendix A and you

1 come up with a number of about thirteen point three
2 (13.3).
3 So, I think I would -- a key point I would
4 take from that as a Board is that there is some
5 discussion about the pieces in here and the actual
6 choices that are made, in terms of your viewpoints on
7 that discussion, can have a material impact on the return
8 on capital.
9 MR. GRANT MINER: Chris, am I -- I
10 believe I'm correct when I say this, in these two (2)
11 examples that you've covered it also -- the backdrop is
12 the global --
13 MR. CHRIS TOWNSEND: Hmm hmm
14 MR. GRANT MINER: -- which has the 70
15 percent life component into it --
16 MR. CHRIS TOWNSEND: That's correct.
17 MR. GRANT MINER: -- which is a very
18 material point as we work towards a Canadian perspective.
19 MR. CHRIS TOWNSEND: Yeah, all the
20 numbers in these -- these, sort of, six (6) slides are
21 all talking about the betas and the risk is measured on a
22 global company that's 70 percent life insurance.
23 The other -- or one (1) other, sort of,
24 easily available method of estimating the return on
25 capital, the -- the -- the beta is looking at historical

1 variability and saying, based on the model, what, you
2 know, return you should have been getting.
3 The -- the discounted cash flow model is -
4 - is a forward-looking one (1) and it's saying, if I look
5 at the current stock price and I look at forecasts of two
6 (2) key components, i.e. the dividend and the growth rate
7 in that dividend, what factor do I need to discount that
8 future cash flow is to come up to my current stock price.
9 So it's assuming that the markets are
10 efficient and stock price is properly reflecting that
11 future cash flow.
12 So, again, just in terms of the numbers
13 here, from a Citigroup Investment Research Report the
14 growth was estimated at about 9 percent for Aviva. A
15 dividend of twenty-eight pence (0.28), again we're
16 talking Aviva globally here, and a price at that time,
17 early 2006, of 723 pence. You divide the dividends by
18 the price you get the yield added on and you get about
19 thirteen point three (13.3) for a implied, sort of, cost
20 of capital.
21 All right. And, again, you can do that
22 for your competitors and we would want to. We want to
23 compare our cost of capital to our competitors. Again,
24 we're somewhere in the middle and, again, there is a
25 fairly significant range.

1 Now, again, again, there's no one (1)
2 answer. You know, the pros of this is, again, it's a
3 fairly simple calculation. You know, it's well grounded
4 in, sort of, options consideration in terms of how should
5 I make my investment in the future and, if we're a
6 publicly quoted company, the information is readily
7 available. As a bonus you're using just the cash in
8 terms of the dividends and the price which is, sort of,
9 something that doesn't change depending on what
10 accounting conventions you use.
11 You know, the cons, certainly from the
12 Board's point of view and Aviva Canada's point of view,
13 you know, you don't get that information available for a
14 -- a private company and, you know, in some cases having
15 that good consensus forecast of future growth can have
16 significant variation.
17 So, again, the message that, sort of, we
18 take is it's important to look at this in looking at what
19 our targets are but we're not going to go out and find
20 one (1) academic with one (1) number that's going to give
21 us the answer we want as businessmen.
22 So, a key point of that is we are
23 competing for capital so it's important to, you know,
24 take a look at what we consider our peer group of
25 competitors because those are the ones we want to beat,

1 if I can put it that bluntly.
2 So, I've listed, you know, seven (7)
3 examples again, their targets listed here are from
4 publicly, you know, stated information, whether it's in
5 their -- in a -- in a report of theirs or from a
6 stockbroker's report. Aviva's target as quoted, I don't
7 have it down there, but to complete the slide is for a 10
8 percent net real return on equity.
9 And we further say that we want a general
10 insurance core or combined operating ratio of 98 percent
11 or below.
12 Now, just to put that back, a 10 percent
13 net real return on equity means you're going to take your
14 10 percent and you're going to add your current estimate
15 of future inflation. So, if, say, the UK inflation is --
16 because again we're talking about our parent company, as
17 I say, about 2 and a half percent, they'd be coming up
18 with a target that they want to get of about 12 and a
19 half percent. And this is post-tax; that's what the net
20 means.
21 Okay, and, again, that's in the order of
22 somewhere near the average of our competitors.
23 So moving to a Canadian context then,
24 Canadian context is clearly that in Canada we are not a
25 quoted company and we are also property and casualty

1 only, okay? So -- but it's a component of what our
2 worldwide group chief executive has to deliver in terms
3 of the overall return he's got to make in terms of the
4 stock market.
5 So, in terms of that, again, from a
6 practical point of view, we're not updating these
7 targets, sort of, every six (6) months. There's, you
8 know, work done to review them but you're not going to
9 move them up or down point three (.3) points just because
10 something changed and it's easier from an internal
11 measurement point to keep a fixed target.
12 So this target we're working towards in
13 terms of 15.6 percent was set back in 2003. It was based
14 on a discussion that we needed a number to get that
15 sustainable ongoing growth because we need the profits to
16 reinvest to get the growth. Obviously, we want to meet
17 our shareholder expectations and our chief executive's
18 expectations. And it's in the context that looking at
19 Canada from the global perspective we are only in the P&C
20 insurance business in Canada.
21 And P&C is perceived as more risky than
22 life. It's harder to estimate our liabilities. It's
23 harder from an investment point of view to immunize
24 yourself against movements in future inflation rates
25 because you typically can't buy enough, sort of, real

1 return bonds in Canada.

2 And the history, certainly in 2003 when
3 this was set, of Canadian regulatory changes in the
4 Canadian market up to that point was of a concern to our
5 parent company. So we ended up with a number that was
6 mutually agreed at something higher than the return that
7 the parent company was promising itself.

8 The next, sort of, sections are
9 specifically to try and translate that return on equity
10 into components of the pricing formula which is
11 ultimately what the Board has to do in terms of setting a
12 rate for private passenger automobile or a ceiling for
13 that rate.

14 So, the -- there's basically three (3)
15 sources of return that we get to come up with that 15.6
16 percent which is shown in terms of the R(E) number at the
17 top of the slides there.

18 So the first one (1) is -- is an
19 underwriting profit and if I can just draw your attention
20 to the one point nine eight (1.98) in terms of all
21 comers for automobile, that's saying a 2 percent
22 underwriting profit. That's actually very close to the
23 same thing as we're talking about the 98 percent combined
24 operating ratio that our parent has set as a target. So
25 we're comfortable in terms of how the formula and the

1 return on equity is connecting back to our parent's
2 publicly stated target.
3 The -- the next source is the investment
4 income on policyholder funds between the time we get the
5 premiums and the time we pay out the claims and, again,
6 you know, roughly speaking here those numbers are, you
7 know, assuming we're investing policyholder funds
8 conservatively in, sort of matched risk-free Government
9 of Canada and holding them for about two (2) years; a
10 little over two (2), two and a half (2 1/2) years before
11 we make the payouts on average. Obviously some of them
12 we pay very quickly.
13 And then the final component, of course,
14 is that for insurance companies you have to keep your
15 capital liquid. You're not actually building a
16 manufacturing plant and that capital, in terms of how we
17 keep it -- like, we tend to invest a significant portion
18 of that into the stock market in Canada and these returns
19 here are maybe a little lower than -- these are returns
20 we use for internal planning purposes. We hope our
21 investment people will achieve higher if they haven't
22 achieved higher this year. And we use that.
23 And -- and then, of course, you have to
24 allow for tax on all those returns to get your net after
25 tax yield.

1 And just as a -- as a point of
2 reference, the first calculation I did was before Alberta
3 reduced its tax on April 1st from 11 1/2 percent to 10
4 percent. And that benefits policyholders by about
5 between a quarter and a half point in terms of the
6 overall premium levels that we can provide them.
7 And then the final piece is that we do
8 have to measure how much capital we have to keep and
9 those numbers down here at the bottom are -- are
10 different depending on whether we're looking at all
11 covers or just, sort of, the basic covers.
12 Looking at our risks and measuring our
13 risks internally a large part of the risk we have to deal
14 with in terms of why we're holding that capital is risks
15 in terms of the bodily injury and accident benefit
16 coverages. They are harder to estimate and more variable
17 in terms of the outcome and that's what we hold capital
18 for so that even if our, sort of, financial statement
19 estimates are -- turn out to be too low we have enough
20 money to be able to pay policyholders.
21 So going on to another question that the
22 Board asked was to talk about, you know, going forward
23 when you're trying to look at things what is going to be
24 the impact of fair value accounting in terms of coming
25 into effect January 1st, 2007.

1 It's perhaps worth noting that we're still
2 in the process of making decisions on exactly how we're
3 going to implement that. But in terms of the internal
4 measures that we use to measure our management team on
5 return on -- on capital, we're using measures on a UK
6 accounting basis and UK accounting basis is not changing,
7 so that we don't see a change from that point of view.
8 And, again, hopefully we see through the economic reality
9 of -- of the change in terms of the measurement.
10 I did include a spot, I think the Board
11 members have this as a separate attachment, though just
12 to take you through some of the impact.
13 So the first two (2) columns just show an
14 example company on, if you will, current accounting
15 basis. And really the actual numbers in that are
16 irrelevant but it's just as a point of comparison. Does
17 everybody have that handout?
18 Yeah, okay. So in terms of the second two
19 (2) columns in terms of fair value accounting, I just
20 want to draw your attention to really one (1) thing. I
21 mean the -- there will be a, sort of, a restatement on
22 January 1st, if you will, of what your position is. And
23 for many companies the key change there will be that any
24 excess that you have in terms of the market value of your
25 equity holdings over the book value will now go directly

1 onto the balance sheet and, therefore, will both increase
2 the amount of assets you're holding and sort of -- and by
3 implication would reduce -- increase your shareholders'
4 equity.
5 All right. So if we then are going from,
6 sort of, the second group of columns to the third group
7 this is -- in the second group of columns interest rates
8 were stable and did not change over the year. In the
9 third group of columns the interest rate at the end of
10 the year is 5.2 percent instead of 4.2 percent so
11 interest rates went up a point.
12 The implication of that, if you move, sort
13 of, down to the next highlighted yellow box in terms of
14 the bond values, when interest rates go up bond values go
15 down because it's the present value of the future
16 payments that hasn't changed.
17 Also, because in Canada we take --
18 discount our claims -- unpaid claims liabilities, so
19 again, that's a future payment stream, interest rates go
20 up, the value of unpaid claims liabilities goes down.
21 And when the value of the unpaid claims
22 liabilities go down that savings, in this case of about
23 $7 million on this -- this sample company, that results
24 in a lower claims incurred on the operating statement.
25 It goes from one, ten (110) down to one-o-three point

1 nine (103.9). So that number looks lower and you're
2 looking at a better underwriting result and a better
3 core.
4 Now, where the offset will come is the
5 investment income is also lower because under the new
6 accounting the change in the value of the bonds will go
7 through the net investment income and so the investment
8 income has also gone down.
9 So the -- the -- you know, the long and
10 the short of it, interest rates going down, in this case
11 are -- are bad for the company. But the key point here
12 is you're going to get more volatility and that
13 volatility will be coming through in both the reported
14 underwriting result and the reported net income.
15 And then, of course, if interest rates go
16 up basically exactly the opposite situation occurs.
17 Interest rates go up -- sorry, interest rates go down, in
18 the last column, then the value of the bonds goes up.
19 The value of the claims liabilities goes up and you will
20 see a worse core but offset by better investment income.
21 Okay?
22 And in terms of measured accounting return
23 on equity, all those three (3) scenarios are actually
24 showing a lowered measured accounting return on equity
25 because the -- the value of the equities is now reflected

1 on the balance sheet. So your income hasn't changed
2 substantially but your starting equity as measured by
3 accounting has changed.
4 And that's our -- I'll hand it over to
5 Grant to just summarize.
6 MR. GRANT MINER: Okay. So we've --
7 we've given you an overview of Aviva as a company, both
8 worldwide, Canada and some greater insight hopefully into
9 what our presence is in the Alberta marketplace. Covered
10 off the -- the -- the ROE models that -- that are -- that
11 we've put on the table for -- for review.
12 I -- I guess I just would like to
13 reemphasize is that we do need a competitive ROE and
14 whereas it's -- it's fairly fixed for planning purposes
15 we know that -- that we have to constantly compete for
16 capital within our parent company and our parent company
17 competes on the marketplace.
18 Perhaps the other comment I'll make is
19 we've reviewed the IBC presentation as well, and not to
20 bring in another entity's presentation in any great
21 depth, but we see a lot of similarities in -- in thinking
22 and consistency as opposed to it being, you know,
23 incongruent between what Aviva as a company is putting
24 forward for your consideration versus IBC and I think
25 that their presentation, our opinion is that it properly

1 reflects the industry as a whole.
2 So that concludes our -- the formal part
3 of our presentation and I'd like to thank the Board for
4 the opportunity for Chris and I to present and we can
5 certainly entertain some questions at this point.
6 THE CHAIRPERSON: Thank you. Questions
7 on this end of the table. Go ahead, Merle's up.
8
9 QUESTIONS BY BOARD:
10 MS. MERLE TAYLOR: Sorry, you may have
11 explained this but I just needed a little help with it.
12 Your table about the three (3) sources of return to the
13 insurance company, you've got a break down by all the
14 different factors --
15 MR. GRANT MINER: Sure.
16 MS. MERLE TAYLOR: -- so do I understand
17 your basic only, that's TPL and accident benefits, right?
18 MR. GRANT MINER: Right. Right.
19 MS. MERLE TAYLOR: And so your difference
20 in your UU which is your underwriting profit, is -- does
21 that reflect that Aviva views that slice as being greater
22 risk and requiring a greater return or have I
23 misunderstood that?
24 MR. CHRIS TOWNSEND: No, the -- the --
25 the return that we're looking at there is the same, 15.6

1 percent on the top line there, okay.
2 MS. MERLE TAYLOR: Yeah.
3 MR. CHRIS TOWNSEND: The key number that
4 changes the underwriting result -- the underwriting
5 profit, if you will, is what falls out of the rest of the
6 equation because you pretty well know how long you're
7 going to be, on average, investing your money.
8 You've made an estimate of the interest
9 you're going to earn on that and the interest you're
10 going to earn on your -- invest in your capital and so
11 the -- the key thing that is -- is how much capital then
12 do you need to support that, okay?
13 And the -- the basic lines are more risky.
14 There is a much longer -- much more uncertainty in terms
15 of outcomes of court cases. You know, in the reforms
16 that have happened countrywide there's the potential for
17 constitutional challenges. The longer payment period
18 gives you more risk that inflation will increase awards
19 in an unanticipated manner.
20 So you need to have more capital set
21 aside. Again, because you want to be able to pay
22 policyholders even if things go badly.
23 MS. MERLE TAYLOR: Okay. Thank you.
24 MR. CHRIS TOWNSEND: And that would be
25 consistent with also the -- the viewpoint of the

1 regulator. They would be looking for more capital on
2 these lines of business supporting this.
3 MS. MERLE TAYLOR: Okay. And so the all
4 covers would include collision but also property?
5 MR .CHRIS TOWNSEND: This is just for
6 automobile. So it's -- it's --
7 MS. MERLE TAYLOR: Just automobile.
8 MR. CHRIS TOWNSEND: -- it's the
9 collision, the comprehensive, first party physical
10 damage.
11 MS. MERLE TAYLOR: Right. Okay. Thank
12 you. That answers the question.
13 THE CHAIRPERSON: Ted...?
14 MR. TED ZUBULAKE: Just to begin, just to
15 pick up on this, so on that same exhibit, the basic only
16 column just -- maybe I missed it but what are these
17 numbers translate into in terms of a underwriting profit
18 margin?
19 MR. CHRIS TOWNSEND: So that's the UU
20 numbers so.
21 MR. TED ZUBULAKE: That's the five (5),
22 I'm sorry.
23 MR. CHRIS TOWNSEND: So once -- so on all
24 covers is about 1.98 percent and for -- for the basic
25 coverage only a little bit over 5 percent.

1 MR. TED ZUBULAKE: Okay. Just help us
2 understand here, is that 5.34 percent a apples and apples
3 comparison to the 5 percent that the Board is using now,
4 the industry-wide adjustment?
5 MR. CHRIS TOWNSEND: It is. Yes.
6 MR. TED ZUBULAKE: So, essentially the
7 numbers are very close so are you suggesting then based
8 on the assumptions you have here the Board -- the Board's
9 current 5 percent converts to a 15.6 percent return on
10 equity for Aviva?
11 MR. CHRIS TOWNSEND: With the other
12 assumptions we've -- we've -- we've -- we've built in
13 here, yes. I mean, one (1) key difference in terms of
14 looking at the rest of the industry would be perhaps how
15 you invest your capital.
16 MR. TED ZUBULAKE: Okay.
17 MR. CHRIS TOWNSEND: If you were to
18 invest that capital more conservatively than Aviva does,
19 and that may be one (1) of the reasons why Aviva has a
20 higher beta. You know, question mark --
21 MR. TED ZUBULAKE: Right.
22 MR. CHRIS TOWNSEND: -- I don't know, but
23 if you were to invest it more conservatively then it
24 would translate into a different return on capital.
25 If you had different, sort of, risk

1 profile in terms of the amount of capital you were
2 required by the regulator to hold and could use a
3 different premium surp. equity ratio than 1.3, again, it
4 would come up with a different number.
5 MR. TED ZUBULAKE: Okay. So this is
6 important so forgive me if I'm --
7 MR. CHRIS TOWNSEND: Yeah.
8 MR. TED ZUBULAKE: I've got to ask these
9 questions because this is key.
10 I'm sure you're aware that others -- I
11 mean, Mercer, my firm, when asked the question a year or
12 so ago with the first industry-wide adjustment, what is
13 the 5 percent underwriting profit margin that the Board
14 is using convert into in terms of return on equity?
15 And based on assumptions that we made,
16 including a two (2) to one (1) premium surplus ratio
17 assumptions and more leverage than what you have here, I
18 think we came out with a number somewhere around 10
19 percent.
20 MR. CHRIS TOWNSEND: The -- the leverage
21 number is a -- is a -- is a -- is a key difference.
22 MR. TED ZUBULAKE: But -- but -- had we
23 used a one point three (1.3) leverage we would have
24 gotten a much lower number not -- not a higher number.
25 So, my question is, we were -- other -- yes.

1 MR. CHRIS TOWNSEND: Okay.
2 MR. TED ZUBULAKE: Others, I will be
3 speaking on this afternoon and I'll ask them the same
4 question, but the challenge -- our -- our -- our
5 conclusion that the 5 percent converts into some --
6 something in the order of 10 percent they were saying was
7 closer to 7 or 8 percent.
8 So I'm trying to understand -- and you're
9 coming at me with 15.6 percent on a number that's very
10 close to the 5 percent, what is driving -- what -- what
11 are we missing here? It can't all be -- the -- the --
12 the returns you're assuming?
13 MR. CHRIS TOWNSEND: Yeah, I -- I'm not
14 familiar with the -- the specific calculations used --
15 submitted last year.
16 MR. TED ZUBULAKE: Right.
17 MR. CHRIS TOWNSEND: I believe it was --
18 MR. TED ZUBULAKE: I'm just -- I'm just
19 very surprised that the 5 percent equates to a 15.6
20 percent when you're using it -- a return on -- I mean, a
21 premium surp. ratio of only one point three (1.3).
22 I -- is that something you could -- rather
23 than take time now, could you just look at that again
24 and --
25 MR. CHRIS TOWNSEND: Well, I -- we can --

1 we can verify --
2 MR. TED ZUBULAKE: Just --
3 MR. CHRIS TOWNSEND: -- the mathematics--
4 MR. TED ZUBULAKE: Well, maybe you could
5 help -- maybe offline we can figure why we're so
6 different in kind of the basic calculation?
7 MR. CHRIS TOWNSEND: Okay.
8 MR. TED ZUBULAKE: Now, the 15.6 percent
9 that Aviva set, is that -- does that vary by company
10 within your group?
11 MR. CHRIS TOWNSEND: That -- that's a
12 number that's set for Aviva Canada as a whole.
13 MR. TED ZUBULAKE: Okay. And do you
14 imagine the -- the capital of the company -- companies
15 vary that target?
16 MR. CHRIS TOWNSEND: Not yet.
17 MR. TED ZUBULAKE: Okay.
18 MR. CHRIS TOWNSEND: It's something we
19 may consider going forward but not yet.
20 MR. TED ZUBULAKE: And you showed us
21 earlier how the -- the basic cap -- the application, I'll
22 quote, "a basic CAPM" arrive -- you arrive at a -- a
23 target, cost of capital of about 10.1 percent and then --
24 but then after making some adjustments, you arrive at a
25 13.3 percent number.

1 Can you explain a little bit more? What
2 adjustments, 'cause again, this is important, what
3 adjustments did you make that recognize -- in addressing
4 some of the shortcomings you find in the CAPM?
5 How did you get it from ten (10) to
6 thirteen (13) --
7 MR. CHRIS TOWNSEND: So -- so the two (2)
8 key adjustments we made --
9 MR. TED ZUBULAKE: Yes --
10 MR. CHRIS TOWNSEND: -- is this number
11 right here in terms of recognizing that Aviva Canada, you
12 know, in terms of a scale type of thing, is a smaller
13 company.
14 MR. TED ZUBULAKE: Okay.
15 MR. CHRIS TOWNSEND: You know, again,
16 from an economist's point of view, certainly our parent
17 company is raising the capital.
18 MR. TED ZUBULAKE: Yes.
19 MR. CHRIS TOWNSEND: But, you know,
20 there's a -- there's a question, I guess, that's sort of
21 from a businessman's point of view, is if they're
22 actually going to put it in Canada, should they actually
23 expect a lower return than on a, say a Canadian company
24 that goes and raises the company itself?
25 I think certainly the view of our

1 shareholders is they would expect to get the same return
2 that a stand alone Canadian entity would get, okay?
3 So, that represents an increase in the
4 cost of capital for a smaller company with more risk,
5 more variability.
6 MR. TED ZUBULAKE: And how did you get
7 one point two two (1.22)? Is there some --
8 MR. CHRIS TOWNSEND: I -- I looked the
9 number up in Ibbotson. There's Appendix Chapter 7 into
10 their -- their annual reports that goes through an
11 analysis of a number of issues in CAPM including things
12 like the January effect and things like that.
13 And it comes up with numbers that
14 historically have been appropriate. They're actually US
15 numbers, but I don't believe they'd be that significantly
16 different from Canada.
17 MR. TED ZUBULAKE: So we can -- the Board
18 can find that number in the -- in Ibbotson --
19 MR. CHRIS TOWNSEND: Yeah --
20 MR. TED ZUBULAKE: -- Ibbotson report?
21 MR. CHRIS TOWNSEND: Yeah. I have a copy
22 of the Appendix that I'm --
23 MR. TED ZUBULAKE: Oh --
24 MR. CHRIS TOWNSEND: That I can provide
25 to you.

1 MR. TED ZUBULAKE: Okay. Okay, we'll
2 look at that, thank you. And then, okay...
3 MR. CHRIS TOWNSEND: And then the --
4 sorry.
5 MR. TED ZUBULAKE: Yes. Oh, sorry, I
6 interrupted you.
7 MR. CHRIS TOWNSEND: I'm just -- just --
8 just writing that down. And the other -- the other point
9 there then is -- is here we've used six point seven five
10 (6.75)
11 MR. TED ZUBULAKE: Right.
12 MR. CHRIS TOWNSEND: In terms of an
13 estimate of -- of really the -- the Canadian market risk
14 premium, if you will. The return the Canadian market
15 would be expecting to get over and above the risk free
16 rate of return, okay?
17 And -- and that is an argument that is,
18 you know, fairly protracted from an academic point of
19 view in Kathleen McShane's Appendix but she is looking at
20 historic returns in the Canadian market and trying to
21 adjust for concerns about, say, mixes, different changes
22 in mix of the -- the index itself, adjusting for betas
23 that, when you do the analysis may not come up with an
24 answer that is actually consistent with the CAPM theory
25 in the first place.

1 And so that's all built in to coming up
2 with that six point seven five (6.75).
3 I believe the range she actually has in
4 the paper, six point two five (6.25) to seven point two
5 five (7.25), so I picked the mid point here.
6 MR. TED ZUBULAKE: Okay.
7 MR. GRANT MINER: Ted, I'd just like --
8 MR. TED ZUBULAKE: Yes.
9 MR. GRANT MINER: -- to come back to you.
10 First question, and this may -- I'm not an economist or
11 financial expert, but -- but I believe our fifteen point
12 six (15.6) is actual ROCE --
13 MR. TED ZUBULAKE: Sorry, is what?
14 MR. GRANT MINER: ROCE, Return on Capital
15 Employed as opposed to ROE, is that not the case?
16 MR. CHRIS TOWNSEND: Yes, again, for --
17 for internal measurement you've got to take these
18 theoretical numbers from the market and -- and come up
19 with a formula that actually -- you're going to measure
20 management against, 'cause if you don't set the formula
21 beforehand, management has this tendency to come up with
22 the exposante (phonetic) answer that's most beneficial to
23 them. So --
24 MR. GRANT MINER: So, you know --
25 MR. GRANT MINER: So it's a bit -- a bit

1 of a moot point but it may be -- we'll include it back in
2 the answer to your -- to the question that you asked, is
3 it take away. I just thought I'd point it out as --
4 because it is a slight difference.
5 MR. TED ZUBULAKE: Before I get to the --
6 I'll come back to that in a moment.
7 Chris, do you -- you select under the
8 basic the same exhibit, a one point three (1.3), I guess
9 premium sir -- leverage ratio for the basic coverage --
10 MR. CHRIS TOWNSEND: Yeah.
11 MR. TED ZUBULAKE: That is based on what
12 -- how do you arrive at that factor?
13 MR. CHRIS TOWNSEND: That -- that is --
14 basically at this stage it is based on a judgment, okay?
15 One (1) of my objectives over the next year is to take
16 our risk base capital work and push it farther down into
17 our actual pricing.
18 MR. TED ZUBULAKE: Yes.
19 MR. CHRIS TOWNSEND: But it's absolutely
20 clear that, as I say, most of the risk that we have in
21 terms of variability in the results from automobile
22 insurance come from the basic coverage --
23 MR. TED ZUBULAKE: So --
24 MR. CHRIS TOWNSEND: -- so we should put
25 most of the capital there.

1 MR. TED ZUBULAKE: So for all coverages
2 you selected two (2) which is a bit of a traditional rule
3 of thumb, I don't know if that's why you picked it, but
4 this -- and then you say, well, for the basic coverages
5 should be a little less than that, because it's more
6 risky, maybe --
7 MR. CHRIS TOWNSEND: Yeah.
8 MR. TED ZUBULAKE: -- because the
9 physical damage coverage is higher.
10 MR. CHRIS TOWNSEND: Yeah.
11 MR. TED ZUBULAKE: How does the two (2)
12 of this -- your starting point, then, relate to, we heard
13 earlier about the minimum asset test.
14 How does that relate to the OSFI
15 requirements of Aviva --
16 MR. CHRIS TOWNSEND: Yeah --
17 MR. TED ZUBULAKE: Do they --
18 MR. CHRIS TOWNSEND: Again, the initial
19 work that I've done in pushing through that, I believe
20 OSFI requirements are -- the actual capital we seem to
21 have ended up holding is, certainly in our opinion,
22 higher than we need from a risk point of view.
23 And probably comes out to be slighter
24 higher than this, so we probably are, you know, towards
25 the one point nine (1.9) as opposed to two (2) as a

1 company as a whole.
2 MR. TED ZUBULAKE: Okay.
3 MR. CHRIS TOWNSEND: The numbers we had
4 as a group at the end of last year were in the order of
5 1.7 billion of capital compared to about 3 billion of
6 premium.
7 MR. TED ZUBULAKE: Okay. Now, thank you,
8 now you certainly understand the Alberta rate situation,
9 the mechanism, the system that's in place here with the
10 industry-wide adjustment?
11 MR. CHRIS TOWNSEND: Right.
12 MR. TED ZUBULAKE: Do you have any
13 suggestions or recommendations, anything to offer to the
14 Board on how -- I mean, what you presented was a Aviva
15 specific target return on equity that your company tries
16 to achieve --
17 MR. CHRIS TOWNSEND: Right.
18 MR. TED ZUBULAKE: Any suggestions to the
19 Board on how to select a proper provision or a target
20 return for purposes of the industry-wide adjustment, one
21 (1) single number that's -- that can be applied to
22 basically all companies in the province?
23 MR. CHRIS TOWNSEND: Well, again I think
24 I come back to Grant's point and I think we -- we support
25 the industry position is that the -- the Board has within

1 its authority, it should be setting a ceiling to protect
2 the consumers and we should be allowing competition to
3 work under that as much as possible.
4 If the in -- if the Board -- and, you
5 know, it's -- sorry, it's consideration of, you know, not
6 just that number but, you know, that sort of number and
7 the investment thing altogether that go into coming up
8 with that underwriting margin.
9 MR. TED ZUBULAKE: Right.
10 MR. CHRIS TOWNSEND: And depending on
11 where you go in terms of return on equity and -- and
12 setting some of the other parameters, you know, if the
13 Board was just say, for instance, to agree that 17
14 percent was an adequate and appropriate ceiling on return
15 on equity, we would not be coming in on our next filing
16 and saying, we're changing that number from fifteen point
17 six (15.6) to seventeen (17).
18 We would still be making our rates based
19 on 15.6 percent.
20 MR. TED ZUBULAKE: So, okay, by ceiling -
21 - so we're clear, you're suggest -- your suggestion is
22 the Board to pick a high, a maximum or relatively high
23 profit margin or target return so that competition can
24 work beneath that --
25 MR. CHRIS TOWNSEND: Right.

1 MR. TED ZUBULAKE: Norma Nielson's point.
2 I guess I can see his point.
3 And, okay, in terms of the issue of --
4 does the Board need to set a, or even deal with, target
5 returns?
6 Right now, the Board, as you know, selects
7 a profit model, the 5 percent.
8 Do you see any problems with the Board
9 continuing down that path, just -- not dealing with
10 return on equities but instead just dealing -- just
11 selecting a -- a -- a profit margin of 5 percent or
12 whatever that number is and -- and not dealing with
13 return on capital or how much capital companies keep in
14 relation to the premium?
15 MR. CHRIS TOWNSEND: The only concern we
16 would -- we would have on that is and we just, as a for
17 instance, that number there is fairly close to the
18 current 5 percent as you pointed out, okay?
19 So, you know, would -- would we be too
20 upset right now in the current economic environment,
21 current risk environment with a 5 percent? Not
22 necessarily, okay.
23 But if some of the economic variables
24 change, you know, if we're end up with a lower interest
25 rate environment which is forecast by some in terms of,

1 you know, slow down in the economy coming from the US and
2 coming over into Canada would result in lower interest
3 rates then, you know, to get that same 15.6 percent,
4 we're not going to get as much from investing either of
5 those two (2) things; we need to get it back from a
6 higher underwriting margin.
7 MR. TED ZUBULAKE: Well --
8 MR. CHRIS TOWNSEND: So, so I think
9 that's the danger --
10 MR. TED ZUBULAKE: Right.
11 MR. CHRIS TOWNSEND: -- of setting it
12 that way is -- is that may be a practical solution but
13 you can't sort of ignore it in your sort of annual review
14 what --
15 MR. TED ZUBULAKE: Okay.
16 MR. CHRIS TOWNSEND: -- the current
17 economic environment is.
18 MR. TED ZUBULAKE: Now, you seem to be
19 suggesting though then at least in Aviva's case that
20 fifteen point six (15.6) is a kind of a fixed target
21 regardless of the economic conditions or -- or does that
22 number itself vary as interest rates rise and fall?
23 MR. CHRIS TOWNSEND: The only -- the only
24 thing that that varies for in terms of the -- our
25 publicly set targets is the anticipated inflation rate,

1 because we've set our number as a -- certainly globally
2 as --
3 MR. TED ZUBULAKE: Yeah.
4 MR. CHRIS TOWNSEND: -- a -- as 10
5 percent net real.
6 MR. TED ZUBULAKE: Okay.
7 MR. CHRIS TOWNSEND: So that now --
8 inflation forecasts have been relatively stable over the
9 last few years, so we haven't seen any substantial
10 changes in that.
11 MR. GRANT MINER: If I could add one (1)
12 more comment --
13 MR. TED ZUBULAKE: Yes.
14 MR. GRANT MINER: -- 'cause you had
15 mentioned it earlier and that -- you were talking about
16 the insurance cycles?
17 MR. TED ZUBULAKE: Yes.
18 MR. GRANT MINER: The challenge that we
19 have is to perform at this level, in theory, no matter
20 what the cycle is and so that's -- that's a very
21 significant challenge for us as an organization and that
22 is to provide, where possible, some levelling in
23 shareholder expectation on a go-forward basis.
24 So that -- that's another -- another
25 factor when you talk about the insurance cycles.

1 MR. TED ZUBULAKE: Last question. Again,
2 everything else being equal, were the Board to increase
3 its profit -- the profit provision in the industry-wide
4 rate adjustment that was just announced, the adjustment
5 would be higher, be it a less negative or a positive --
6 MR. CHRIS TOWNSEND: Yeah.
7 MR. TED ZUBULAKE: How did -- how do you
8 reconcile that with the -- the fact that rates would be
9 going up when the industry is reporting such huge profits
10 over the last year to -- I mean, how does --
11 MR. CHRIS TOWNSEND: Well, I guess
12 there's two (2) points in that. If it is a ceiling, just
13 because the Board has allowed rates to raise -- to rise,
14 it doesn't mean the rates will actually rise.
15 So that would be --
16 MR. TED ZUBULAKE: Well --
17 MR. CHRIS TOWNSEND: -- from a
18 competitive point of view --
19 MR. TED ZUBULAKE: The evidence to date
20 suggests that that -- that would be the case. We haven't
21 seen many rate reductions, but anyway.
22 MR. CHRIS TOWNSEND: Well, yeah, I mean,
23 the question is how much.
24 MR. TED ZUBULAKE: Right.
25 MR. CHRIS TOWNSEND: And that becomes

1 into the complicated assessment of what our actual loss
2 costs are.
3 MR. TED ZUBULAKE: Yeah.
4 MR. CHRIS TOWNSEND: And the -- the
5 movement in those loss costs is --
6 MR. TED ZUBULAKE: But --
7 MR. CHRIS TOWNSEND: -- was -- is going
8 to be a bigger factor --
9 MR. TED ZUBULAKE: But the effect is
10 right now -- the industry, at least, at the industry-wide
11 hearings basically we're saying either leave the rates
12 alone or even increase the rates.
13 Yet the industry is reporting huge
14 profits. How does -- how do the -- how do you reconcile
15 that to the public? I mean, the fact that on the one (1)
16 hand the industry is saying or is reporting big profits,
17 yet they on the other hand they're saying the rates are
18 inadequate.
19 MR. GRANT MINER: When -- when you are
20 talking about industry reported profits, are you talking
21 Canada-wide or --
22 MR. TED ZUBULAKE: Canada --
23 MR. GRANT MINER: -- lines of business
24 combined --
25 MR. TED ZUBULAKE: Canada-wide, Alberta--

1 MR. GRANT MINER: -- and yet on the
2 pricing side you're just talking about private passenger
3 auto Alberta?
4 MR. TED ZUBULAKE: I'm just talking about
5 what's in the papers, the --
6 MR. GRANT MINER: Well, I think in all
7 fairness you should --
8 MR. TED ZUBULAKE: I mean I don't --
9 MR. GRANT MINER: -- make sure the
10 relationship is --
11 MR. TED ZUBULAKE: Yeah.
12 MR. GRANT MINER: -- there between the
13 two (2) comments.
14 MR. CHRIS TOWNSEND: And the other point
15 is timing, because you're reporting profits on past rates
16 and --
17 MR. GRANT MINER: Right.
18 MR. CHRIS TOWNSEND: -- if rates had been
19 red -- reducing, it takes sort of twelve (12) months for
20 those reduced rates to earn through in the income in
21 reported profits.
22 MR. TED ZUBULAKE: Yeah. So to some
23 extent at least, the big profits that are being reported
24 today and last year are due to favourable over-estimating
25 the reserve -- the claimed costs from prior years, is

1 that --
2 MR. GRANT MINER: It's earned premium
3 based on prior rates. We also have -- for example, if we
4 look at current year, we've had favourable weather --
5 MR. CHRIS TOWNSEND: Absolutely.
6 MR. GRANT MINER: -- compared to, you
7 know, our historic. We haven't -- didn't get zinged with
8 hail.
9 MR. CHRIS TOWNSEND: No floods out here--
10 MR. GRANT MINER: Which clearly does
11 affect automobile as well.
12 THE CHAIRPERSON: Ted, I have to move
13 them along here now.
14 MR. GRANT MINER: Yeah. And --
15 THE CHAIRPERSON: Another hearing. Are
16 there any -- yes, go ahead.
17 MR. LEWIS KLAR: Yeah, thank you.
18 MR. GRANT MINER: Oh, okay.
19 MR. LEWIS KLAR: I'd like to, kind of,
20 just briefly, because we're in a time crunch, look at 25,
21 your slide 25.
22 MR. GRANT MINER: Okay.
23 MR. LEWIS KLAR: Now, that's the ROE --
24 MR. GRANT MINER: Yeah.
25 MR. LEWIS KLAR: -- target fifteen point

1 six (15.6) on the ROE. Now, I just want to see if I
2 understand this correctly. So this -- this box here
3 indicates your actual ROE from the years 2001 to 2005?
4 MR. GRANT MINER: Yeah.
5 MR. LEWIS KLAR: And now I have a few
6 questions about you -- so you went down to a low of two
7 (2) point something percent, 2000 -- in 2002 and then
8 jumped up in a period of one (1) year to over -- about 15
9 percent.
10 So I have a few quest -- let me just give
11 you the three (3) questions. So -- the first -- the
12 first question being: What would explain -- how do you
13 explain that, the enormous increase in that one (1) year
14 period?
15 Secondly, since it's continued to go up,
16 not at that rate, but it's continued to go up since 2003
17 and you're now over your target ROE according --
18 according to the mid-2005's, so my second question would
19 be: Is -- is it your -- your -- a feeling or knowledge
20 that it's actually continued to go up since mid-2005, so
21 that it's even higher now and that it's a trend that you
22 think will continue?
23 And the third question is: How do you
24 react, is this something that really, Ted touched on it -
25 - how do you react when you're over your 15.6 percent?

1 Do you lower premiums?
2 You suggest that you did in your talk --
3 talk. You said -- you stated that 15.6 percent no matter
4 what.
5 So, have you lowered premiums since you've
6 hit and exceeded your target or have your premiums
7 basically stayed the same?
8 Have you reacted to that -- to that over
9 the target ROE?
10 MR. GRANT MINER: Okay. I don't remember
11 all the questions you asked, but I'll start with the last
12 one.
13 MR. LEWIS KLAR: Okay, yeah.
14 MR. GRANT MINER: Have we lowered rates--
15 MR. LEWIS KLAR: Well --
16 MR. GRANT MINER: -- is the question.
17 MR. LEWIS KLAR: -- have you lowered your
18 premiums because you're now over and above your target of
19 15.6 percent which you said is basically want that to be
20 the sam, come hell or high water.
21 MR. GRANT MINER: Okay, Mr. Chair, I'll
22 keep comments very brief.
23 Have we lowered rates?
24 MR. LEWIS KLAR: Yes.
25 MR. GRANT MINER: Yes, we have. Some of

1 that is through regulatory. And we're talking Canada-
2 wide here so there is regulatory changes as well as
3 competitive conditions. And on the other lines of
4 business which include commercial, clearly there has been
5 a softening in the marketplace so that those rates have
6 been coming down.
7 The impact, as it works its way to the
8 financials will be felt in future years as opposed to --
9 as opposed to current year.
10 MR. LEWIS KLAR: So -- so you do keep
11 them -- so you just -- your rates are -- your premiums
12 are sensitive to this 15.6 percent.
13 If the -- is higher than 15.6 percent, you
14 therefore adjust your premiums accordingly?
15 MR. GRANT MINER: We know that the
16 marketplace, because we're talking about the competition,
17 say in this case, below a premium cap, that the
18 marketplace will require us to -- to be competitive and
19 to give some of that rate back to the consumer.
20 MR. LEWIS KLAR: Well -- and following
21 from Ted that hasn't happened. Can you also explain this
22 -- and the second question is: Is this -- is this
23 increasing? Is this trend line increasing upwards from
24 mid-2005 to, I guess we're now almost near the end of
25 2006?

1 MR. GRANT MINER: Okay. Right now our
2 profitability is in '05 -- sorry, in '06. Canada-wide
3 is similar to what it is in '05.
4 MR. LEWIS KLAR: So it's about -- you
5 would be about 17 percent ROE there?
6 MR. GRANT MINER: Depends on business
7 unit and -- and also which part of the country you're in.
8 MR. LEWIS KLAR: Okay. My third
9 question.
10 And How do you -- what is the reason for
11 that huge drop in that one (1) year period?
12 MR. GRANT MINER: That's actually before
13 I started with the Company. I'm not quite sure.
14 Is it Pilot?
15 MR. TED ZUBULAKE: You're going to take
16 credit for that --
17 MR. GRANT MINER: Yeah, I wish I could.
18 Yeah, certainly -- certainly, the numbers
19 in 2001 and 2002 do reflect the sort of realization of
20 some of those risks I was talking about in terms of
21 adverse loss reserve development. And that was
22 definitely in the 2001 numbers and it would be in the
23 2002 numbers in respect of Pilot insurance as well.
24 And, in addition, rates were rising at the
25 time but, most notably I think in the -- sort of the

1 commercial unregulated market, there was some significant
2 price increases that were going through at that time.
3 MR. LEWIS KLAR: Okay. Thank you.
4 THE CHAIRPERSON: Gentlemen -- okay.
5 MR. LEWIS KLAR: I know you're late, Mr.
6 Chair. Maybe we'll have a shorter lunch.
7 THE CHAIRPERSON: Thank you.
8 MR. DENNIS GARTNER: Is the Alberta auto
9 insurance market as competitive as other jurisdictions in
10 this country?
11 MR. GRANT MINER: You may be more
12 familiar with -- before I jump in.
13 MR. CHRIS TOWNSEND: I think it's
14 competitive. Is it as competitive? I would suggest that
15 probably Quebec is the most competitive because companies
16 can change their rates very quickly for very small
17 segments of their book of business there. It's probably
18 the most competitive.
19 And there's probably a few additional
20 companies in Ontario that are not in Alberta so it's
21 probably slightly more competitive, but probably not
22 substantially.
23 MR. DENNIS GARTNER: Okay. The --
24 there's been a lot of consolidation in the general
25 insurance industry in -- in this country and I believe

1 about four (4) -- four (4) or five (5) of the largest
2 writers in this province now write approximately 50
3 percent of the business.
4 Is that a concern?
5 MR. GRANT MINER: I think it's -- I think
6 there's in the top ten (10) write about 60 percent. I
7 think the top few write about probably in the 30 to 35
8 percent range. We're you talking private passenger auto
9 Alberta?
10 MR. DENNIS GARTNER: Do we have those
11 figures?
12 MR. BILL MOORE: Yeah. Based on the CI
13 data of the top four (4) companies, based on written
14 premiums in Alberta, do write 49 percent of the market.
15 MR. GRANT MINER: For which lines of
16 business?
17 MR. BILL MOORE: If you throw you guys
18 in, it's fifty-five (55).
19 MR. GRANT MINER: For which lines of
20 business, though?
21 MR. BILL MOORE: Everything.
22 MR. GRANT MINER: Everything?
23 MR. BILL MOORE: All of the auto. Just -
24 - but just auto.
25 MR. GRANT MINER: Just auto? Okay.

1 MR. BILL MOORE: Yeah.
2 MR. GRANT MINER: So, Dennis, your
3 question is, is that a concern?
4 MR. DENNIS GARTNER: Yes, is -- well, is
5 that concentration in consolidation going to affect the
6 competitive -- competitiveness of the market in a
7 negative way and consumers in a negative way?
8 MR. GRANT MINER: I still think we have
9 over sixty (60) -- sixty (60) markets that are writing
10 business in Alberta, and even though there may be a
11 greater market share in those top companies, it just
12 means I think we're going to compete that much harder for
13 the consumers' dollar, as opposed to less.
14 It is -- if you're thinking we're edging
15 towards a oligopoly, absolutely not. I don't see that
16 that's -- that's the future for Albertans. It's going to
17 be very competitive market place as long as we're allowed
18 to compete.
19 MR. DENNIS GARTNER: How would you define
20 a oligopoly --
21 MR. GRANT MINER: Well, instead of sixty
22 (60) you have two (2) for example, which that is not --
23 that is not where we're -- that is not our current state
24 and I don't envision that that's where we're at.
25 MR. LEWIS KLAR: Okay, thank you.

1 MR. GRANT MINER: Okay.
2 THE CHAIRPERSON: Thank you, gentlemen.
3 We appreciate your presentation. And, as you know, we're
4 -- be down the road and I'm not trying to rush you off,
5 but I got one (1) more hearing this morning to get in
6 here.
7 MR. GRANT MINER: Thank you very much.
8 THE CHAIRPERSON: So, Peace Hills, you're
9 up.
10
11 (BRIEF PAUSE)
12
13 THE CHAIRPERSON: All right. Diane,
14 would you begin.
15
16 PRESENTATION BY PEACE HILLS INSURANCE:
17 MS. DIANE BRICKNER: Good, thank you very
18 much. I'd just like to introduce myself. I think I've
19 met most everyone. I'm Diane Brickner, President and CEO
20 of Peace Hills Insurance.
21 On my right, we have Marvin Yellowbird.
22 Marvin is the Chairman of the Board of Directors of Peace
23 Hills Insurance and he's also on the Board of Peace Hills
24 Trust and he's on council for the Sampson Cree Nation.
25 THE CHAIRPERSON: He's your boss, is he?

1 MS. DIANE BRICKNER: He's my boss.
2 THE CHAIRPERSON: He's got a lot of
3 problems.
4 MS. DIANE BRICKNER: That's right. I
5 think it just emphasises the seriousness of this
6 presentation to our company and -- and so, and the
7 commitment also that our shareholders have to Peace Hills
8 Insurance.
9 On my left, you've all met Jamie Hotte.
10 Jamie's our vice-president of marketing and underwriting
11 for Peace Hills Insurance.
12 Peace Hills Insurance will be celebrating
13 our 25th anniversary in 2007 and so we're in our 24th
14 year of business; started in 1982.
15 We're committed to the -- serving the
16 community and we feel that that's best met by cons -- or
17 providing our product through the independent insurance
18 brokers. So a 100 percent of our business is distributed
19 through the independent insurance broker.
20 And -- and a lot of our product over the
21 last number of years has been sold through the rural
22 parts of -- we -- we -- a number of years ago we
23 increased our emphasis on rural Alberta.
24 So, our brokers are spread throughout the
25 small communities as well as Edmonton and Calgary.

1 Peace Hills is located -- we have our head
2 office located in Edmonton and we have a branch office
3 here in Calgary. And in 2000 we opened an office in
4 Vancouver.
5 We have just over a hundred and fifty
6 (150) employees that serve about three hundred (300),
7 just over three hundred (300) independent insurance
8 brokers in British Columbia, Alberta, Saskatchewan,
9 Manitoba, the Northwest Territories, Nunavut and the
10 Yukon.
11 We've built our company on the philosophy
12 of flexibility and approachability and -- and we've
13 really focussed on that.
14 We've dedicated -- we're dedicated to
15 providing our customers with the best possible service
16 that we can. And -- and that doesn't just go towards our
17 broker and our product and our price, it goes right
18 through the organization into our claims.
19 Our corporate philosophy is to treat
20 everyone fairly in everything that we do.
21 The company, as I said, started in 1981
22 when the Sampson Cree Nation purchased a dormant charter
23 from the Edmonton Canadian Insurance Company and we set
24 up a new operation and renamed it Peace Hills Insurance.
25 We -- we started writing personal lines

1 business here in Alberta. And since that time the
2 company has expanded to commercial lines and to farm
3 business and we write, as I mentioned, in all
4 jurisdictions west of Ontario.
5 We have our head office, as I mentioned,
6 in Edmonton. And -- and our head office also
7 accommodates our Northern Alberta branch as well as the
8 underwriting for the rest of Canada which we refer to
9 often as the rock (phonetic).
10 The Alberta auto insurance market
11 generates as we talked just a few minutes ago, pardon me,
12 $2.5 billon in premium with sixty-nine (69) active
13 writers in the auto market.
14 And the top five (5) companies, and this
15 is what we just were mentioning a minute ago, Dennis was
16 talking about, we believe write approximately 35 percent
17 of the premium. The top ten (10) companies, as you
18 mentioned, write about 48 percent of the premium.
19 This makes Alberta one of the least
20 concentrated and the most competitive auto markets in
21 Canada. Peace Hills is the eleventh largest auto writer
22 in the province of Alberta and one of only three (3) auto
23 insurance companies that have their head office here in
24 the province.
25 Alberta accounts for 99 percent of our

1 automobile premiums and it represents 54 percent of our
2 company's total writings. So you can see that the
3 Alberta auto insurance market is a much more significant
4 market to Peace Hills than to any other insurance
5 company.
6 Clearly, any changes that we're -- are
7 made to the auto insurance product or to the pricing has
8 a much greater bottom line impact to Peace Hills than
9 most other insurance companies. We have no other
10 province to take our automobile product to.
11 Jamie's going to address the review of the
12 profit level, but I just wanted to comment on the Sampson
13 Cree Nation and the fact that they're put their
14 investment into Peace Hills Insurance.
15 They have huge investments in real estate.
16 They have -- own Peace Hills Trust a 100 percent. They
17 also own oil and gas companies and Peace Hills Insurance.
18 So they've deployed their capital and --
19 and -- and they have investment expectations of between
20 12 1/2 to 14 percent of -- from Peace Hills Insurance.
21 So, it's important for us that we can
22 achieve that. Of course, it's important for management
23 that we can -- that we can report back to our
24 shareholders that our auto product, which is a
25 significant portion of our business, can achieve the --

1 the return on equity that they're looking for.
2 So with that, I'm going to pass it over to
3 Jamie and he can -- I know you have this package in front
4 of you, so we didn't bring a our slide presentation.
5 MR. JAMIE HOTTE: Thank you. In the
6 package, there's two (2) exhibits and we came today with
7 the idea that you're going to be pummelled with all sorts
8 of data and analysis over the next few days going through
9 this process.
10 Based on what -- what -- we have seen
11 IBC's proposal and I believe they'll presenting to you
12 this afternoon and -- and in a general sense we're very
13 much in concurrence with the general theme of their
14 report. So we very much decided to keep our -- our
15 position certainly specific to Peace Hills and what our
16 needs are in terms of meeting our shareholders'
17 objectives.
18 So, in your packages there's two (2)
19 exhibits. Exhibit 1 is basically an analysis we've done
20 based on our 2005 data with -- with an outcome of what --
21 what the minimum ROE that our-- our shareholder would
22 expect, which is 12 1/2 percent.
23 These -- both these exhibits and the
24 process that we went through, we used an expense ratio of
25 30.3 percent, which is our -- our Peace Hills historical

1 experience for our company. It is above industry average
2 but -- but because we're a smaller company and -- and
3 eluding back to some of Diane's comments, that we are
4 flexible to take more time to underwrite the risks, there
5 is a -- there is a cost attached to that.
6 So -- so that 30.3 percent that we used in
7 our analysis is our actual expense ratio as an average,
8 looking historically.
9 We've used the payment patterns as per the
10 historical experience of Peace Hills as well. And that
11 would be out of our 2005 appointed actuary report; a
12 corporate tax rate of 32.1 percent; a risk-free rate of
13 return of 3.9 percent for our investment income on the
14 insurance operations, based on an average duration of
15 just less than three (3) years and an average of the
16 current Government of Canada one (1) to three (3) and
17 three (3) year bond rates; and a return on surplus of 5.9
18 percent as per Peace Hills investment performance in
19 2005.
20 We've also used a premium to surplus ratio
21 of one point seven five (1.75), which is in line with the
22 expert testimony presented in similar hearings that were
23 held in New Brunswick, and a loss ratio of 66 percent,
24 which is based on the 2003 to 2005 on level trend and
25 loss ratio for Peace Hills.

1 So with that set of assumptions, Exhibit
2 1, when you run those numbers through, the premium margin
3 comes out at 7.4 percent.
4 So -- so I guess the message we need to
5 send today is we're not adverse to the -- the concept of
6 using a premium margin concept. It's the amount of -- of
7 the actual margin that we're being allowed in order to
8 meet the objectives that we need to meet.
9 Now, certainly the -- the -- the
10 approached used today is simple to use, it's simple to
11 explain, it's simple to understand, and it certainly
12 allows for easy comparison amongst companies regardless
13 of how their capital is structured.
14 So, you know, all the presentations you
15 will hear over the next number of days certainly will be
16 all over the place because we did weigh our capital in
17 very many different ways.
18 So -- so certainly we do agree with
19 conceptually that is probably not a bad approach to take.
20 And -- and our biggest point here is just that we don't
21 feel it's perhaps enough in terms of the outcome of -- of
22 the ROE that -- minimum ROE there are -- there are
23 several we would expect.
24 So on Exhibit 1, with a premium margin of
25 7.4 percent based on the assumptions that -- that we've

1 made would provide us with a return on equity of 12.8
2 percent. So just slightly above the minimum that our
3 shareholder expects.
4 Exhibit 2 is the exact same exhibit. And
5 the only difference we do is we -- we replace the 7.4
6 with the 5 percent and that drops the return on equity
7 down to 9.9 percent. So, as you can see, that -- that's
8 falling short of -- of the minimum expectation that our
9 owners put on us.
10 And that's the really the basis of our --
11 our presentation. The difficulty is it is a moving
12 target. I think, you know, there was some discussion in
13 the earlier presentation of -- of interest rates
14 changing. There's many things that happen.
15 So, certainly we would support sort of a
16 ceiling or a cap so there's enough room in that margin
17 that -- that, you know, we would do the same thing that
18 Aviva's plans would be, is we want to be competitive, we
19 want to write business.
20 And so we would support, as opposed to a
21 provision but sort of a cap and -- and so our
22 recommendation would be if you allowed us between 7 1/2
23 and 8 percent on that premium margin calculation, that
24 would give us a lot more room to remain competitive and
25 more than likely we wouldn't need to take it all, but it

1 does leave room for any of those things that move in the
2 market.
3 And that's our presentation.
4 THE CHAIRPERSON: Thank you.
5 MR. JAMIE HOTTE: Unless --
6 THE CHAIRPERSON: Questions. Yes...?
7
8 QUESTIONS BY BOARD:
9 MR. LEWIS KLAR: I appreciate the -- the
10 -- the unique nature of the Company and -- and I think
11 it's a viable company for Alberta because of it.
12 I'd like you to comment on -- on this,
13 though. Under the present system we set a -- a rate and
14 then companies can come and seek, you know, exemptions
15 from the reductions. I think Peace Hills has just -- has
16 taken advantage of that.
17 MR. JAMIE HOTTE: That's correct.
18 MR. LEWIS KLAR: And what is wrong with
19 that system, sort of set -- setting up profit or ROE
20 which -- which generally works, but allowing individual
21 companies in unique circumstances such as your own to
22 come and seek an exemption?
23 For example, we heard from Aviva that
24 their target is 15.6 percent, significantly higher than
25 yours.

1 MR. JAMIE HOTTE: Right.
2 MR. LEWIS KLAR: And as I understood it,
3 although Ted was questioning that it -- at 5.3 percent
4 they were hitting about 15.6 percent -- 15.6 percent.
5 And 7 percent profit margin, they were -- who knows where
6 they'd be. You know, you'd be significantly higher than
7 that.
8 So, that of course will be, you know, I
9 think unreasonable for the consumer if -- if companies
10 were coming -- were taking advantage of that and coming
11 in with these huge ROE's.
12 So what is -- what is wrong with the
13 existing system that sets an -- that sets a profit which
14 may not be satisfactory for companies such as yours but
15 is more than satisfactory for other companies, that
16 allowing those companies who have unique circumstances
17 from coming to the Board and seeking exemptions?
18 MR. JAMIE HOTTE: You know, probably
19 nothing other than the fact that it is an expensive admin
20 -- administratively and from a time wise. So it's --
21 MS. DIANE BRICKNER: We were declined.
22 MR. JAMIE HOTTE: And we were declined --
23 MS. DIANE BRICKNER: You turned us down.
24 MR. JAMIE HOTTE: You turned us down, so
25 we didn't take advantage of the process.

1 (BRIEF PAUSE)
2
3 MR. LEWIS KLAR: We weren't in this
4 place, but nevertheless, you know the --
5 MR. JAMIE HOTTE: But barring that,
6 again, you know, we firmly believe within a ceiling, at
7 least we have to remain competitive and even more so than
8 the large national companies.
9 We are a small regional player. It's
10 critical that we have to stay in the marketplace. And --
11 and we just think it's awkward and it's probably costly
12 and less effective every time they to have to go and put
13 forth that argument to -- to the Board.
14 And so again, our recommendation would be
15 if you give us a little bit of latitude and -- to more of
16 a ceiling with that margin built in. It still -- it
17 still allows us to do what we need to do. But there's
18 two (2) things we need to -- we need to earn that minimum
19 equity, our return on equity, but we also have to remain
20 competitive and grow the company.
21 So we're always on top of -- of remaining
22 competitive. And, in fact, with the new system, there's
23 a lot of business we use to write on our books now is
24 sitting in the -- in the pool, and we'd love to have it
25 back if we had a little bit more room to price onto that

1 business.
2 So, if you like -- it's interesting. We -
3 - we just talk about it, we just put our budget together
4 and our share -- what we actually process for the risk
5 sharing pool is -- is exceeding $10 billion. And a lot
6 of that came off our book of business and we used to
7 write that on our own competitively.
8 So -- so we are very unique. And -- and
9 certainly that is an option, you know, to come to the
10 Board and -- and appeal -- appeal it. The difficultly
11 administratively is -- and using even our last appeal as
12 the example, we had to make -- do a makeshift discount so
13 we could go through the appeal process. And so by the
14 time we actually we were turned down, many months have
15 passed by
16 So, administratively, it is -- it's a
17 nightmare because of the time, I think, so.
18 THE CHAIRPERSON: Further questions...?
19
20 (BRIEF PAUSE)
21
22 THE CHAIRPERSON: Oh, I'm sorry, Dennis,
23 I didn't see you.
24 MR. DENNIS GARTNER: The same question as
25 I asked -- that I asked to Aviva about the business plan

1 because you're an Alberta company.
2 Since the reforms in your view do you see
3 a difference in the competitiveness of the Alberta
4 market?
5 MS. DIANE BRICKNER: Yeah.
6 MR. JAMIE HOTTE: We -- we do.
7 MS. DIANE BRICKNER: Yeah, that's --
8 MR. JAMIE HOTTE: In fact, you know, as I
9 said we just in the last few weeks have been working on
10 our budget and -- and projections and we are expecting --
11 we're -- we're seeing all the signs of a very competitive
12 market and we are trying to hold our premiums. We're
13 trying to hold our premiums aside from the mandatory
14 reduction but we're -- we're seeing some pressures. So
15 definitely there is competition out there.
16 MR. DENNIS GARTNER: Do you have any view
17 as to why that market is becoming more competitive or --
18 or is it just the same as it always was?
19 MS. DIANE BRICKNER: It's profitable.
20 MR. JAMIE HOTTE: It's -- certainly it's
21 profitable. I -- I think if you think back to -- to pre-
22 reform and -- and what led up to that and then 2004
23 October and it came and you know there was so much
24 uncertainty I think companies weren't sure what to do and
25 they were just trying to implement the new system and --

1 and we were sidetracked --
2 MS. DIANE BRICKNER: Hmm hmm.
3 MR. JAMIE HOTTE: -- with just putting in
4 a new auto system.
5 You know, really this system itself, we're
6 okay with the system. It appears to be working. Most of
7 the dust is settling. We're not getting complaints. Our
8 retention has improved and there's lots of many, many
9 positive things we see with the core system.
10 And I think that comfort is, we talked
11 about competitiveness now, to an extent, in our areas.
12 In fact we -- we did apply to the Board and we did
13 actually take some reductions in some certain classes of
14 business and that was effective June. And the Board did
15 approve that.
16 So -- so we do see that competitive cycle
17 starting up again.
18 MR. DENNIS GARTNER: So would -- does
19 that mean we'll -- we'll see reductions in -- in your
20 view we'll see reductions in the next year in -- in
21 pricing?
22 MR. DIANE BRICKNER: I think so.
23 MR. JAMIE HOTTE: I --
24 MS. DIANE BRICKNER: I think what we are
25 seeing -- sorry, Jamie -- is we're -- we're feeling

1 pressure from our brokers and from our branch managers
2 and our underwriters to either add more to our -- make --
3 make our product more valuable, add more frills to the
4 product and in some cases to reduce prices in certain
5 areas.
6 And as Jamie mentioned we have reduced
7 prices in some of the, you know, eight (8) star rating,
8 seven (7) star rating business, but definitely the
9 market's softening and that's because as Jamie mentioned
10 there's more certainty and I think we talked about it.
11 Grant and I and Jamie on our way up here
12 as saying we remember sitting in this room a number of
13 years ago right in this very spot and -- and you had the
14 flip chart out and we said you know what? When you asked
15 me what I thought of it I said we can -- we can provide
16 anything you give us as long as it's fair.
17 And so, you know, that -- that's all we're
18 asking is because Peace Hills' costs for reinsurance are
19 higher than our competitors, most of our competitors, the
20 larger ones. The cost of us doing business is -- is more
21 expensive for a lot of reasons because we're a small
22 company.
23 You need to make sure that whatever you
24 set is fair for the big ones as well as the small ones
25 because we want to continue to be here for another

1 twenty-five (25) years; not me personally, but...
2 THE CHAIRPERSON: Further questions at
3 this end of the table?
4 MR. DENNIS GARTNER: So just to -- to
5 summarize then we should be expecting if the market is in
6 fact competitive then RWE's are -- if they stay where
7 they are and indications at least what I'm reading is is
8 that they will stay where they are for a little while
9 yet.
10 We should see some -- some price
11 decreases?
12 MS. DIANE BRICKNER: You will see
13 competitiveness in the market, certainly not general. I
14 don't think everybody's going to reduce their prices
15 overall but they're going to pick and choose spots where
16 they believe they can be more competitive and as Jamie
17 said, we have a lot of business that we're giving to the
18 risk sharing pool that we -- we did well on and we would
19 like to have that business back but...
20 MR. JAMIE HOTTE: And -- and that's
21 probably one (1) of the key things. We don't see the
22 cycle happening as quickly as we might have seen it pre-
23 reform and there's a huge concern on the size of the risk
24 sharing pool and -- and that creates a huge uncertainty--
25 MS. DIANE BRICKNER: Yes.

1 MR. JAMIE HOTTE: -- as to, you know,
2 what -- what's going to happen with that. Now they have
3 made some adjustments downward but it's only a few years
4 old. So that's probably what, you know, normally if --
5 if we think historically a competitive cycle, you sort of
6 see it coming and -- and it happens a lot quicker.
7 Certainly there's that looming, to see
8 what is really the end result, when it's so large? You
9 know, if -- if it wasn't that large it wouldn't be such a
10 big factor but, you know, when you -- when you look at
11 how big that is, it's well in excess of $400 million.
12 MR. DENNIS GARTNER: Yes, and -- and I'm
13 not in a position -- don't get me wrong, I'm not
14 criticizing the market for not being competitive yes.
15 MR. JAMIE HOTTE: Right. Right.
16 MR. DENNIS GARTNER: In fact if -- if
17 those ups and downs aren't as quick or aren't as -- as
18 large, that may be of benefit to consumers.
19 MS. DIANE BRICKNER: To the consumers,
20 yes.
21 MR. DENNIS GARTNER: It's too early to
22 judge. But I quite frankly thought we would be seeing
23 some -- seeing more price -- price reductions than --
24 than we already -- than -- than we've seen so far in
25 Alberta and if they're not there yet but they're coming I

1 think we could live with that.
2 MR. JAMIE HOTTE: And you know we can
3 probably only speak the best for ourselves --
4 MR. DENNIS GARTNER: Of course.
5 MR. JAMIE HOTTE: -- and -- and, you
6 know, not only did we -- we look at some of our, you
7 know, sort of typical standard preferred classes or what
8 we used to call our, " paying business" we -- we took
9 some substantial reductions on younger drivers, so not
10 the sixteen (16) year olds but the twenty-one (21),
11 twenty-two (22), twenty-three (23) year olds.
12 You know, we -- we cut our rates by 25 or
13 30 percent. So we did that and that was effective June
14 so we were very much looking in the market, where can we
15 be competitive and, you know, would certainly be
16 strategies behind -- behind that.
17 So -- so we -- we plan to move. I mean,
18 you know, it is profitable for us. You know, we are --
19 we are moving. We're starting to see competition not so
20 much in rates yet but we're seeing added value things
21 that are adding in free coverages. There's one (1)
22 giving Aeroplan points. I mean you're just starting to
23 see --
24 MS. DIANE BRICKNER: Exactly.
25 MR. JAMIE HOTTE: -- it pick up. The

1 momentum is picking up.
2 MS. DIANE BRICKNER: And I think that
3 from a shareholder's standpoint and Marvin can certainly
4 address that if he wants but we have a lot of pressure
5 from our shareholder to grow. I mean the company's done
6 well for a number of years and so they put a lot of
7 pressure on to see significant growth.
8 So to do that, you know, you all -- you
9 all have to know that, like, to -- to grow significantly
10 you have to reduce your price. So we don't have the
11 capital to buy Aviva so we have to do it -- we have to do
12 it.
13 THE CHAIRPERSON: Thank you. Ted or
14 anybody?
15 MR. TED ZUBULAKE: Just quickly. But you
16 would be reducing prices even though the industry-wide
17 adjustment only has a 5 percent revision as opposed to
18 the 7.4 percent that you would like to have?
19 MR. JAMIE HOTTE: We would but that's
20 right across the board so fundamentally that does not
21 allow us to be strategically competitive.
22 MR. TED ZUBULAKE: Okay. Thank you.
23 THE CHAIRPERSON: Thank you. Any other
24 questions? Thank you very much for your presentation.
25 MS. DIANE BRICKNER: Thank you.

1 THE CHAIRPERSON: We'll recess now until
2 after lunch.
3
4 --- Upon recessing at 11:58 a.m.
5 --- Upon resuming at 1:01 p.m.
6
7 THE CHAIRPERSON: Good afternoon. We've
8 had a busy morning.
9 We're looking forward to your presentation
10 this afternoon and, Jim, I'm going to call on you to
11 introduce people.
12 I introduced the Board this morning and I
13 think you know them all --
14 MR. JIM RIVAIT: Sure.
15 THE CHAIRPERSON: -- so I won't go
16 through it
17 again and we'll hear your presentation and then the Board
18 will ask questions for the purpose of clarification if
19 they so desire and you have our attention for the whole
20 afternoon so --
21 MR. JIM RIVAIT: Okay.
22 THE CHAIRPERSON: -- you're on.
23
24 PRESENTATION BY IBC:
25 MR. JIM RIVAIT: Well, Thank you very

1 much, Mr. Chair, and I'm going to ask that some of the
2 people that we brought with us to help me out in their
3 introduction just so I don't foul anything up.
4 I think you know folks from IBC; there's
5 Jane Voll, she's our vice-president of policy and chief
6 economist. Also from IBC is Grant Kelly beside her.
7 He's a director in our Policy Group and we have I think
8 quite an all-star team with us today from various
9 universities and -- and areas of the country with a wide
10 range of experience.
11 So I -- I'm going to ask -- first I'll
12 have Rich Phillips; he's a professor at Georgia State
13 University, then Sharon Tennyson; she's Associate
14 Professor at Cornell, Richard Derrig, he's with Opal
15 Consulting and visiting professor with the Wharton
16 School, University of Pennsylvania, and Richard Gauthier
17 with Price Waterhouse Cooper.
18 So -- so maybe, Richard -- Rich, we can
19 start with you just to give the group a little bit of
20 background.
21 DR. RICHARD PHILLIPS: Sure. Good
22 afternoon everyone. My name is Richard Phillips, and as
23 Jim said I'm from Georgia State University in Atlanta,
24 Georgia. I'm the Bruce A. Palmer Professor of Risk
25 Management Insurance and I'm also the chairman of the

1 department at Georgia State.
2 I don't know how familiar you are with our
3 department but we are twenty-seven (27) full-time faculty
4 focussed on risk management and insurance. It makes us
5 the largest risk management insurance academic group I
6 believe in North America and I'm -- I can't vouch for the
7 world but I think it's pretty darn close. We're a very
8 large and dedicated institution.
9 I've been there for thirteen (13) years.
10 I graduated, my PhD from the University of Pennsylvania
11 in 1994 and prior to my Graduate School I'm originally
12 from the State of Minnesota which is also another great
13 hockey capital of the world.
14 We enjoyed the Calgary Flames last night
15 so it was fun to come back north and see snow in
16 November. We don't see that very often in Atlanta. And
17 I did my Undergraduate in Mathematics at the University
18 of Minnesota.
19 MR. JIM RIVAIT: Sharon..?
20 DR. SHARON TENNYSON: Hi. I'm Sharon
21 Tennyson. I'm an economist and I'm on the faculty in
22 Public Policy Group at Cornell University. I have a PhD
23 in economics from Northwestern University with a
24 specialization in Industrial organization regulation. So
25 my area of expertise is government regulation of markets.

1 And I have a particular interest in
2 government regulation of insurance markets and I've done
3 a great deal of work on regulation of automobile
4 insurance markets.
5 DR. RICHARD DERRIG: Oh, that's me. My
6 name is Richard Derrig. I'm a mathematician. I trained
7 at Brown University. I'm not an actuary, I always say
8 that, but I lost my way about thirty (30) years ago and
9 studied -- stumbled into insurance.
10 I was twenty-seven (27) years at the
11 Automobile Insurers' Bureau of Massachusetts, Workers'
12 Compensation of Massachusetts, and for fifteen (15) years
13 at the Insurance Fraud Bureau as the Vice President of
14 Research.
15 Over that time period we've done a lot of
16 research on -- with academics and the industry people on
17 research of financial matters related to pricing and
18 we've collaborated over the years with Wharton
19 culminating with my teaching of the risk management
20 course last semester.
21 And then finally I want to tell you that
22 Massachusetts contributed -- Tony Amonte who scored the
23 two (2) goals that won for the Calgary Flames last night.
24 MR. RICHARD GAUTHIER: My turn? Richard
25 Gauthier, a partner at Price Waterhouse Coopers. I am an

1 actuary. This is positive or negative; I'm not sure yet.
2 I'm a Fellow of the Canadian Institute of Actuaries, a
3 Fellow of the Casualty Actuarial Society, American
4 Academy of Actuaries.
5 I consult to a variety of entities from
6 government entities, regulatory boards, insurance
7 companies. I head a group of fifteen (15) professionals
8 that consult to the actuarial requirement, actuarial
9 field of consulting to basically Vancouver to St. John --
10 St. John. I can never figure out which one (1) is in
11 Newfoundland and the -- and in that capacity I've been
12 asked by IBC here to present some views as -- as we move
13 along through this hearing and assist in that.
14 MR. JIM RIVAIT: So as you've seen we have
15 quite a lineup of -- of folks and I hope you can take
16 full advantage and -- and while I'm going to be mindful
17 of the time and as you've seen we've got about ninety
18 (90) slides so we're going to have to move through them.
19 Mr. Chair, if you feel it's appropriate
20 for people to take or for us to take questions as -- as
21 we go along since it is such a long time, I'd be happy to
22 do that.
23 THE CHAIRPERSON: That would be fine,
24 Jim, we direct them through the Chair.
25 MR. RICHARD GAUTHIER: And as -- just for

1 housekeeping is there a point that you want to take a
2 break this afternoon at a particular time or are we going
3 straight through or what would you like?
4 THE CHAIRPERSON: I'm surprised you got
5 all these Yankees across the border the way it's been
6 lately.
7 DR. SHARON TENNYSON: It was difficult.
8 DR. RICHARD DERRIG: They prefer the Red
9 Soxs down there.
10 MR. JIM RIVAIT: Okay. We'll go to the
11 next one.
12 Your -- your request was very specific and
13 -- and, you know, you -- you asked some questions and
14 hopefully we can get to all of these questions today.
15 Firstly, an appropriate target ROE level
16 for basic automobile insurance written in Alberta, the
17 appropriate level components of the reconciliation
18 between profits revision, percent of premium in ROE,
19 calculation techniques or models to convert target ROE to
20 an appropriate profit provision and the impact of pending
21 changes to financial accounting.
22 So we'll -- we will get to all of those
23 and, you know, we have to talk about these four (4)
24 questions in the context of your mandate so I've taken it
25 directly from the regs. I don't really have to recite it

1 to you, but I'll -- I'm going to read it in nevertheless:
2 "The mandate of the Board is to set
3 premiums for Basic coverage, monitor
4 premiums for optional coverage and
5 review and approve appropriate rating
6 programs for new insurers entering the
7 Alberta Market. The new Board will
8 annually set the maximum premiums for
9 Basic coverage that all insurers can
10 charge."
11 So I think that's laid out fairly clearly
12 and I'll -- I'll talk a bit about the P&C industry in
13 Alberta; you've heard a lot of it before.
14 We know in our economy today and how busy
15 things are that insurance sort of underlies all the risk
16 taking that's occurring when -- when you see the kind of
17 development and building and so on that's occurring in
18 this province. I mean we may be talking about automobile
19 insurance as it relates to this Board but insurance
20 covers all aspects of society.
21 Invested assets in Alberta exceed 5.4
22 billion. Thirteen-thousand (13,000) people work in the
23 Alberta property and casualty insurance industry.
24 Alberta insurers wrote over 4.9 billion in insurance
25 premiums in 2005. Industry paid over 3.15 billion to

1 Albertans in claims and 326 million in taxes and levies
2 was paid to the government.
3 And I mean these are all significant
4 contributions to the Alberta economy but we know a
5 healthy insurance industry is vital to any economy and we
6 want to see a healthy insurance industry in Alberta.
7 So you'll see a couple of themes here that
8 will -- or a few things that we'll be pursuing throughout
9 the afternoon -- competition -- one (1) competition is
10 the best regulator for price and profit. Two (2) -- and
11 we'll have some experience from other jurisdictions that
12 we hope you find applicable and we'll have some specific
13 recommendations for you.
14 So what I will do is I'm going to be
15 turning it over to Jane and Sharon Tennyson to talk about
16 the first theme and that's competition.
17 MS. JANE VOLL: Thank you, Jim. Actually
18 Sharon's going to do the heavy lifting on this one and
19 I'm just here for Canadian content and with -- with
20 Grant's assistance.
21 What we -- we talk a lot about
22 competition; I'm sure every submission you receive from
23 us since you formed yourselves as a Board has included
24 references to competitive industry and competitive
25 markets and so on.

1 And we thought we should take a few
2 minutes to explore what -- what does that mean for us
3 because when we took some time to think about that
4 ourselves, people have different things in mind when they
5 think about a competitive market and think about what
6 that entails.
7 And we thought we would try to establish
8 some common ground in terms of an understanding of what -
9 - what it means to have a competitive market to oversee
10 as you do because the -- the recommendations that we
11 would make and -- and the decisions that you are -- are
12 challenged with coming up with rely to a great extent on
13 your conception of the market and how it works, so we
14 will take a few minutes.
15 In our view it is very competitive out
16 there in the Alberta auto insurance marketplace right now
17 and competitive markets work for consumers. And now
18 we'll turn it over to Sharon to explore this a little
19 more fully.
20 DR. SHARON TENNYSON: Thank you. So
21 I'm -- I'm going to talk a little bit about what we mean
22 in practice by a competitive marketplace and we will have
23 two (2) main points to emphasize here, the first being
24 that automobile insurance markets generally and Alberta's
25 auto -- auto insurance markets specifically are

1 competitive.
2 And the second point that I want to make
3 is -- is that that is -- that is good news. It's good
4 news for society because competitive markets give
5 producers the incentives to use resources efficiently.
6 It's good news for consumers because
7 competitive markets are the most responsive to consumer
8 needs, desires, demands if you will, and it's good news
9 for regulators because competitive markets can help you
10 achieve the objectives that you would like to achieve in
11 your regulation.
12 But let's -- let's turn a little bit to
13 talk about models of competition. So we have here
14 economists' traditional model of a perfectly competitive
15 market, right?
16 So we've got two (2) curves here, the
17 supply curve. The upward-sloping curve there represents
18 the number of units of the good that producers are
19 willing to provide in the market at any price and the
20 demand curve, the downward-sloping curve there is
21 representative of the number of units of the good that
22 consumers want to purchase at any price, right?
23 So not surprisingly producers want to sell
24 more when the price is higher and consumers want to
25 purchase less when the price is higher so the curves go

1 the opposite direction.
2 Now, one (1) of the great features of a
3 competitive marketplace, and we see that depicted in the
4 diagram here, is that the market is going to come to a
5 resting point where the quantity that's demanded by
6 consumers is exactly met by the quantity that's supplied
7 by consumers, right?
8 That's the -- represented by the
9 intersection of those two (2) curves here and just for
10 concreteness we're saying that's the quantity of three
11 (3) and a price of three (3); that that's just a -- a
12 general representation.
13 What happens in these -- in this perfectly
14 competitive marketplace is that all consumers will pay
15 the same price for the product and the price that
16 consumers pay is just equal to the cost of bringing the
17 last unit of that product to the marketplace.
18 Another feature of competitive markets is
19 that if consumer demand for the product changes, supply
20 will respond to those changes in consumer demands.
21 So why am -- why am I showing you this
22 diagram? There's not going to be a test later. Why --
23 why I'm showing this diagram is I think this is whether
24 explicitly or not the model that most of us have in mind
25 when we hear the word, "competition". This is a

1 traditional model of perfect competition that's put out
2 there by economic theory.
3 What I want to emphasize is that this is a
4 model. It's a construct. It's a simplification. This
5 doesn't represent any actual market anywhere in the world
6 and certainly when I say to you that automobile insurance
7 markets are competitive, this -- this is not the
8 representation that I have in mind. I have a much more
9 complex view that takes into account the realities of a
10 marketplace.
11 So for a long time since at least the
12 1930's or 1940s economists have recognized that this
13 model rests on a number of critical assumptions that make
14 its applicability in real world contexts a little bit
15 unrealistic.
16 So the model that we put up there rests on
17 assumptions that everyone has perfect information so
18 consumers and suppliers know all prices and all the
19 locations of goods and services without even having to
20 make any effort to know those things.
21 A second assumption is that there's one
22 (1) identical cost of goods sold for all suppliers; all
23 suppliers have the same cost curve.
24 And a third assumption is that the market
25 is filled with just a single product, that all products

1 put out by all producers are exactly identical.
2 And these are clearly a little unrealistic
3 when you look at markets. And what's come under
4 criticism over the years of this model of perfect
5 competition from economists is primarily this third
6 assumption that there's one (1) uniform product.
7 At least since the 1930's, and in fact
8 Edward Chamberlain received the Nobel Prize for
9 developing this more realistic view of what we mean by
10 competition markets, at least since that time it's been
11 recognized first of all that it's impossible as a -- as a
12 matter of fact for all products to be identical. Even if
13 they appear on their face to be identical they probably
14 differ in some degree of quality, or if not quality,
15 location or time or some services attached with them.
16 So to sort of think of all products in a
17 marketplace being identical is unrealistic but
18 Chamberlain's main point and where we go from there is
19 that this is -- this is not even a desirable thing,
20 right?
21 What this assumption of uniform products
22 does is it ignores the fact that consumers have different
23 tastes and in fact consumers may have a preference for
24 variety of products in markets. It's beneficial to
25 consumers to have some choice in -- at least in a small

1 way of what they're consuming.
2 So I don't want to buy the same suit as
3 you necessarily or I don't want -- Richard doesn't want
4 to buy exactly the same necktie as someone else, right?
5 So there's some benefit to consumers of having product
6 variety in the marketplace.
7 And what Chamberlain developed into --
8 into this theory of competition with differentiated
9 products is the idea that this product differentiation
10 is good for consumers, that's a benefit for consumers.
11 And secondly that this model of perfect
12 competition that we think of with this supply curve and
13 demand curve intersecting it at a single price is -- is
14 not even representative of the ideal form of a market for
15 consumers if consumers have different tastes or some
16 preference for variety in markets, okay?
17 And so we'll keep in mind that that's how
18 we think of perfectly competitive markets but when we
19 start to think about whether an actual market is
20 competitive, when we look at competition policy or
21 regulatory policy we want to embellish our model a little
22 bit and think about the realities of competitive
23 marketplaces.
24 And so when we think about regulatory
25 policy or competition policy most economists think about

1 competition in terms of a notion of workable competition,
2 not this perfect competition with homogeneous products
3 but a more nuanced idea of competition which takes into
4 account the realities of the marketplace.
5 Michael Porter of Harvard Business School
6 has developed probably the -- the best way of describing
7 this idea and his model is what's presented in our slide
8 here.
9 Porter argues that there are five (5)
10 important characteristics of a market that determine how
11 competitive it is. So we're thinking now in terms of
12 degrees of competitiveness once we -- once we start
13 moving into real markets.
14 So these include first how strong is the
15 threat of new entrants, how strong is the thread of
16 substitute products, the competitive rivalry across firms
17 in the industry, the bargaining power of suppliers, and
18 the bargaining power of customers.
19 Now, Jane and Grant are going to --
20 because I am coming from south of the border -- help us
21 think through to what extent we can apply these
22 characteristics of -- of Porter's model of workable
23 competition to the Alberta auto insurance market.
24 MS. JANE VOLL: Thank you, Sharon. We
25 could spend a long time discussing this and it's -- I

1 would have a great time but I know that we've got other
2 business to get to this afternoon that's in keeping with
3 your real question so I propose we go through this rather
4 quickly, but if anyone wants to elaborate on any of this
5 any further we would certainly welcome that opportunity.
6 As Sharon said, auto insurance
7 marketplaces and -- and -- including the Alberta auto
8 insurance marketplace is competitive by the model of
9 workable competition and we know that because we look at
10 each of those factors outlined by Michael Porter and look
11 at some of the signs as to whether it's true or not.
12 So, for example, what is the threat of new
13 entrants? If new entrants can come into an industry
14 relatively easily, it is more competitive. Our -- our
15 understanding is that new entrants can enter the P&C
16 insurance industry very easily compared to many other
17 industries so this -- this is one (1) of the factors what
18 -- that make this industry competitive.
19 The Federal Superintendent has a $5
20 million minimum capital that you need to get into the
21 business. Alberta has three (3). There are also a
22 number of ways to reach consumers. You can -- you don't
23 have to build your own sales force. You can get in and
24 use the broker's sales force for example.
25 So there are a number of -- of aspects of

1 the way the industry's set up. There's -- there is very
2 low or no economies of scale for example. You don't have
3 to be huge in order to compete effectively.
4 So there's a number of reasons why it's
5 easy for new entrants to get in and that's one (1) of the
6 factors that makes the auto industry in Alberta -- auto
7 insurance industry in Alberta more competitive.
8 Suppliers, did you want to say anything or
9 shall I just carry on?
10 DR. SHARON TENNYSON: Hmm hmm.
11 MS. JANE VOLL: You've got a couple of
12 points --
13 DR. SHARON TENNYSON: Okay. Well, the
14 -- the industry insurance industry -- when we talk about
15 power of suppliers we're talking about firms that supply
16 input to the industry. So the insurance industry and --
17 and the greater the bargaining power of suppliers to
18 determine the price of transactions for those inputs the
19 more competition there is in the industry receiving those
20 supplies.
21 So the insurance industry has to deal with
22 many suppliers of inputs including lawyers, health
23 providers, auto repair shops for example but we want to
24 keep in mind the -- the primary -- the most important
25 suppliers to the insurance industry are those on the

1 financial end.
2 So we can think of reinsurers as being
3 suppliers to the insurance industry and we can also think
4 of global capital markets being suppliers to the
5 insurance industry.
6 And these suppliers of the financial -- on
7 the financial end of the insurance industry have
8 significant bargaining power in dealing with the
9 insurance industry.
10 MS. JANE VOLL: To build on that with
11 respect to Alberta, you know to -- to get a barrel of oil
12 out of the ground you need capital in the form of hard
13 capital. You need machines and equipment and all of that
14 kind of thing.
15 In order to sell an insurance policy you
16 need capital but you need financial capital. Where does
17 that 5 million bucks come in order to pass the OSFI
18 hurdle or the 3 million to get past the Alberta entry
19 fee?
20 You have to convince someone to put their
21 money at risk and -- and that capital comes from an
22 extremely competitive capital market where the P&C
23 insurance industry anyone wanting to go into business is
24 a price taker.
25 They go there and -- and -- and do their

1 best to convince capital to come and -- and take a chance
2 in the Alberta auto marketplace. Definitely not a price
3 take -- a price setter in that global setting.
4 DR. SHARON TENNYSON: In terms of the
5 threat of substitute products what we mean by that is if
6 there are many different product varieties and if it's
7 easy for consumers to substitute one (1) of those product
8 varieties for another, the industry is going to be more
9 competitive.
10 The reason being obviously that actions
11 taken by a producer to raise prices or do not meet the --
12 the varietal demands of consumers are going to lead
13 consumers to make a switch.
14 MS. JANE VOLL: So on this one (1)
15 there's a lot of substitute ability for an auto insurance
16 policy in Alberta. Maybe Jim decides every year, do I
17 want a policy from ING or Allstate or Peace Hills and --
18 and one (1) isn't necessarily the same as -- as the
19 other.
20 Consumers are buying a risk transfer,
21 transferring the uncertainty of those losses but they're
22 also buying the reputation of that company. What we know
23 about the pace and manner in which they handle claims,
24 you're buying the way that they sell the product to you,
25 what they

1 -- how they interact with you as a consumer.
2 You're buying the whole collection of
3 attributes when you decide or I decide whether to, you
4 know, insure my car with -- with Co-Op this year or -- or
5 State Farm or -- or whatever.
6 So there's a lot of substitute ability and
7 -- and I guess the next slide goes into that a little is
8 his -- any of us can move every year. We can choose a
9 relatively low cost to stick to another insurer and --
10 and insurers are always trying to make themselves
11 attractive to -- and have retentions and so forth.
12 And the different mixes and blends they
13 have lead to price differences. But this -- this I all
14 leads to the fact there is -- there's quite a bit of
15 substitute ability in the product and -- and that leads
16 to consumers having a lot of power in the market vis-a-
17 vis an insurer because they could be with you for a year
18 and then they're gone.
19 Do you want to do this illustration?
20 DR. SHARON TENNYSON: I can do the -- the
21 Coca-Cola illustration. This is just a general
22 illustration of how a product that on its face appears to
23 be a homogenous product can in fact have attributes that
24 make it differ in time and place and accompanying
25 services, right?

1 So Coca-Cola is a Coca-Cola, right? We
2 know that, you know, this -- this bottle looks the same
3 pretty much wherever we buy it. But there -- there are
4 differences in time and place and associated services and
5 amenities with consuming a coke.
6 And those are going to lead to --
7 consumers have different preferences over which of these
8 cokes they consumer at a particular point in time. It's
9 going to lead to different prices for the coke. In -- in
10 different sort of, you know, bundles of attributes that
11 go with the coke, okay?
12 And so even though a coke is a coke is a
13 coke, it isn't really, right? It depends on where you're
14 buying it, when you're buying it, the services that go
15 with it, the convenience that might go with it at a
16 particular point in time.
17 So even though the -- the product appears
18 to be one (1) -- one (1) product, a homogenous product
19 actually in the context of consuming it, it can have some
20 -- some variety depending on time and place accompanying
21 the services.
22 MS. JANE VOLL: So again on -- on
23 substitute ability, we -- we just want to take a moment
24 and say back to Alberta insurance marketplace, what does
25 that mean?

1 You know, if I were living in Calgary and
2 was 40 years old and married maybe not to the minivan but
3 I had a Windstar minivan in 2003, I -- I could go out and
4 the average of all of the quotes in the marketplace would
5 have offered me a premium of seven hundred and thirty-
6 eight (738).
7 The median if you start at each end and
8 count your way in, would have been a company offering a
9 policy at six hundred and thirty-six (636) and the lowest
10 price might have been a four twenty-seven (427) and --
11 and there's all kinds of choices in between there.
12 I might choose -- I might look at the four
13 twenty-seven (427) and I might say, you know what, I -- I
14 think I want the six thirty-six (636) because that
15 company is -- they have an office in my building so
16 they're convenient for me to reach and you know what,
17 they give me a really good deal on my home insurance.
18 And they have a payment plan that I really like.
19 So maybe that's the company I'm going to
20 go with or that there might be another collection of --
21 of attributes that work for me and that's what is part of
22 me choosing from -- from one (1) company to the next.
23 MR. JIM RIVAIT: Jane, I think it's
24 important to make that point if you go to the SGI or MPI
25 websites, you'll find out that this same risk at Manitoba

1 Public Insurance costs one thousand and eighty dollars
2 ($1,080) and at Saskatchewan Government Insurance eight
3 hundred and fifty-six dollars ($856).
4 So it can give you a sense that, you know,
5 we hear about comparability and when we live in the sea
6 of public insurance, the competitive system here sees a
7 lower price for that risk.
8 MS. JANE VOLL: And -- and an array of
9 choice.
10 DR. SHARON TENNYSON: The bargaining power
11 of consumers is important for determining competition in
12 a marketplace. Now in -- in automobile insurance,
13 consumers don't have direct bargaining power in terms of
14 being able to negotiate with an individual insurer the
15 price and coverage that they're receiving.
16 But they do have indirect bargaining power
17 due to their ability to choose across -- to choose their
18 insurance provider. And the ease they have in switching
19 between providers during -- across different years.
20 As long as there are a large number of
21 insurers in the marketplace, consumers have considerable
22 bargaining power in this implicit or indirect way.
23 MS. JANE VOLL: So it's a one (1) year
24 contract. You presently have sixty-five (65) insurers
25 giving the consumer lots of -- lots of choice to shop

1 around and any insurer that -- that's not meeting their
2 preferences, they're out of the picture and that consumer
3 can move on.
4 I think the next picture just illustrates
5 that graphically -- this is just a sub set of them.
6 There's a whole lot more, it gives the consumer a lot of
7 -- a lot of choice and a lot of ability to get the terms
8 and conditions and package of -- of services that they're
9 looking for.
10 DR. SHARON TENNYSON: You also want to
11 look at the degree of competitive rivalry across firms in
12 the industry. One (1) of the most important features
13 that's going to determine competitive rivalry across
14 firms is having a large number firms in the industry.
15 A large number of firms that offer
16 different, slightly differentiated products will lead to
17 rivalry to gain market share in the industry. Firms will
18 have not only an incentive to compete over price but to
19 try new marketing and service strategies to introduce
20 different product varieties if those meet consumer needs.
21 And so we -- we want to look at -- to the
22 extent that an industry has a large number of firms
23 offering a -- a diverse array of products, this is how we
24 can evaluate competitive rivalry in an industry.
25 MS. JANE VOLL: Just maybe you want to

1 take a minute on this one (1) objective measure of --
2 DR. SHARON TENNYSON: There -- there are
3 some objective or statistical measures that national
4 agencies who -- who oversee competition policy tend to
5 use the compare industries, a summary sophisticate if you
6 will of -- of trying to indicate the degree of
7 concentration of an industry.
8 So the Herfindahl -- the Herfindahl index
9 or the Herfindahl-Hirschman score is one (1) of those
10 summaries sophistic which takes into account not just the
11 number of firms in an industry but the relative market
12 shares across all the firms in the industry.
13 And aggregates that up into a score and in
14 the US the Department of Justice oversees competition
15 policy and in Canada the OSFI -- I'm sorry, who --
16 MS. JANE VOLL: Europe Competition
17 Policy.
18 DR. SHARON TENNYSON: There you go. The
19 overseer of competition policy in Canada have similar
20 objective measures for comparing across industries this
21 Herfindahl index or score in both cases they use as an
22 indicator of a very competitive market a Herfindahl index
23 or score of one thousand (1000) or less.
24 And we have a rate here in this graph,
25 Alberta's auto insurance market in comparison to some --

1 some others and we see that Alberta's auto insurance
2 market in terms of combining this number of competitors
3 and the relative market share across competitors,
4 definitely comes in below a thousand (1,000) unlike some
5 of the others.
6 And so by this objective measure we wanted
7 to create a summary statistic. We -- we would say that
8 Alberta is definitely a competitive market.
9 THE CHAIRPERSON: Merle, would like to
10 jump in with a question.
11
12 QUESTIONS BY BOARD:
13 MS. MERLE TAYLOR: Would you just explain
14 this to me because this is automobile insurance, BC and
15 Saskatchewan have government insurance, so I would have
16 thought that there's only one (1) supplier of the
17 product. So why would they score --
18 MR. GRANT KELLY: If they're not below
19 it.
20 MS. MERLE TAYLOR: I beg your pardon?
21 MR. GRANT KELLY: Yeah. It also includes
22 optional coverage so it's total. So the -- the market
23 shares of the optional coverage, there's relatively few
24 insurers picking that. That means that's why they have
25 such a high score.

1 MR. DAVID WHITE: Lower is better, right?
2 MR. GRANT KELLY: Lower is better -- the
3 lower the number the -- the more competitive the market--
4 MR. DAVID WHITE: When you say Alberta is
5 significantly below a thousand (1,000), it's not that
6 significantly below a thousand (1,000). Is a thousand
7 (1,000) the benchmark? How does a thousand (1,000) play
8 into this?
9 DR. SHARON TENNYSON: The -- a monopoly
10 market -- and this -- this is your point, why -- why
11 don't those markets have government insurance come out
12 with a really big score. Right?
13 A monopoly market would come in an index
14 of ten thousand (10,000).
15 MR. DAVID WHITE: Okay.
16 DR. SHARON TENNYSON: So one thousand
17 (1,000) is -- is not a benchmark that say, If you're
18 above a thousand (1,000) it's not competitive and if
19 you're below a thousand (1,000) you are.
20 A thousand (1,000) is a -- an obvious
21 benchmark that says, We're very convinced that there's
22 not a problem with too few farms or too much
23 concentration in the market if we have something that's a
24 thousand (1,000) or less. Okay? But markets may be
25 quite competitive if they have a Herfindahl index well

1 above a thousand (1,000).
2 MS. JANE VOLL: And to Merle's point, we
3 can come back and clarify it because the -- the monopoly
4 markets you're familiar with in BC, Saskatchewan and
5 Manitoba would be -- I think we would want to make sure
6 and make sure that we're giving you a clear picture of
7 what's in here.
8 THE CHAIRPERSON: I think we understand.
9 MS. JANE VOLL: Yeah.
10 MR. TED ZUBULAKE: Just one (1) question.
11 This morning we've heard various sets of numbers in terms
12 of the concentration of business in Alberta. The numbers
13 didn't match.
14 MS. JANE VOLL: Okay.
15 MR. TED ZUBULAKE: What is the source of
16 your numbers here in -- for the Alberta bar graph in
17 terms of number of companies and concentration, size of
18 market?
19 MR. GRANT KELLY: We take the MSA data
20 and that's the -- the usual benchmark. Any company
21 that's not in MSA that reports their numbers to the
22 Federal regulator, OSFI, are added. So we think that
23 this is the most comprehensive list of insurers operating
24 in Canada, so that's the source of --
25 MS. JANE VOLL: What time period because

1 there's no year or anything?
2 MR. GRANT KELLY: That's for 2005.
3 MR. TED ZUBULAKE: And would that be the
4 same source as --
5 MR. BILL MOORE: Well, but this is
6 national all lines data too.
7 MR. GRANT KELLY: Yeah.
8 MR. BILL MOORE: When you -- when you
9 look just -- just at Alberta in 2005 and you look at the
10 direct written premiums all of these -- all private auto,
11 the top four (4) firms own about 49 percent of the market
12 here.
13 MR. GRANT KELLY: Actually, this is auto
14 markets --
15 MR. BILL MOORE: Yeah.
16 MR. GRANT KELLY: -- by province. So
17 it's total auto. It's not basic auto, it's the total
18 auto --
19 MR. BILL MOORE: Okay. Fair enough. But
20 the numbers that -- the 49 percent that I quote, Joel
21 Baker will give us the same number on Friday morning. So
22 given that concentration, and I think the economist would
23 raise an eyebrow when the concentration gets above 40
24 percent, is --
25 MS. JANE VOLL: It's the sum of the

1 squares of the market shares. It's not total market
2 shares. The formula itself is the sum of the squares of
3 the market shares that produced the thousand (1000).
4 MR. BILL MOORE: I understand, yes.
5 MS. JANE VOLL: So you can have the 40
6 percent or 30 percent concentration among the top number
7 of players as you do in Alberta and still be a very
8 competitive marketplace.
9 MR. BILL MOORE: Yeah. My apologies.
10 I'm jumping ahead to your next slide, where you I think
11 you're going to talk about the concentration by premium
12 volume, or at least you did in your paper.
13 But to Ted's point, this morning we heard
14 numbers as low as the top five (5) firms owing 35 percent
15 of the market here. I think unambiguously, based on auto
16 premiums, the top four (4) firms actually own 49 percent
17 of the market.
18 Does that change your view as to how
19 competitive the Alberta market is?
20 DR. SHARON TENNYSON: No, not -- not at
21 all.
22 MR. GRANT KELLY: Not at all.
23 DR. SHARON TENNYSON: I -- I think a four
24 (4) firm concentration ratio, which is the jargon for
25 what you're talking about, of -- of 49 percent, even

1 ignoring how many other firms are in the market, it would
2 be a reasonably competitive statistic if you -- if you
3 lay that out across other industries or looked at the
4 competitive dynamics of an industry.
5 MS. JANE VOLL: One (1) of the other
6 measurement issues here is the difference between groups
7 and individual company. And you may be seeing a market
8 share for the top four (4), if it's top four (4) groups,
9 being a number and the market share of the top four (4)
10 companies being a different number.
11 So just something to --
12 MR. BILL MOORE: My numbers would be the
13 group's , yes.
14 MS. JANE VOLL: -- to be mindful of,
15 yeah.
16 So again, with -- to Sharon's point,
17 within the competitive rivalry what you're trying to
18 measure is how many different business models are going
19 head to head in the marketplace. And the more of them
20 that are, the -- the more intense the -- the competition
21 and the -- the better for the consumer.
22 So there's companies with origins all over
23 the place that are here competing in the -- some of them
24 -- some companies are owned by shareholders, some are
25 private investors, some are mutual, some are owned by

1 non-profit institutions, the Government of Saskatchewan
2 owns one (1).
3 Obviously, capital with different
4 motivations is coming here and trying to develop a
5 formula for success and do better than the next guy at
6 getting the product to the market. So there are many
7 indicators of -- of aggressive rivalry.
8 Another way that we illustrate this is
9 that each business model goes and tries its best in the
10 marketplace that year to sell its prices and meets its
11 costs, and it will end up with a return to shareholders,
12 and -- and they -- they differ. Okay?
13 So each business model is going to be
14 more or less successful in any given year. And the more
15 successful models would try to be copied by their peers,
16 you know.
17 Yesterday, I was with a guy from one (1)
18 insurance company and said, you know, Half my job is
19 that, finding out what other companies have tried, what
20 worked, what didn't work, and how I can get that, you
21 know, steal the best ideas of it and get into my company.
22 So they're very intensely competing to
23 try to extrap the most successful aspect of any one (1)
24 given model and migrate them into their own and develop
25 their own formula.

1 Richard..?
2 DR. RICHARD PHILLIPS: I'd like to make a
3 -- a point here. It's kind of a philosophical point of
4 how economic theories changed over the last twenty (20)
5 years. And the anecdote I'd like to use to -- to make
6 the point is to think about the telecommunications
7 industry in the United States.
8 If you think back to the 1970's or 1980's
9 you'll remember that AT&T or MA Bell was a -- was the --
10 monopolist telephone company in the United States that
11 was broken up by the Department of Justice into baby
12 Bells, which were regional Bells across all the different
13 part of the -- of the United States.
14 So, for example, in the Midwest part of
15 the United States, when I was growing up as a kid, the
16 baby Bell that was created was US West
17 Telecommunications. And in the southeast, where I live
18 now, it was Bell South. In the northeast, I can't
19 remember, Bell Atlantic I think was the -- what was
20 created.
21 And what's happened over time is that
22 economists have found out that this model that you're
23 saying here of workable competition, historically we
24 thought of that you had to have twenty (20), thirty (30),
25 forty (40), fifty (50) companies in an industry that --

1 to really allow it to have workable competition. You had
2 to have concentration ratios below 40 percent, below 30
3 percent in order to have workable competition.
4 And what -- what a lot of mainstream
5 economists discovered through empirical research over
6 time is that we can actually con -- we can tolerate a lot
7 higher degrees of concentration and fewer companies than
8 we did before because this competitive rivalry really
9 works, that these guys will still go after each other in
10 competitive ways in these marketplaces.
11 And so if you take the telecommunications
12 industry as just the example here, in the 1980's we start
13 with a monopolist that gets broken up into all these baby
14 Bells and since that time period we've been putting them
15 all back together again. And so in my own home town of
16 Atlanta AT&T has just repurchased Bell South and that was
17 approved by the Department of Justice just last year and
18 that merger is happening as we speak today.
19 And -- and that's -- that's after Bell
20 South had already bought one (1) or two (2) other
21 regional Bells around the United States.
22 So I think -- I think part of what -- the
23 point we're trying to make here is that you have sixty-
24 five (65) companies with fairly low concentration ratios
25 by almost any measure and economics has -- the theory has

1 gotten more developed over time to say that we can even
2 tolerate a lot higher concentration than even you're
3 seeing here and that's still going to be workably
4 competitive in the marketplace.
5 DR. SHARON TENNYSON: I -- I agree. Part
6 -- part of the expansion of the model away from the --
7 the model of perfect competition which assumes that you
8 need to have atomistic firms relative to the marketplace,
9 right, is -- is to develop this more nuance understanding
10 of -- of the marketplace dynamics.
11 All of these features play into whether or
12 not a marketplace is going to be competitive, not just
13 numbers of firms or concentration ratios. Right? This
14 is -- the theory has moved beyond this idea that what we
15 need to do is count the number of firms and look at the
16 concentration. We need to look at all of these features
17 as -- as disciplining the market to be competitive, even
18 if there aren't -- one of these is the threat of new
19 insurance even if there aren't many firms in the
20 industry.
21 There are well-developed theories
22 validated by empirical research now that say that if
23 there's a strong enough threat of new entry, even if it
24 doesn't actually occur, this can drive the market down
25 into a competitive outcome, even if you have two (2) or

1 three (3) firms in the industry and no more, okay?
2 So the theory has developed beyond the
3 simple model of atomistic competition as what determines
4 whether the market is competitive, to recognize that all
5 of these -- these features that we've talked about in --
6 in Porter's model of workable competition are really what
7 determine the competitiveness of a marketplace.
8 And if we look at the Alberta auto
9 insurance market we see that -- that these five (5)
10 features of workable competition apply fairly readily to
11 the marketplace.
12 And -- and this is the basis of my
13 argument to you that the Alberta auto insurance market is
14 competitive; not -- not the old, you know, supply -- you
15 know, the simple supply/demand model, but this model
16 which takes into account the realities of the marketplace
17 and our -- our growing understanding of what determines
18 competition in markets.
19 MR. JIM RIVAIT: Thanks, Sharon. What
20 we're going to do to spur -- the next theme is look at
21 some of the -- what's occurring in other jurisdictions
22 and we'll have most of our panel join in for this.
23 Sharon is going to talk about Illinois,
24 Rich Phillips will talk about South Carolina, and Richard
25 Derrig will talk about both New Jersey and Massachusetts.

1 So there's three (3) --
2 THE CHAIRPERSON: Do you want to --
3 MR. JIM RIVAIT: -- those three (3)
4 points.
5 THE CHAIRPERSON: Do you want to see if
6 we have any questions at this point?
7 I have one (1) questions, if I may. In
8 your model there, to make it relevant to what we're
9 talking about, shouldn't there be another box, something
10 identified as regulatory authority?
11 Doesn't that influence the competitive
12 factor?
13 MS. JANE VOLL: I -- I think we get to
14 that a little later in our presentation:
15 THE CHAIRPERSON: All right.
16 MR. JIM RIVAIT: I think that's why we're
17 here.
18 THE CHAIRPERSON: Well, I'm looking at
19 model. I mean, your model leaves me fine but -- okay.
20 Well, we'll --
21 DR. SHARON TENNYSON: The -- the model is
22 -- the model is assuming the sort of pre-regulatory or
23 competition policy perspective. It's saying, Let's
24 suppose we're going to evaluate a market for its
25 potential competitiveness to decide to what extent we

1 need to intervene with government policy, right? So
2 certainly government policy interventions are going to
3 overlay all of -- all of this.
4 THE CHAIRPERSON: Just, what I was
5 interpreting was competitive rivalry within the industry
6 as a center core and that is certainly influenced by the
7 factor of government regulation.
8 DR. RICHARD PHILLIPS: And I would add to
9 that by just saying that I think the -- the model you
10 have here allows you to start thinking about if you do
11 want to intervene into this marketplace, how do you want
12 to do it. So if you're trying to increase competition,
13 here are five (5) boxes on which you can focus your
14 attention on.
15 And what is -- if you don't -- if you
16 conclude that you don't have competition, which I think
17 we would argue that you -- you do, but if you conclude
18 there's not enough competition, it now helps to guide the
19 discussion of, well, are you trying to increase the
20 threat of new entrance, are you trying to increase the
21 bargaining power of consumers?
22 So it gives you -- it gives you a way to
23 think about how can we increase competition rather than
24 just saying, well, let's just cap prices and we'll it a
25 day.

1 MS. MERLE TAYLOR: On that point, when I
2 think -- when I think of substitute products, then you've
3 got a choice as to whether you buy it or not, you know.
4 And with -- certainly with like property insurance, it's
5 a choice, you decide to not insure your home, that's a
6 choice.
7 Whereas -- I mean, the government has
8 dictated that you must buy auto insurance if you want to
9 drive a vehicle. That means your only other choice is to
10 not buy a vehicle or to go against the law and drive
11 without insurance and run the risk that you might be
12 heavily fined or whatever, take the consequences. So,
13 you know, I just --
14 DR. SHARON TENNYSON: They are none the
15 less different firms offering substitute products in the
16 marketplace. So you don't have a government monopoly
17 offering a single bundle of insurance coverages for auto
18 insurance in this province as -- as yo might in some
19 others, right?
20 You have sixty-five (65) companies all
21 offering their own nuanced take on what does this product
22 look like, including who am I, the seller, right? Do you
23 enjoy my brand's image? Do you enjoy my claim service?
24 All -- all of these -- all of these play
25 into what does it mean to -- to have this bundle of auto

1 insurance services. And so it's not a question of do I
2 buy or do I not buy. That would be the case if you had a
3 monopoly insurer that offered a plain vanilla policy that
4 included both mandatory and optional coverages. I -- I
5 don't know that anywhere has that.
6 But in -- in this situation you have many
7 different choices and that's the choice that the consumer
8 has, in addition to the choice to buy or not to buy.
9 DR. RICHARD PHILLIPS: Let give me
10 another example that you're -- you're probably familiar
11 with and that I talk about with my students, and it's the
12 example of Microsoft Windows.
13 I assume everybody in here either has --
14 uses a computer or has someone that uses it for them, and
15 I would bet that, just like the rest of the world,
16 Microsoft is the dominant operating system on computers
17 in Canada. And it's a little bit like the driving
18 example, it's hard to do business if you don't have a
19 computer in the twenty-first century.
20 And you'll recall that Microsoft was sued
21 by the Department of Justice -- how many years ago now;
22 ten (10) years ago, five (5) years ago now -- and
23 essentially made this comment here that, yes, we're a
24 monopolist -- we're almost a monopolist providing an
25 operating system for personal computers. Really, their

1 only rival at the time was Apple and the McIntosh but,
2 nevertheless, Microsoft still had 95 percent of the
3 marketplace.
4 But they -- they went in and argued this
5 point that it's the threat that if we do raise our prices
6 too much, if we don't continue to innovate, if we don't
7 continue to give consumers what they're looking for,
8 somebody will come in and take this marketplace from us.
9 And I think in operating systems they've been pretty
10 successful in keeping those threats out.
11 But in lots of other areas where you would
12 think that they would also have a comparative advantage,
13 like internet browsers for example, they have not been
14 successful at keeping them out. And in search engines on
15 the Internet, for example, the dominant search engine is
16 for free by Google.
17 So I think there's -- the notion -- and
18 that -- this comes back to my point of what do we need
19 for a concentration ratio -- ratio to be low enough.
20 What -- what defines low enough in order to have workable
21 competition in the marketplace.
22 And there's an extreme case where you have
23 what appears to be a monopolist who was successful at
24 arguing that -- that they -- this is really a competitive
25 market and you should -- you should not take Microsoft

1 and break it up into separate companies and force them to
2 operate different from each other.
3 THE CHAIRPERSON: Thank you.
4 MS. JANE VOLL: Merle, one of the points
5 that comes to mind for me is that -- that I -- I don't
6 think we're done yet in terms of consumers exercising
7 their power in the marketplace. We've got lots of
8 evidence and worked with the superintendents in lots of
9 jurisdictions showing us the consumers level of education
10 about what their options are and where to go may not be
11 as -- you know, they may not be as aware of all the
12 choice available to them, of all the product options
13 available to them.
14 You know, we -- we surveyed companies in
15 Ontario on behalf of the Government not that long ago and
16 found there were, you know, fifty (50) different claims
17 forgiveness policies out there, but the -- how would the
18 consumer know, you know? Each company had their own
19 little way of offering or offering breaks for young
20 drivers, or whatever.
21 So I think part of the -- one (1) of the
22 issues in -- in here for me is that consumers certainly
23 have power, they can take their business anywhere else,
24 but -- and they certainly have preferences, but they may
25 not have found the -- the most transparent way, those

1 consumers, to find the companies that are serving their
2 preferences the best.
3 MR. JIM RIVAIT: And part of the -- part
4 of the issue relates to that is that the -- if focus is
5 always on price and -- and not on these other things,
6 that's what people are going to look -- look to. They're
7 not going to think about how is this company going to
8 treat me when I have a claim, or what other kinds of
9 options are there. They're just going to think about,
10 The Government's telling me that I -- I should get the
11 product at this price and I should applying to this.
12 So I think the pursuit that we have to
13 focus on that takes away from the other competitive
14 elements of the business that are important to consumers.
15 And over time, if they -- those things get pushed out of
16 the market, consumers will lose.
17 THE CHAIRPERSON: Dennis has a question.
18 Dennis...?
19 MR. DENNIS GARTNER: Yes, a few points.
20 I'm the superintendent of insurance and so I have a lot
21 of contact with insurers as well as industry and the
22 brokers of industry. So I just thought I should give you
23 that background.
24 First of all, thank you very much for your
25 comments on the concentration of industry and the fact

1 that the views of economists have changed over the years
2 and what this concentration actually does for consumers
3 or doesn't. I found that to be very, very helpful.
4 Leading -- leading from the comments of
5 both Jim and -- and Jane my perception, I don't have any
6 data, but it seems to -- to me through contact with
7 consumers and -- and the contact that my office has with
8 consumers that price is what consumers shop at -- shop
9 for.
10 Is there any data to refute that, that
11 consumers actually understand that an insurance product
12 is differentiated and that that differentiation is
13 meaningful to them and that they'll actually pay for it?
14 THE CHAIRPERSON: Want to give it a
15 shot, Richard?
16 DR. RICHARD DERRIG: I can certainly
17 give you an example.
18 I live in Providence, Rhode Island, which
19 is the historic home of a company called Amica Insurance.
20 Amica traditionally has made profits that exceed most of
21 the insurance industry in the United States.
22 Amica sells a quality product. Amica is
23 always the number 1 service property and casualty insurer
24 in the United States and has been for at least five (5)
25 years if not ten (10). And Amica Insurance is the only

1 property and casualty insurance company that appears on
2 the top twenty-five (25) best service companies in the
3 United States, across all industries.
4 So I can tell you that my colleague --
5 consumers because I've been with Amica for a long time,
6 very well know what they're paying for; they're paying
7 for service and they're paying for high quality service.
8 And I can tell you that when I call Amica, I don't get,
9 "Press 1 for bodily injury", Press 2 for a physical
10 damage claim", I get service and I'm willing to pay for
11 it, and they are national.
12 They're all over the place and they're
13 very successful because people, a certain group of people
14 out there in the United States, and I believe they're in
15 the top fifty (50) companies, maybe even higher, they're
16 willing to pay for that.
17 MR. DENNIS GARTNER: But I -- I
18 appreciate that and I -- I don't have any difficulty
19 accepting that but that doesn't answer the question.
20 Indeed, the question --
21 DR. RICHARD DERRIG: Is there --
22 DR. SHARON TENNYSON: When there are
23 empirical studies that --
24 MR. RICHARD DERRIG: -- is there any --
25 yeah.

1 MR. DENNIS GARTNER: There may not be.
2 I'm -- I'm not trying to challenge you. I'm trying to
3 obtain knowledge and information.
4 DR. SHARON TENNYSON: We --
5 MR. RICHARD DERRIG: I know it's not --
6 DR. SHARON TENNYSON: -- we were trying
7 to think of whether we can think of references to
8 academic literature and that specifically relate the two
9 (2).
10 DR. RICHARD PHILLIPS: There's one (1)
11 that I can think of --
12 MR. DENNIS GARTNER: There's -- well
13 there's a couple --
14 DR. RICHARD PHILLIPS: -- that relate to
15 financial quality of the firm to prices. Now, the
16 problem there is that's a little difficult to piece that
17 out because partly if you have a -- if you have a -- an
18 insurance company that's lower financial quality, it's
19 kind of like borrowing. It's like buying bad debt,
20 right? You're always going to discount it a little bit
21 just because you're not sure if you're going to get paid
22 back or not.
23 So there is a -- there is a linkage
24 between financial quality and prices which may be a
25 mixture of both -- I'm buying a lower financial quality

1 product, therefore I'm going to discount it just because
2 I face a credit risk a little bit.
3 What the literature does show there is
4 that the discount that's applied to lower financial
5 quality companies drops faster than the actual insolvency
6 cost that's being imposed on that consumer.
7 So in other -- you could say it that --
8 another way to say that consumers are willing to pay a
9 premium above the -- above what the -- the discounted
10 rate is for a high financial quality company beyond just
11 what the promise is. It's the -- from pure financial
12 economics evaluation point of view.
13 DR. SHARON TENNYSON: And -- and I can --
14 DR. RICHARD PHILLIPS: That's one (1)
15 example.
16 DR. SHARON TENNYSON: -- I can think of a
17 -- a similarly indirect relationship which is there are
18 some studies that look at complaint data for insurance
19 companies, okay?
20 So again it's not directly related to a
21 preference for service quality and so forth. But there
22 are studies that -- that relate complaint data to
23 outcomes for insurance companies and there is a
24 relationship between the price and demand and complaints
25 in -- in the sense of companies that have higher

1 complaints do worse than companies that have lower
2 complaints.
3 MR. DENNIS GARTNER: So if we could those
4 that --
5 MS. JANE VOLL: Building on that --
6 MR. DENNIS GARTNER: -- that would be --
7 be useful.
8 DR. RICHARD PHILLIPS: Yeah. I'll talk
9 about it.
10 MS. JANE VOLL: Yeah. There was just
11 another standard research that we've recently been
12 looking at that has to do with companies that are
13 effective at in -- in -- customer satisfaction generates
14 a higher return on equity for them. And so the --
15 presumably the customers who are enjoying those extra
16 service features are willing to pay a higher price for
17 them.
18 And the evidence that comes to mind for me
19 of why are -- is everyone just motivated by price, would
20 suggest to me that you -- we wouldn't see ranges in
21 Compuquote then. Everybody would run to the bottom
22 feeder and -- and that would be the way it would go but
23 why -- why -- you know, I -- I think the fact the market
24 sustains all of these diversities is -- is somehow
25 telling us -- telling us something.

1 MR. DENNIS GARTNER: Well, Ms. -- I want
2 to put it in perspective though. I'm taking about
3 experience in my office. We're not talking about any
4 random sample, we're talking about people who are
5 motivated to pick up the phone and call the
6 superintendent of insurance, so.
7 And I don't -- I have no idea whether
8 we're getting a representative sample. Probably we're
9 not and I was interested having you folks, the -- the
10 eminent scholars in North America, if there was anything
11 that you could help us with.
12 DR. RICHARD PHILLIPS: Dennis, there's a
13 new study by two (2) colleagues of mine at Georgia State,
14 Marty Grace (phonetic) who's a professor there and a guy
15 named Bob Kline (phonetic).
16 Bob was, prior to coming to Georgia State,
17 he was the Director of Research for the National
18 Association of Insurance Commissioners in the US. And
19 they -- they just brought a study that was published this
20 summer looking at life insurance companies that are
21 members of a -- a group called IMSA; it's the Insurance
22 Market Standards Association or Authority. I can't
23 remember what the "A" stands for.
24 But essentially IMSA was formed following
25 the market conduct problems that several life insurers in

1 the early to mid-1990's where some of the agents for
2 Prudential and Met Life and some of the other large
3 companies were accused of turning life insurance
4 policies, where the agent benefited by the cancelling of
5 an old policy for a policyholder and then selling a new
6 policy to get a first year premium again.
7 And these companies formed a trade
8 association which said that there would have to be a set
9 of standards that companies would have to agree to
10 voluntarily follow in order to become members of IMSA.
11 And what -- what Bob and Marty looked at
12 was to figure out if consumers were willing to pay a
13 premium for their membership in IMSA, whether or not that
14 higher degree of professionalism was rewarded in the
15 marketplace or not. And interestingly, they also showed
16 that these companies from a cost point of view are more
17 efficient and from a profit point of view they're also
18 more efficient.
19 So not only do the consumers -- it's kind
20 of a win-win for everyone, that when people are
21 transparent and when voluntarily adopted to join this and
22 become let's say above the board, that everybody won.
23 The consumers appreciated that and the -- the companies
24 themselves performed better afterwards as well.
25 I'd be happy to share that with you.

1 MR. DENNIS GARTNER: Okay. If you can
2 that would be quite useful.
3
4 --- UNDERTAKING NO. 2: To provide study produced by
5 Marty Grace (phonetic) and
6 Bob Kline (phonetic).
7
8 MR. DENNIS GARTNER: Two (2) other quick
9 points. The -- the insurance industry in Canada is just
10 coming -- coming into a third good year. ROE's have been
11 -- been good. We don't have direct information on
12 Alberta auto but we know the loss ratios are -- are
13 fairly good. And our conversations with companies and
14 the -- the data we get respecting provincial companies
15 also is an indication that they're making a fairly
16 healthy return on the automobile product.
17 The prices haven't come down very much
18 except through the regulated process that the Alberta
19 Government established. Companies can bring down their -
20 - their prices more if they wish and -- and they may have
21 room to do so. Is -- when -- when will we expect that to
22 happen?
23 We've had three (3) years of good returns
24 now and prices have been fairly constant. Does that --
25 is that -- is that normal? Is that a --

1 MS. JANE VOLL: Can I suggest that the
2 Act of the Constitutional challenge is clear?
3 THE CHAIRPERSON: Do you want to take
4 this question, Richard?
5 MS. JANE VOLL: It's having to do with
6 price stickiness.
7 DR. RICHARD DERRIG: Oh, sticky prices,
8 yes. One (1) of the -- one (1) of the points that I
9 thought is a very important point for -- for EPOS is the
10 notion of what's called "sticky prices".
11 Sticky prices mean that once you have a
12 price in the marketplace, if it should move in one (1)
13 direction or the other and it doesn't, but it tends to
14 stay where it is, there's a reason for that and it's on
15 the -- on the low side and the high side, both -- both
16 ways.
17 I think the question you're asking is on
18 the low side. If you've -- if you've got a price and you
19 think that the competitive price should be lower there
20 needs to be more than just those five (5) boxes. What
21 there needs to be is some notion that a -- a window of
22 opportunity that's fairly long has to be in place in
23 order for companies to lower prices as low as they can
24 make them without the fear of having rate suppression in
25 the future or owner's regulation in the future.

1 Once insurers in the insurance context --
2 once insurers get the idea that they're going to be free
3 to compete now and into the future, then they will
4 compete and lower the prices as low as they can get them
5 for the market share. And I have a couple of examples
6 for you but that's -- that's the idea. It's the same as
7 on the up-side.
8 On the up-side the prices can get sticky
9 because of, for example regulation, and I can certainly
10 tell you the Massachusetts story. But it can get sticky
11 on the up-side, that is the regulators don't allow it to
12 rise with cost and once that happens those are sticky
13 prices on the up- side and there -- there are then dire
14 consequences for that; mostly companies just don't bother
15 writing anymore, it's not profitable.
16 So you -- you have to have an overall
17 framework where the companies can move and understand
18 that the rules of the game are going to continue, they're
19 going to be able to compete, and they're going to be able
20 to interact with the other companies and have what they
21 termed the rivalry that comes from competition.
22 Otherwise they'll play it safe. And the examples that
23 I'll talk about a little bit are certainly Massachusetts
24 at the moment and California.
25 MR. JIM RIVAIT: Some -- some of that

1 stuff will be well illustrated through the stories that
2 are told by --
3 DR. RICHARD DERRIG: Okay. Thank you,
4 Mr. Chairman.
5 THE CHAIRPERSON: Carry on.
6 MR. JIM RIVAIT: Okay. So, Sharon,
7 you're going to start with Illinois and be the first up
8 on that?
9
10 CONTINUED BY IBC:
11 DR. SHARON TENNYSON: I -- I am the first
12 up. So what -- what we're doing here is we're bringing
13 to you some case studies or experiences from individual
14 states in the US. So we assume you're much more familiar
15 than we are with how the experience of auto insurance
16 regulation in Canada, since we have a larger number of
17 states than you have provinces and this is something
18 which you can regulate at the state level. We have lots
19 of different models of regulation of auto insurance
20 markets in the United States and we're going to relate to
21 you some experiences from selected individual states.
22 I'm going to talk just a few minutes about
23 the state of Illinois. Illinois is the only state in the
24 US that has no rating law and never has. So imagine
25 that; insurance prices are determined by the market,

1 okay?

2 There's nothing in the books or the

3 legislation that says someone is -- has the opportunity

4 to have an oversight, or this is -- the Government has

5 the oversight but we're not going to exercise it; that

6 just isn't the rating law in Illinois. So it's -- it's

7 like most other markets that are competitive at which

8 prices truly are determined in the marketplace.

9 So there's no regulatory review of rates

10 for excessiveness or inadequacy. They do regulate

11 insurance markets, right? There is solvency oversight,

12 there is market conduct oversight, right? So all the

13 other pieces of regulation are in place in Illinois, they

14 just don't have a rating block.

15 And the outcome of -- for auto insurance

16 markets in Illinois has been exemplary, has been great.

17 There hasn't been a history of government intervention in

18 the market and yet there aren't problems in the Illinois

19 auto insurance market.

20 Availability is good as measured by the

21 number of insurers operating in the marketplace and as

22 measured by levels of concentration. So the -- the

23 Herfindahl Index in Illinois which takes into account

24 both the number of producers and concentration of market

25 shares simultaneously is low in the range of a thousand

1 (1,000) or a little above a thousand (1,000), despite the
2 fact that the bulk of the population in Illinois resides
3 in the Chicago and surrounding metropolitan areas.
4 So this is not just, you know, -- I mean
5 it's a mix of urban and rural but a large population
6 centre.
7 Auto insurance prices are not high
8 relative to the nation. Insurance rates are consistently
9 at or lower than the national average and residual
10 markets are small despite again the fact we have a large
11 concentration of drivers in urban markets.
12 So the experience of Illinois which is
13 taking a dramatically, you know, a brave regulatory
14 approach if you will, which says completely hands-off and
15 we're going to leave this to the marketplace, shows that
16 in -- in this instance competition works in insurance
17 markets just as you would expect it to work in markets
18 for other products.
19 DR. RICHARD PHILLIPS: My job is to talk
20 about South Carolina. And the reason that I'm here to
21 talk about South Carolina is that I, together with the
22 two (2) authors I mentioned before, Bob Kline and Marty
23 Grace, we wrote a paper looking at the experience of
24 South Carolina, which for your purpose is actually quite
25 interesting because beginning in the mid 1970's South

1 Carolina begin to regulate rates and became more
2 aggressive at regulating rates through the '70s and
3 through the '80s and through the early 1990's until they
4 had almost a market collapse in the late 1990's. And then
5 they made fairly radical change and said, No, this isn't
6 working, we'd like to get back to something that looks
7 more like the marketplace determining rates rather than
8 the regulator determining rates.
9 And I have this quote here which I'll read
10 to you. It's a little small. This was testimony.
11 Remember the time period here is about twenty (20) years
12 of a regulated marketplace from the mid '70's to the end
13 of the 1990's.
14 In 1999 South Carolina was the magic year.
15 They blew up the regulatory system that they had in place
16 and adopted a much more competitive notion for the
17 overview of rates in South Carolina.
18 And so this is about four (4) years after
19 that. This is the Insurance Commissioner of South
20 Carolina who was testifying before Congress on April 10th
21 in Washington, DC, on April 10th, 2003. And the quote
22 is:
23 "For years neither actuarial
24 methodology nor supply and demand had
25 much to do with auto insurance

1 ratemaking in South Carolina. Politics
2 drove that ratemaking process within
3 our state."
4 And this gets to the point of sticky
5 prices that Richard mentioned a minute ago.
6 "Politically there was never an
7 opportune time to raise insurance
8 prices. This resulted in significant
9 rate suppression. In the short term,
10 rate suppression kept the cost of
11 insurance down. However, in the longer
12 term insurers were leaving the market
13 because they were unable to secure an
14 adequate rate for their product."
15 Hence the global capital markets which
16 Sharon mentioned earlier.
17 "As a level of -- hence the level of
18 competition within the market
19 decreased. Rate suppression as well as
20 frequent legislative changes designed
21 to address short-term ills of one (1)
22 form or another also sent the wrong
23 signals to the marketplace.
24 These provided incentives for -- to
25 consumers [I don't like the way he

1 worded this] to consumers to continue
2 to engage in risky behaviour, e.g.
3 speeding, because the insurance
4 premiums they paid were artificially
5 low for some and did not accurately
6 reflect their insurance rates.
7 Consequently in the system good drivers
8 were subsidizing the insurance of bad
9 risk drivers."
10 This provides kind of a nice abstract of -
11 - from an insider's point of view I guess, your
12 counterpart in the state of South Carolina. And what I
13 thought I would do is present to you some statistics that
14 we had developed as part of our research to try to add
15 some flavour to Commissioner Csiszar's comments.
16 So what was the regulatory regime in South
17 Carolina during this twenty (20) year time period?
18 The system was one of prior approval rate
19 regulation, which meant that insurers were required to
20 submit rates to the Insurance Commissioner so that they
21 could be approved by the Commissioner before they could
22 be used in the marketplace.
23 The risk classification, and then two (2)
24 lines down, the limits on underwriting were restricted so
25 that insurance companies were not allowed to engage in --

1 in the ways they would like to classify different risks
2 in the marketplace for underwriting purposes which made
3 the categories broader that they were putting risks into
4 and then charging a common price to.
5 The rate hearings that were held were
6 public. There were residual market subsidies so when
7 insurers -- insureds were not able to find insurance in
8 the private marketplace they could go to a residual
9 market mechanism.
10 That residual market mechanism was not
11 designed to run at an operating loss every year. But by
12 the time 20 years went by they were running at an
13 operating loss of 40 percent relative to the premiums
14 that they were collecting.
15 So they were highly inadequate. In order
16 to make up for those -- the question is: Where does the
17 40 percent come from that they're not collecting from
18 these policyholders? The answer was that it was paid by
19 the policyholders in the private marketplace through what
20 was known as a recoupment fee.
21 That recoupment fee was a tax that was
22 placed on the drivers in the private marketplace and
23 those fees went directly to drivers that were in this
24 residual market mechanism.
25 And there was a take-all-comers rule. And

1 it did not really affect -- the insurance companies
2 frankly didn't care very much about the take-all-comers
3 rule because if they didn't like the insured, the
4 mechanism that was set up in the State of South Carolina
5 was one where they were passed to this residual market
6 mechanism, and the insurance company only collected a fee
7 for doing the underwriting and the claim servicing but
8 they had no financial risk themselves.
9 Consequently, not only did the
10 policyholders in the residual market mechanism not have
11 incentives to drive carefully or try to reduce losses,
12 but the insurance company claims adjusters had no
13 incentive to try to keep claim costs down for drivers in
14 this residual market mechanism, because they were just --
15 all of those claim costs were just passed on along
16 directly to this residual market mechanism.
17 And the losses from that mechanism came
18 from policyholders in the -- in the private system.
19 Let me show you some statistics of what
20 happened. This is showing you the profitability of auto
21 insurance in South Carolina for this -- this -- and then
22 I'm comparing that to the states in the southeast region
23 of the United States and then I'm also comparing that
24 profitability to the US as a whole.
25 And you can see that the regulatory system

1 in South Carolina did what it said it wanted to do. It
2 was successful at suppressing rates. This data comes
3 from the National Association of Insurance Commissioners,
4 so it's a consistent methodology to measure profitability
5 across all of these different jurisdictions.
6 And you can see that insurers in South
7 Carolina for long periods of time were unprofitable. You
8 can see that the market in the early 1980's had fairly
9 small or modest residual markets, drivers in the residual
10 market. But after years and years of rate depression
11 their residual market mechanism had grown to be about 42
12 percent in the early part of the 1990's. And -- then
13 that was kind of the experience there.
14 Now a reasonable question is: Is this
15 unique to South Carolina or not? And that's on the next
16 line. And what I'm showing you there is the size of the
17 residual market. So the percentage of drivers who are
18 unable to find insurance in the private market in South
19 Carolina versus the States of Alabama, Florida, Georgia
20 and Virginia which are the neighbouring states for South
21 Carolina, obviously.
22 And you can see that, you know, South
23 Carolina's just kind of off the charts relative to these
24 other states that have more competitive market systems;
25 that drivers in the other states in the southeast for the

1 most part, 90 to 95 percent of the time are easily able
2 to find insurance in the competitive market and that's
3 not the case in South Carolina at this time.
4 The next slide shows you the impact that
5 this had on a number of insurers that were competing for
6 business in the State of South Carolina. Over this time
7 period of the 1990's it -- about 1994 to 1995, the number
8 of insurance companies had dropped to around fifty (50)
9 insurers operating in the State of South Carolina. And
10 the average number of insurance companies competing for
11 business in the other southeast states that I've
12 mentioned before is approximately two hundred (200)
13 insurance companies competing for business.
14 So you can see that in the other states in
15 the southeast, it's approximately four (4) times the
16 number of insurers that are competing for business in
17 these more competitively rated environments.
18 You can see there's an uptake in the
19 number of companies between 1998 and 1999; that was
20 because the reform debate was taking place during late
21 1998 and was enacted in early 1999. And once that
22 performs were put into place, the number of insurance
23 companies went from about sixty (60) to over a hundred
24 (100) just in that year. You had about thirty (30) to
25 forty (40) companies that came in, in 1999, once they

1 knew those reforms were in place and they were going --
2 and they were actually going to stick.
3 In 2003, just for comparison sake, there
4 are a hundred and sixty-five (165) insurance companies
5 competing for business in the State of South Carolina and
6 moving it much closer to the average of the other
7 southeast states.
8 The next line is designed to show you how
9 the subsidies that were paid through the residual market
10 mechanism, where they were directed to. What this chart
11 shows you are two (2) -- two (2) series here along the X-
12 axis you have the individual counties in the State of
13 South Carolina.
14 On the left-hand side of the axis is the
15 loss ratio, so it's the profitability of the business in
16 that county. And then on the right hand axis is the
17 average cost for bodily injury accidents for claims that
18 are filed in those counties.
19 And what you'll see is a direct
20 correlation -- negative correlation between the profit --
21 well I guess it depends how you define it. There's a
22 direct correlation between the profitability and the
23 costs for the assoc -- for the -- that the claims that
24 are being provided by the -- by policyholders in those
25 counties.

1 So all the way up to your right, to the
2 extreme right, the loss costs are the lowest in these
3 counties all the way to the right. There about a hundred
4 and twenty dollars ($120) over this -- late 1990's, per
5 driver in those counties. And on the extreme end of the
6 other side, those loss costs average about two hundred
7 and sixty (260) or two hundred and seventy dollars ($270)
8 per driver in those counties.
9 And so what you'll see is that these low
10 cost counties have very low loss ratios; that these
11 drivers are paying a lot of money in premiums relative to
12 the loss payments they're getting back from their
13 insurance companies, and they're having a direct transfer
14 to these high cost counties on the lefthand side, where
15 these are drivers who impose a lot of costs on the
16 insurance system and their loss ratios are well above 100
17 percent.
18 So if you have a loss ratio of 120 percent
19 for example, for every dollar of premium that you're
20 paying, those drivers are receiving back a hundred -- a
21 dollar twenty ($1.20) in loss payments for their
22 insurance -- from their insurance carriers. And that's
23 before including any underwriting expenses to sell this
24 business.
25 So what's happening in South Carolina over

1 this time is a very systematic approach by the insurance
2 commissioner in the State to subsidize high cost drivers
3 by these -- through these recruitment fees that were paid
4 by the drivers that remained in the -- in the competitive
5 market system.
6 And the next slide shows that -- the point
7 we're trying to make here is that these drivers who are
8 receiving all of these subsidies have very bad incentives
9 for trying to control their -- their risky behaviour.
10 They have bad incentives for maybe avoiding filing of a
11 very small claim that they might not otherwise. They
12 have every incentive to try to build up their claims
13 because they get more out of the insurance system than
14 they pay into the insurance system.
15 And overall, what you see is that the
16 inflation rates in South Carolina in insurance premiums
17 is exactly almost twice or -- it's actually a little bit
18 more than double what it was nationwide even though rates
19 are being suppressed in this environment.
20 So the insurance companies are leaving --
21 they're not profitable enough and so they're leaving this
22 marketplace. And so even though prices are being
23 suppressed, the inflation or the growth rates in the
24 average premium that a South Carolina policyholder is
25 paying is twice as much as it was in the nation at the

1 exact same time.
2 And so all of these things, slowly over
3 time, over 15 or 20 years, they just continue to build up
4 and they build up and they build up and they create this
5 pressure that the market's really kind of collapsing;
6 there's no insurers competing for business; risky drivers
7 have no incentive to try to change their behaviour
8 whatsoever; it doesn't control loss cost inflation over
9 time, that this actually gets passed back. So it's just
10 -- the whole market's just kind of a mess.
11 What did South Carolina do? They dropped
12 their prior approval rate mechanism and they adopted
13 something known as flex-rating.
14 Flex-rating requires an insurance company
15 to file a rate filing with the insurance commissioner.
16 They're allowed to use those rates as long as the rates
17 aren't -- the rate increase is not above a particular
18 level. And I can't remember what the threshold is. I
19 think it's --
20 DR. RICHARD DERRIG: Mostly plus or minus
21 seven (7).
22 DR. RICHARD PHILLIPS: Yeah, plus or
23 minus. So as long as, from year to year, you don't
24 request increase in premium outside of this band the
25 insurance company's allowed to operate outside that --

1 within -- within that -- within that range.
2 If you request a 10 percent increase in
3 premiums which is outside the range, then the insurance
4 commissioner can ask for you not to use those or come in
5 and try to justify that somehow in some sort of a rate
6 hearing.
7 But those rate hearings were private,
8 there were no longer public rate hearings after the
9 reforms were announced. So you're giving essentially
10 insurance companies as long as nothing strange is
11 happening and they're not asking for anything outrageous,
12 they're allowed to be competitive within those -- within
13 that environment.
14 And if you get something extreme, then an
15 insurance commissioner gets to ask and say, hey, let's
16 hold on here, let me -- can you try to tell me what's
17 going on in this system.
18 They reduced the restrictions on the
19 limits on underwriting and on risk classification so
20 that insurance companies could target and risk price
21 better individual drivers to try to avoid the subsidy
22 effects that were happening before.
23 There was a residual -- the residual
24 market subsidies that were allowed before to grow to be
25 40 percent were eliminated. And there was no all-comer

1 rule anymore. So it didn't require that an insurance
2 company take every policyholder -- every potential driver
3 -- or every driver in the system can still find insurance
4 through the residual market mechanism, it's just that it
5 doesn't require the insurance company to provide that.
6 What's happened in South Carolina, just
7 some statistics here to give you an idea. In 1998
8 immediately before the reform there were seventy-eight
9 (78) companies. In 2003 there were a hundred and sixty-
10 five (165).
11 In 1998 there six hundred thousand
12 (600,000) policies in the residual market mechanism. In
13 2003 that had dropped to three hundred and forty (340)
14 policies. As I said earlier it eliminated the subsidies
15 for risky drivers and then according to the National
16 Association Insurance Commissioner some data I was able
17 to find there.
18 In 1998 immediately before these reforms,
19 South Carolina ranked 24th in the average insurance
20 premiums paid by drivers in that State. So if you rate -
21 - a high cost State like Washington, DC or New York or
22 New Jersey would be number 1 and a very low cost state
23 like South Dakota for example, would be state number 50.
24 So South Carolina in 1998 was 24th and
25 over the next couple of years by the end of 2001, their

1 rank had dropped down to 34 in the nation.
2 So I think South Carolina is a nice
3 example of a state that in the early -- in the mid 1970's
4 is a little bit what we -- the three (3) of us here,
5 Alberta is right now, that we've decided maybe we'd like
6 to go down this road of intervening a little bit into the
7 insurance markets.
8 South Carolina gives you twenty (20)
9 years worth of experience to see the types of decisions
10 they made and the consequences of those. And then kind
11 of going back to something that looked more like the
12 Illinois model that allows more competition to determine
13 the outcomes of marketplaces and some of the positive
14 effects on how we think about the functioning of this
15 marketplace for the citizens in that state.
16 So I would encourage you -- I have a copy
17 of the Commissioner's complete testimony that he gave
18 before Congress and there's a -- there's a chapter in
19 this book that Sharon has in front of her that --
20 MR. TED ZUBULAKE: Mr. Chair, a couple of
21 questions.
22 THE CHAIRPERSON: Just a minute. We have
23 -- we have a number of questions. I think it's 2:30, do
24 you want to take 15 minutes and come back with questions?
25 Have coffee?

1 Okay, let's break for 10 minutes and than
2 we'll come back.
3
4 --- Upon recessing at 2:26 p.m.
5 --- Upon resuming at 2:37 p.m.
6
7 THE CHAIRPERSON: All right, are we all
8 ready? I have, where is he? We had a -- I was just
9 going to mention that we have David Marshall with us but
10 I can't --
11 MR. TED ZUBULAKE: He'll be right back.
12 He just --
13 THE CHAIRPERSON: He's right back, is he?
14 David has just been appointed today to the Board.
15 David's a new member of the Board and he was here
16 observing but now as officially as I say he's now a
17 member of the Board so he's no longer observing. We lost
18 him somewhere. Short term Board member and I had Chris
19 Townsend wanted just a few seconds at the end.
20 So I'll catch you at the end, Chris, just
21 for a second. Chris had some corrections for something
22 he said this morning that he wants to get in. So we'll
23 just do that at the end and we're aiming for about what?
24 3:30, four o'clock?
25 MR. JIM RIVAIT: It's going to be tight

1 but we can move it along and I want to make sure, Mr.
2 Chairman, that we take full advantage --
3 THE CHAIRPERSON: I couldn't agree more.
4 MR. JIM RIVAIT: -- of -- I spoke to
5 Brian here and I think they've got a lot to add.
6 THE CHAIRPERSON: Okay.
7 MR. JIM RIVAIT: And we'll try and move
8 it along. We've got Richard Derrig. He's going to talk
9 about New Jersey --
10 THE CHAIRPERSON: No, I'm not trying to
11 move you too fast. I know you've got a lot of high
12 priced help here.
13 MR. JIM RIVAIT: Yeah.
14 THE CHAIRPERSON: Board Members.
15 MR. JIM RIVAIT: Oh, you're going to go
16 to questions?
17 THE CHAIRPERSON: Questions, yes. Go
18 ahead.
19
20 CONTINUED QUESTIONS BY BOARD:
21 MR. LEWIS KLAR: It sounds -- it sounds
22 like the South Carolina model's a bad model. But I'm
23 really not sure what relevance that has for this rate-
24 making process in Alberta.
25 Firstly, the quote that you extracted said

1 that neither actuarial methodology nor supply and demand
2 had much to do with rate setting there. Well of course
3 that's not the case here.
4 DR. RICHARD PHILLIPS: Hmm hmm.
5 MR. LEWIS KLAR: In fact this whole --
6 whole purpose of this today -- two (2) to three (3)
7 days, is to determine how best to work out our actuarial
8 model, how best to determine profit in -- as a factor of
9 that actuarial model.
10 DR. RICHARD PHILLIPS: Hmm hmm.
11 MR. LEWIS KLAR: So I -- appreciate your
12 presentation. If they didn't use actuarial methodology
13 nor supply and demand, I don't know how they set rates.
14 Perhaps they just -- just denied all increases based on
15 politics. Is that what they did?
16 How -- how did they go about this
17 ratemaking in South Carolina?
18 DR. RICHARD PHILLIPS: I think -- I think
19 of what you saw in Commissioner Csiszar's commentary
20 there, is the benefit of hindsight in 2003.
21 MR. LEWIS KLAR: Hmm hmm.
22 DR. RICHARD PHILLIPS: That in probably
23 in 1975 when they started to intervene, they were trying
24 to keep some semblance of actuary methodology and supply
25 and demand.

1 And I think if you read a little bit
2 between the lines of what he's saying in his
3 congressional testimony there is that over time as they
4 get further and further away, they keep on making small
5 little changes here and there and it drives them further
6 and further away.
7 And so I think he's really talking about
8 kind of what was happening late of the 1990's. One (1)
9 of the ironies about insurance regulation in the United
10 States and Richard Derrig know this perhaps better than I
11 do, is that even though Massachusetts has probably
12 regulated its suppressed rates more than just about any
13 other state in the US, they have also had some of the
14 most sophisticated thinking about actuarial models in
15 Massachusetts than they had anywhere in the country.
16 And the Massachusetts model is actually
17 the news in a variety of other states within the US.
18 Wouldn't that be fair to say, Richard?
19 DR. RICHARD DERRIG: Yeah. Yeah.
20 DR. RICHARD PHILLIPS: So I mean it's --
21 it's not so much that you have a technology, it's -- or
22 if you have a model or if you don't have a model. I
23 think the question is how far away from the competitive
24 market outcome are you kind of willing to tolerate and
25 when you get far away from the competitive market

1 outcome, does it have a -- a set of unintended
2 consequences that lead to the types of problems that
3 we're talking about here.
4 And I think that's -- that's probably the
5 -- the important point.
6 THE CHAIRPERSON: Thank you. Ted..?
7 MR. TED ZUBULAKE: Well I had questions
8 along the same lines. Let me ask them anyway.
9 I gather you attribute the rate
10 suppression to the -- the prior approval system that
11 South Carolina had in the way they implemented it or --
12 DR. RICHARD PHILLIPS: Hmm hmm.
13 MR. TED ZUBULAKE: -- worked it. So was
14 it in your view, was it the -- was it more of the case
15 of the -- the South Carolina department actuaries having
16 different views on projected loss costs and trends that
17 the various components of the -- of the rate setting
18 process or was it directly -- more directly attributed to
19 the profit margin that South Carolina Insurance
20 Department would allow companies to include in their
21 rates?
22 And -- and what was the profit margin in
23 South Carolina allowed?
24 DR. RICHARD PHILLIPS: I don't know what
25 the profit margin was they allowed. I'm not sure if

1 that's how they were regulating it at the time. What
2 they -- what they were regulating were -- insurers were
3 required to file increases in premiums and what they
4 called indicated loss cost increases that they were using
5 to base their assumptions on.
6 And those increases would be reviewed by
7 the commissioner within the state and then they request
8 a, you know, our indicated loss inflation says that
9 premiums should go up by 15 percent and the insurance
10 commissioner would say, no, you get a 4 percent increase.
11 And in other years the, you know, the --
12 the increase from the companies might be 5 percent and
13 they might actually allow that to go through. So I -- I
14 think it just -- the way that it was done was -- is a
15 compounding of decisions over time on a year by year
16 basis that drive you further and further away over time
17 from -- from whatever that competitive market outcome is.
18 You also in South Carolina have a very
19 strong dynamic where the rural population in South
20 Carolina outside of the major cities of Columbia and
21 Myrtle Beach had a lot of political power in the State
22 Legislature then.
23 And frankly the majority, unlike in
24 Massachusetts where the majority of the subsidies flow to
25 the urban drivers in Boston, the majority of the

1 subsidies in South Carolina flowed to the rural drivers
2 in -- in South Carolina.
3 And that was largely driven by the -- the
4 political process through the State Legislature imposing
5 kind of political will on the process itself. So I think
6 you have a, you know, variety of things are -- are
7 happening there.
8 MR. TED ZUBULAKE: I guess I don't
9 understand your comment about the compounding because you
10 know, rates are set every year and regardless of what
11 rates are charged in the past, it's all looked at in a,
12 you know, kind of a fresh -- a fresh look.
13 DR. RICHARD PHILLIPS: Now, because what
14 happened is there'll be a request for -- we'd like a 15
15 percent increase.
16 MR. TED ZUBULAKE: Right.
17 DR. RICHARD PHILLIPS: And then they'll
18 say, no, you get a 10 percent increase. So the next
19 year, the insurance industry will come back and say well
20 last year we asked for fifteen (15), you gave us ten (10)
21 so -- and this year we need another fifteen (15) more
22 plus we need the five (5) we didn't get the year before.
23 So now we're requesting twenty (20). Well you're still
24 only going to get ten (10).
25 So what happens is that over time, you get

1 further and further away from where they want to be.
2 MR. TED ZUBULAKE: Yeah. I guess I don't
3 understand the catch-up. But let me ask you this.
4 Then so you're not aware of any -- what
5 profit margin South Carolina would allow each year?
6 DR. RICHARD PHILLIPS: No, I don't know
7 if there was a policy regarding profit. Like in January
8 1st this is the estimate -- this is the profit margin
9 we're allowing for companies to come in. I don't know
10 that.
11 MR. TED ZUBULAKE: Right.
12 DR. RICHARD PHILLIPS: I do have
13 statistics on what the actual --
14 MR. TED ZUBULAKE: The actual --
15 DR. RICHARD PHILLIPS: --profit margin
16 turned out to be. And it's negative for a decade.
17 MR. TED ZUBULAKE: You also said -- I'm
18 sorry for rushing but we're pressed for time.
19 DR. RICHARD PHILLIPS: No, no, no.
20 MR. TED ZUBULAKE: But you said that the
21 residual market was designed not to lose money. I think
22 that's what you said. So -- so how are the rates set for
23 the residual market -- or for the pool of --
24 DR. RICHARD PHILLIPS: You're talking
25 pre-reform or post reform?

1 MR. TED ZUBULAKE: Pre-reform.
2 DR. RICHARD PHILLIPS: Pre-reform, they
3 were set such that if an insurance company if a -- if a
4 policyholder could not obtain insurance in the private
5 market --
6 MR. TED ZUBULAKE: Right.
7 DR. RICHARD PHILLIPS: -- they could go
8 to an insurance company and say you must write me --
9 MR. TED ZUBULAKE: Right.
10 DR. RICHARD PHILLIPS: -- the insurance
11 company will say, I know, but I'm going to put you into
12 this residual market mechanism.
13 MR. TED ZUBULAKE: Right.
14 DR. RICHARD PHILLIPS: That mechanism
15 would then charge a premium that was set by the insurance
16 commissioner in the state and at the end of the year if
17 there was a loss in that mechanism, then there was what
18 was known as a recoupment fee --
19 MR. TED ZUBULAKE: Right.
20 DR. RICHARD PHILLIPS: -- that was
21 essentially a tax on private consumers in the private
22 market and it flowed directly to that residual market
23 mechanism.
24 MR. TED ZUBULAKE: But in setting the
25 rate for the residual market, did the commission

1 knowingly --
2 DR. RICHARD PHILLIPS: Oh yeah.
3 MR. TED ZUBULAKE: -- suppress the rate?
4 DR. RICHARD PHILLIPS: Oh, sure.
5 MR. TED ZUBULAKE: So then you -- I
6 thought you said earlier that it was designed not to lose
7 money. Again that's not -- that wasn't --
8 DR. RICHARD PHILLIPS: After the reform
9 it's designed not to lose any --
10 MR. TED ZUBULAKE: Maybe I just misheard.
11 DR. RICHARD PHILLIPS: -- but just to
12 give you an example. In -- this is the most extreme so
13 kind of the bottom out. In 1996 the earned premium in
14 the residual market facility was $490 million of which
15 the net underwriting loss was $200 million.
16 So the -- the kind of a ratio of the loss
17 relative to the premiums that were earned was a negative
18 41 percent --
19 MR. TED ZUBULAKE: Right.
20 DR. RICHARD PHILLIPS: -- loss. There's
21 no -- that does include the underwriting expenses but it
22 doesn't include if you were actually running this as an
23 insurance company, there's no capital backing that,
24 there's no tax associated with that capital, there's no -
25 - there's no promised return to the capital provider.

1 MR. TED ZUBULAKE: Right.
2 DR. RICHARD PHILLIPS: So, you know, a
3 negative 40 percent return should really be a negative
4 fifty-five (55), you know, something like that.
5 MR. TED ZUBULAKE: But in this province
6 things are a little different. In theory -- you might
7 disagree with the number, but in theory -- there should
8 be enough money in the system to provide for any losses
9 incurred by the pools that we have, that exist in
10 Alberta.
11 DR. RICHARD PHILLIPS: And that was the
12 theory in the -- in the late 1970's in South Carolina as
13 well. It was very small --
14 MR. TED ZUBULAKE: Right.
15 DR. RICHARD PHILLIPS: -- and when it's
16 very small you can collect a very small subsidy from the
17 ninety (90) or 95 percent of people that are in the
18 private market and that mass of people may be paying a
19 little bit to just a few when the -- when the losses are
20 relatively small --
21 MR. TED ZUBULAKE: Right.
22 DR. RICHARD PHILLIPS: -- doesn't really
23 affect very much.
24 MR. TED ZUBULAKE: Right.
25 DR. RICHARD PHILLIPS: But then over time

1 you allow this to just grow and grow and grow.
2 MR. TED ZUBULAKE: Right.
3 DR. RICHARD PHILLIPS: And so what
4 happens is now you have 50 percent of the market paying a
5 tax --
6 MR. TED ZUBULAKE: Right.
7 DR. RICHARD PHILLIPS: -- and 50 percent
8 of the market receiving a subsidy. And so every time you
9 transfer another person over there the losses get bigger
10 over here and the fees that these guys have to pay get
11 larger on a per-person basis and there's less of them.
12 MR. TED ZUBULAKE: Right.
13 DR. RICHARD PHILLIPS: And so what
14 happens is that you just -- you drive this wedge further
15 and further into the system.
16 MR. TED ZUBULAKE: Yes. And one (1) last
17 point. You mentioned that under the new reform that
18 South Carolina went to flex rating.
19 DR. RICHARD PHILLIPS: Hmm hmm.
20 MR. TED ZUBULAKE: Two (2) questions. A
21 question and a comment. What about the filings that are
22 not within the threshold, are they still subject to prior
23 approval?
24 DR. RICHARD PHILLIPS: The filings that
25 are inside the bound?

1 MR. TED ZUBULAKE: No. Outside the
2 bounds.
3 DR. RICHARD PHILLIPS: Outside the bound,
4 they -- the insurance commissioner has the right to
5 review those before they can be put into place --
6 MR. TED ZUBULAKE: Okay.
7 DR. RICHARD PHILLIPS: -- or used in the
8 marketplace.
9 MR. TED ZUBULAKE: They will be subject,
10 I guess, you're saying prior approval.
11 DR. RICHARD PHILLIPS: Right.
12 MR. TED ZUBULAKE: Just to let you know.
13 I also provide actuarial consulting services to the
14 State of Rhode Island.
15 DR. RICHARD PHILLIPS: Okay.
16 MR. TED ZUBULAKE: Rhode Island is
17 technically a file-and-use state but for years it's been
18 a more rigorous file-and-use state because filings were
19 subject to prior review by outside actuaries like me.
20 DR. RICHARD PHILLIPS: Okay.
21 MR. TED ZUBULAKE: And companies would
22 generally not implement the rates until they got that
23 stamp back from the Department, even though it was a
24 file-and-use state.
25 DR. RICHARD PHILLIPS: Right.

1 MR. TED ZUBULAKE: Anyway, Rhode Island
2 went to a flex-rating system about a year ago. In Rhode
3 Island the band is plus or minus 5 percent. What we're
4 seeing now, the company is still required to make filings
5 that they have to provide --
6 DR. RICHARD PHILLIPS: Hmm hmm.
7 MR. TED ZUBULAKE: -- full actuarial
8 indications even though they can get the 5 percent
9 increase automatically. What we're seeing, a number of
10 companies are submitting filings with rate indications of
11 large negative indications, yet they're asking for a plus
12 5 percent increase.
13 Is that the way flex-rating in competition
14 is supposed to work?
15 DR. RICHARD PHILLIPS: Are you saying --
16 MR. TED ZUBULAKE: Even though the
17 companies say, Our actuary has calculated an indication
18 of minus ten (10), if we should reduce our rates by 10
19 percent, we're asking for a 5 percent increase. And
20 since it's within the flex-rating bounds, you know, we're
21 implementing it and, Department, you can't stop us, that
22 kind of thing.
23 DR. RICHARD PHILLIPS: I --
24 MR. TED ZUBULAKE: Did you see that in
25 South Carolina happening?

1 DR. RICHARD PHILLIPS: I'd be real
2 hesitant -- I don't know the Rhode Island --
3 MR. TED ZUBULAKE: Yes.
4 DR. RICHARD PHILLIPS: -- marketplace --
5 MR. TED ZUBULAKE: Right.
6 DR. RICHARD PHILLIPS: -- at all. So I'm
7 a little bit nervous to comment on it --
8 MR. TED ZUBULAKE: But in South Carolina
9 are companies required to file, since they implemented
10 flex-rating, are a lot of companies just simply taking
11 plus five (5), plus five (5), plus five (5) and --
12 DR. RICHARD PHILLIPS: I just haven't
13 been involved with the -- in the post-reform --
14 MR. TED ZUBULAKE: Okay.
15 DR. RICHARD PHILLIPS: -- to actually,
16 you know, set in the working elements there. So I -- I
17 guess I'm must a little reluctant to --
18 MS. JANE VOLL: Richard --
19 DR. RICHARD PHILLIPS: -- comment on
20 that.
21 MS. JANE VOLL: -- Richard Gauthier and
22 Derrig and -- and Sharon may have a point on flex-rating
23 systems with -- given their experience with those types
24 of systems.
25 MR. TED ZUBULAKE: But I don't want to

1 take away from the order of presentation.
2 MS. JANE VOLL: No. It --
3 MR. TED ZUBULAKE: Okay.
4 MR. RICHARD GAUTHIER: If I may for a
5 moment. In my experience companies have -- have their
6 indication and then they have their selection. And what
7 I've seen is indications of X -- of minus X and then they
8 decide to reduce their rates by a little amount smaller
9 than X, so call it 9 percent of non-indicative
10 indication. But conversely too, if the indication is
11 plus ten (10), they may decide to go plus seven (7).
12 Like, in my experience, companies are --
13 in the Canadian environment companies are much more
14 concerned about price stability than it first appears,
15 okay? In the sense that they are -- they have their
16 indication and they are not creature of extreme, they're
17 creature of -- of caution.
18 So my experience whether -- has been that
19 indications are -- are in fact indications, selections
20 are made and for the most part the selections are
21 tempered values of the plus and minuses with a view --
22 with a view -- that tempering is done with a view of --
23 towards price stability.
24 MR. TED ZUBULAKE: But you say that but
25 yet it was for that reason, price instability, that was

1 one (1) of the reasons why I think Alberta went for this
2 system , like, there's a price instability that -- more
3 in the late 90' and early 2000.
4 THE CHAIRPERSON: Jack, do you have a
5 question?
6 MR. JACK DONAHUE: Actually, yes,
7 probably more of a comment than a question, but maybe
8 following up on that. The statement that South
9 Carolina's reforms were prevalent twenty (20) years ago,
10 where at Cal -- Alberta is today I think is sort of not
11 fully there.
12 Alberta didn't look at only one (1) side
13 of the equation. South Carolina looked at one (1) side
14 of the equation, the income side, regulated premiums.
15 Alberta not only regulates premiums only
16 for mandatory coverage but they address the cost side,
17 the claim side. And what they did was they put in major
18 tort reforms in this province as part of these reforms,
19 major tort reforms that limited to four thousand dollars
20 ($4,000) for non-exemplary minor damages. They're about
21 8 percent of all claims cost in this province.
22 And we brought in diagnostic treatment
23 protocols designed by the medical profession here to get
24 victims back out on the street quicker and produce costs.
25 So that had the effect of taking out a quarter of a

1 billion dollars out of the system on the claim side.
2 So when you start to look at apples to
3 apples, these aren't apples to us anymore. On one (1)
4 side only you can talk about -- you have to understand--
5 DR. RICHARD PHILLIPS: Yes.
6 MR. JACK DONAHUE: -- there was another
7 side in Alberta, none of this was ever addressed in
8 South Carolina.
9 DR. RICHARD PHILLIPS: Yeah. And my
10 understanding in conversations is that those -- those
11 reforms have been pretty successful here. And that --
12 that clearly is something that South Carolina did not do,
13 which allowed for kind of the rampant cost inflation that
14 -- that you saw and led to -- led to some of this.
15 But I don't -- that being said, I don't
16 think you can ignore the outcome that you had in South
17 Carolina. I think, you know, the question is whether
18 you, to me, whether you want to trust the political
19 process to set these rates or you want to allow workable
20 competition to set these rates.
21 MR. JACK DONAHUE: I think that's what we
22 tried to do in Alberta, is to have a balance.
23 MR. JIM RIVAIT: No and we -- we
24 presented it and Rich heard some of our discussion
25 yesterday, we present it as -- as quite balanced and the

1 importance of the government seeing that balance. But I
2 mean --
3 MR. DENNIS GARTNER: It's not a political
4 process that sets the rates in Alberta, it's a regulatory
5 process. A regulatory process based primarily on data
6 that the insurance companies supply through a statistical
7 agent. That's going to make the biggest difference at
8 the end of the day.
9 This Board sets rates independently. It
10 doesn't go ask the Government or the Minister if it
11 should set rates. In fact, I think the Government or the
12 Minister -- if the Board thought it was acting
13 politically rather than in a regulatory fashion, would
14 instruct the Board to do its job.
15 So I take exception to the word political.
16 That's not where we're at.
17 MR. JIM RIVAIT: What I was saying that
18 while, yes, it was a balance and we got the two hundred
19 and fifty (250) to $300 million, but we're not going to
20 get that again next year. So now when we go forward, if
21 you add that --
22 MR. JACK DONAHUE: That's not a one (1)
23 year --
24 MR. JIM RIVAIT: -- going to be a
25 reduction --

1 MR. JACK DONAHUE: -- one (1) year
2 arrangement.
3 MR. JIM RIVAIT: -- and that's the better
4 --better system. What's that, sorry?
5 MR. JACK DONAHUE: But that wasn't a one
6 (1) year one (1) time, that was put in place in the tort
7 reform --
8 MR. JIM RIVAIT: No, we've saved it and
9 there's been premium reduction to reflect it. Now we're
10 going forward, setting premium reductions with this
11 system.
12 THE CHAIRPERSON: I think that exhausts
13 our questions. David just came in. And I announce,
14 David, that you've been appointed today. You don't know
15 it yet but you're on the Board. You were out of the
16 room, so --
17 MR. DAVID MARSHALL: Thank you, Mr.
18 Savage.
19 THE CHAIRPERSON: So you can, if you take
20 a chance, you can ask questions but I'm not sure that
21 we'll accept them yet. You got to get --
22 All right. Jim, go ahead.
23 MR. JIM RIVAIT: We'll go on with the New
24 Jersey and Massachusetts examples and then we'll get at
25 some of the -- the questions in -- in a bit more detail.

1 DR. SHARON TENNYSON: May --
2 MR. JIM RIVAIT: Sorry.
3 DR. SHARON TENNYSON: -- may I just
4 interject here that we're -- we're looking at these four
5 (4) examples and I -- I don't think anybody means to
6 suggest that any one of these examples is a replica of
7 what's going on in Alberta.
8 We're -- we're presenting some experiences
9 from different states in the United States as these case
10 studies of -- of what has happened in particular states
11 in the United States and we'll try to -- this is from an
12 academic perspective. Well, I sort of joked about
13 selling the book.
14 This -- you've all been provided with
15 copies of these academic papers I think --
16 THE CHAIRPERSON: Yes, we have.
17 DR. SHARON TENNYSON: -- as part of our
18 reply. This -- this is not a book that we publish; it's
19 a book that came out of a -- a conference sponsored by
20 AEI-Brookings Institute which was the -- the forum for
21 starting these case studies of the different ways of
22 regulating automobile insurance rates in the US states.
23 So we're presenting these case studies to
24 you as part of the academic literature on models of
25 regulation, what works, what doesn't and I -- I don't

1 think anybody means to suggest that one (1) particular
2 case is representative of what's going on in Alberta.
3 So you'll -- you'll hear some other things
4 as well so don't -- don't think we're also saying that,
5 you know, every other model is exactly what's going on.
6 THE CHAIRPERSON: Go ahead, proceed.
7 MS. JANE VOLL: Of course if Alberta
8 looked like Illinois that would be fine.
9
10 CONTINUED BY IBC:
11 DR. RICHARD DERRIG: All right. In
12 Jersey and Massachusetts, interesting states. I grew up
13 in New Jersey so I know an awful lot about New Jersey and
14 I worked for most of my career in Massachusetts.
15 I was chosen by this group, the Brookings
16 folks, to review the analysis that's in there on New
17 Jersey and Massachusetts.
18 And so these are slides you'll see up here
19 taken from my commentary in the book. And you just heard
20 about South Carolina and Illinois and their average
21 premiums being ranked twenty (20), thirty (30) out of
22 fifty (50) in the -- in the country.
23 Let's start with the old days. In 1989
24 Massachusetts was fifth highest in average expenditure
25 and New Jersey was first. 1998, Massachusetts had a

1 reform law which I'll get to in a moment that moved us at
2 least down to ten (10). New Jersey as you might notice
3 there is still number 1.
4 The problem is illustrated by the next
5 slide which is if you look at the '90s, Massachusetts had
6 an overall underwriting profit of minus -- about minus 3.
7 New Jersey was ten (10) points lower based on much higher
8 premiums.
9 So companies were losing quite a bit of
10 money in New Jersey. The crisis about prices was
11 building and among the analysts that were independent and
12 outside of the insurance industry of which Dowling
13 Company in Connecticut is one (1), they tagged
14 Massachusetts and New Jersey as the only two (2) states
15 that had these two (2) qualities. They were high
16 regulatory environments, they had high risks, and they
17 had low profitability prospects.
18 So when you have people out there talking
19 to the marketplace about companies, whether or not they
20 would like to do business in either of these two (2)
21 states and their advice is, these two (2), it's not a
22 good -- it's not a good situation.
23 So why was New Jersey so negative and why
24 did they have the highest possible premiums in the -- in
25 the United States? Well, on the company's side they --

1 first of all they had an excess profit blowout which was
2 ludicrous given the big losses they were having.
3 Secondly, next to Massachusetts they had
4 theft and fraud rings that were out of control. As a
5 matter of fact most of the -- there -- there actually was
6 an economic paper written about why rates were so high in
7 Philadelphia and it was because they were New Jersey
8 drivers coming over and registering in -- in Philadelphia
9 believe it or not.
10 Along the way they invented different
11 kinds of residual markets and the way that it actually
12 worked was you'd start with one (1) until it had a huge
13 deficit and then there would be a reform and somebody
14 would be charged a deficit and they'd move on to another
15 one.
16 So I'm only talking about one (1) round,
17 which is a -- a joint underwriting association where the
18 deficit reached about 3 billion that were then tacked
19 onto all the rest of the companies which then was passed
20 on to consumers. And I believe near the end there was a
21 sixty dollar ($60) charge added to everybody's bill.
22 And then finally there was, in terms of
23 regulatory control, the Commissioner of New Jersey had a
24 unique way of looking at rates, especially profitability.
25 And they invented a term called surplus-

1 surplus which meant that they could decide that there was
2 a part of the capital behind a company that just sort of
3 wasn't worth considering because, well, maybe it had too
4 much.
5 Well, what's too much? Too much is in
6 the eyes of the beholder. And they had from 1970 through
7 at least the beginning of 2000, the Commissioner had the
8 ability to deny the use of part of the capital and then
9 use that.
10 So what did the big reform do at the end
11 of the last millennium? The new legislation that turned
12 New Jersey around had first of all given New -- New
13 Jersey insurance companies the ability to set individual
14 claim risk rates.
15 That is they -- they threw out, like
16 California -- I'm sorry, like South Carolina, they threw
17 out the restrictions, the excess profit law was repealed,
18 the required refunds, in case of high profits, that never
19 were there, they invested in both statutory changes and
20 in a better fraud bureau activities along with the
21 Attorney General, to in fact provide governmental
22 resources to reduce fraud.
23 And the residual market deficit is now
24 pretty low. It's nowhere near the billions that were in
25 the -- in the past.

1 So New Jersey is another turnaround. It's
2 a little later occurring so that we don't have the great
3 hindsight that South Carolina has for New Jersey, but
4 there are plenty of indications so far that these reforms
5 at the end of the 90's and the reforms only a year or two
6 (2) ago are both working and the companies are coming in
7 and they're -- they're actively competing for -- for
8 business.
9 As a matter of fact, someone told me, from
10 people I know because I live there, that you can almost
11 go nowhere now in New Jersey without seeing
12 advertisements for auto insurance, and this is completely
13 new in the last two (2) or three (3) years; that was the
14 turnaround.
15 Now, in Massachusetts, where I have the
16 most experience, the current regulatory regime began in
17 1978. You might ask, Why 1978? Well, because 1977 was
18 the year of competitive rates. Competitive rates lasted
19 three (3) months.
20 As soon as the Boston legislators were
21 charged what they actually incurred, they repealed it.
22 They actually didn't repeal it because that wasn't a good
23 idea, but they gave the Commissioner the ability to
24 suspend the competitive rating law and set premiums.
25 And this year, for 2007, for the thirtieth

1 consecutive year the Commissioner is suspending
2 competitive rates and -- in setting premiums.
3 The premiums are estimated by one (1)
4 industry-wide average value model. That is, We're going
5 to set rates and we're going to try to make it average
6 rates and then that's what everybody will pay. No
7 innovations. No differentiation. If you can get below
8 those rates, feel free to do it but generally we're --
9 we're going to set the rate for what everybody pays.
10 And you were talking about models and so
11 on, what's the profit model. Well, it's not so much the
12 model that matters but it's the selection of the
13 parameters. So you could select minus five (5), you
14 could select plus five (5), you could select plus ten
15 (10), but if the estimation of the claims and the
16 expenses are too low that's not what's really in the
17 rates.
18 What's really in the rates might be much
19 less. So that it's the parameters that really matter.
20 And in Massachusetts over those years we
21 have, since competitive rating was suspended, we have
22 really two (2) distinct eras which I think provide you
23 with some experience as to what might happen given the
24 way that the regulation was -- was actually done.
25 First of all, the two (2) eras are 1978 to

1 1996 and then 1998 to about 2006. At the end, where we
2 are right now, there's a slowly eliminating competition
3 by lowering the ceilings, that is the average rates.
4 1997 to 1998, ceiling-like rates that increased
5 competition. And, you know, let me show you the numbers.
6 In era number one, that was the era of
7 rate -- rate suppression. And the -- the graphic that's
8 up there is how the actuaries -- this goes back to the
9 South Carolina -- how the actuaries who were listened to
10 by the rate -- State regulator underestimated the claims
11 and expenses and maybe even had, you know, reasonable
12 profits provisions.
13 At the end, looking back from 1978 to
14 1989, until the Government reformed the whole system, you
15 can see that virtually every year the actual cost of the
16 policies were underestimated to as much as minus 19
17 percent of an underestimation.
18 And then you see over in 1987/1988 there's
19 -- they only estimated -- underestimated it by 3.6 and
20 minus 2 percent. That's because the Supreme Court
21 intervened and forced the -- the Insurance Commissioner
22 to raise rates by an average of 8 to 10 percent each of
23 those years.
24 So this is what happens when you really
25 want to suppress rates and you dictate average rates that

1 are ceilings that are inadequate. Now, again, there's no
2 -- there's no indication that this is what's going to
3 happen or is -- is about to happen in -- in Alberta.
4 The second era I think is a little more
5 instructive. The era comes from a massive reform law
6 that was passed in 1989 that changed the way bodily
7 injury liability was distributed, the claims were paid
8 and so on, changed lots of pieces of how the market
9 operated.
10 It didn't change the way the Commissioner
11 was still allowed to suspend competition but what it did
12 was it -- the -- and I think this goes back to your point
13 -- what it did was it lowered the cost.
14 And so with the cost being lowered, that
15 meant that the rates could go down. And what happened
16 was in fact the rates did not go down as set by the
17 Commissioner.
18 And so what I show here in this graphic is
19 that beginning in 1995, when companies virtually did not
20 deviate from the Commissioner's rates and essentially the
21 -- the rates were very redundant, companies made a lot of
22 money.
23 Once they knew that that's the way it was
24 going to work, in 1996 there was an average discount
25 deviations across all companies of minus seven -- minus 7

1 1/2 percent. So here's the ceiling. The average company
2 rate was 7 1/2 percent below that. The next year it was
3 9 percent below that.
4 And one (1) thing that I'm not even
5 showing in the graphic is that companies also competed on
6 the finance charge plans. Many of them eliminated the
7 interest rate on finance charges, which is worth about
8 between one (1) and 2 percent, even more.
9 And then as we went on toward, you know,
10 today, what happened was the -- the Commissioner -- the
11 State kind of reversed that policy, very slowly, but as
12 they reversed the ceiling rates the discounts and
13 deviations went down.
14 And so we are now in the 2005, which is
15 the latest data, there's only about 1.8 percent across
16 the whole industry of the discount from the
17 Commissioner's rates and yet the -- the actual claim
18 costs are going down and down and down.
19
20 Mostly as a result of fraud elimination
21 across the State of Massachusetts on the order of 250
22 maybe even up to as high as $400 million. So that's my
23 illustration of competition on their ceiling if the
24 companies want to do it, they can do it and they will do
25 it as long as they have some confidence and as soon as

1 the suppression or the -- the aura of setting rates
2 perhaps too low they'll go back the other way.
3 You -- you don't do it. So that's the
4 sticky price story and the rates and in the last two (2)
5 years by the way have gone down 5 percent. I think last
6 year was 8 percent. So, you know, the ceiling's coming
7 down but it's not coming down as fast as the same as
8 we're making by taking fraud out of the system; mostly on
9 bodily injury.
10 So the lessons from Massachusetts from my
11 perspective is that you should seriously consider setting
12 maximum rates that are maximums imitating Massachusetts
13 in 1997 would be really nice which means that given your
14 questions for this Hearing, that would mean to talk about
15 the Return on Equity as perhaps either a -- a range where
16 the maximum rates are using the higher end of the rate
17 estimate for equity, lowest and estimates for expected
18 asset returns and fair estimates for losses expenses from
19 taxes.
20 One (1) thing that's not on here which I
21 should also -- I'd like to mention is that California is
22 joining Massachusetts in the sticky prices these days.
23 The costs in California are going down. They went down
24 in the -- after the -- in the 90's rather. That's
25 documented in this book.

1 The costs went down and the rates did not
2 go down. Not as fast. And the reason was because the
3 insurers had no faith that the -- the Proposition 103
4 Restrictions would be -- would not be reimposed.
5 That was 1988 and we are now in 2006 and
6 the Commissioner is considering re-imposing Proposition
7 103 Restrictions on profit and on subsidies and so forth.
8 And there prices again like in the '90's
9 are sticking too high given the costs. And the reason is
10 because the regulator is sending the wrong signal about
11 don't bother competing because worse days are coming,
12 we're going to be passing -- they've already passed one
13 (1) of the sets of regulations on subsidies and they're
14 about to pass the other -- the other half. The other
15 shoe is about to drop.
16 So my final point is only true competitive
17 efficient markets can produce prices that cover all costs
18 and induce innovation to the benefit of policyholders. I
19 tried to rack my brain for the innovations since 1978 in
20 Massachusetts and as far as I can tell there aren't any.
21 I mean, all of these things that are now
22 popping up in New Jersey about accident forgiveness from
23 Allstate, all the other range of things that have changed
24 the marketplace out of product offering.
25 I believe we have exactly the same product

1 that we had in 1978 and there won't be any because the
2 companies are not free to -- to act.
3 And as I was telling someone at the break,
4 Progressive which is the most active competitor in the
5 United States is now the third largest company for auto
6 insurance, visits the Commissioner of Insurance in
7 Massachusetts annually where she asks them, you know, is
8 it about time that you enter Massachusetts?
9 And they keep telling her, no. But this
10 year they are in Massachusetts for the first time they're
11 writing and they're writing only competitive commercial
12 auto which has been competitive since 1981. So it's only
13 private passenger that's really been restricted with the
14 sticky prices.
15 The commercial market has been humming
16 along with rates going up and down over that time and has
17 the attractiveness even given the situation of
18 Massachusetts of attracting Progressive to come and to
19 start to capture the market from the domestic companies.
20 So that's sort of my -- my take on it.
21 The regulatory alternatives which is the -- the last
22 slide I'll talk about that -- that lie before all of
23 these regulators are first of all, relying on competitive
24 markets.
25 Illinois is the big example. Secondly, a

1 low price ceiling, price cost uniformity is
2 Massachusetts, monitoring the market average and allowing
3 for a range of competition. That's the flex-rating view
4 and fourth is promoting competition through an effective
5 price ceiling which is what I understand a -- the
6 proposal here is today.
7 So we're proof that it can work, we're
8 proof that it can -- it's also possible not to work
9 depending on the attitudes of the signal sent to the
10 marketplace. And the final answer by the way is these
11 folks talked about, you know, Rich talked about only a
12 hundred (100) companies in South Carolina and now there's
13 almost two hundred (200) companies.
14 And that's the norm in the southeast in
15 Massachusetts. Would you like to guess how many
16 companies write private passenger auto in Massachusetts?
17 Hearing none, the answer is 17 and most of them you
18 probably have never heard of.
19 THE CHAIRPERSON: Thank you. Are you
20 going to stop for questions now? Questions from this
21 end? No questions? Questions...?
22
23 CONTINUED QUESTIONS BY BOARD:
24 MR. TED ZUBULAKE: First as to your point
25 about New Jersey having the highest rates in the US, I --

1 I live in New Jersey. I just want to say that we New
2 Jerseyians are darn proud of that we're number 1 in
3 something.
4 MR. JIM RIVAIT: There's lots of jokes
5 about New Jersey being number 1 in a bunch of stuff.
6 THE CHAIRPERSON: Thank you.
7 MR. TED ZUBULAKE: But more seriously.
8 Again, this is a hearing, a meeting, a session about
9 profit margin.
10 Can you tell us what profit margin is
11 used in Massachusetts in the annual rate setting process?
12 DR. RICHARD DERRIG: Well what I'm
13 telling you with those two graphics is that the formal
14 number that's used is less important than what than what
15 the final one is.
16 MR. TED ZUBULAKE: No, but what I'd would
17 like to know what the formal number is with all respect.
18 DR. RICHARD DERRIG: Well the formal
19 number comes out of the -- this modelling, whole
20 modelling techniques and selection of parameters. And
21 the selection of parameters determines what the final
22 answer is.
23 MR. TED ZUBULAKE: Okay then what is the
24 target, the Return on Equity that is an input to that
25 model?

1 DR. RICHARD DERRIG: The -- the equity
2 cost to capital has been around -- indicated by -- by a
3 value line and the discounted cash flow model has been
4 around eleven (11).
5 The Commissioner currently is choosing the
6 lower numbers which is why the signal is we're not really
7 interested in allowing you to compete under this number.
8 MR. TED ZUBULAKE: But just so I
9 understand, you -- you called it a return -- a, what was
10 it, capital -- cost of equity capital of 11 percent. Is
11 that what you..?
12 DR. RICHARD DERRIG: The -- the value
13 line numbers are around eleven (11).
14 MR. TED ZUBULAKE: But you called that a
15 cost of equity capital.
16 DR. RICHARD DERRIG: Right.
17 MR. TED ZUBULAKE: Now is that the -- is
18 that the same as a target return on equity. I -- I don't
19 know a lot about this but --
20 DR. RICHARD DERRIG: That's the same as
21 the target return on equity.
22 MR. TED ZUBULAKE: But what about the
23 cost of debt? Isn't that in fact the --
24 DR. RICHARD DERRIG: The cost of debt is
25 in there and for --

1 MR. TED ZUBULAKE: Is that embedded in
2 the --
3 DR. RICHARD DERRIG: -- for Massachusetts
4 insurers we don't use that. We use the national and the
5 national is roughly 20 percent.
6 MR. TED ZUBULAKE: Cost of debt is 20
7 percent?
8 DR. RICHARD DERRIG: No, no, no, no, no.
9 Twenty percent debt which is --
10 MR. TED ZUBULAKE: Right.
11 DR. RICHARD DERRIG: -- I think believe a
12 far cry from Canada.
13 MR. TED ZUBULAKE: Right, right.
14 DR. RICHARD DERRIG: Which is more like
15 two (2).
16 MR. TED ZUBULAKE: So -- so we
17 understand, we were trying to relate Massachusetts'
18 profit numbers with what we're trying to --
19 DR. RICHARD DERRIG: Well the current --
20 the current numbers finally come out to be about zero.
21 MR. TED ZUBULAKE: No, that's a profit
22 model. But I'm saying you start with a -- a --
23 apparently input it to this -- internal rate of return
24 model --
25 DR. RICHARD DERRIG: Yeah.

1 MR. TED ZUBULAKE: -- is a 11 percent
2 cost of equity capital. Some number -- some -- some cost
3 of debt capital I gather which gets 20 percent weight
4 which must be lower than the 11 percent --
5 DR. RICHARD DERRIG: Right.
6 MR. TED ZUBULAKE: -- so what is the
7 weighted average cost of capital I guess is the way to
8 put it that enters into that IRR model?
9 DR. RICHARD DERRIG: Well if you -- if
10 you take the estimate based on the public data correctly
11 interpreted which is our view, you'd end up with
12 something between ten (10) and twelve (12).
13 If you -- the Commissioner chooses to go
14 lower they can because something you'll --
15 MR. TED ZUBULAKE: Can I ask --
16 DR. RICHARD DERRIG -- excuse me.
17 MR. TED ZUBULAKE: Sorry.
18 DR. RICHARD DERRIG: But something you'll
19 hear about how you can underestimate betas when -- so you
20 can choose low -- low returns if you'd like to. And
21 currently Commissioner's choosing lower returns --
22 MR. TED ZUBULAKE: Right.
23 DR. RICHARD DERRIG: -- and that's
24 pressing the -- the rates and you see the results that
25 companies are not competing.

1 MR. TED ZUBULAKE: I understand that but
2 the industry whoever test -- presents at that public
3 hearing on behalf of the companies --
4 DR. RICHARD DERRIG: That's me.
5 MR. TED ZUBULAKE: That's you. You're
6 using -- I'm confused now. Before you said 11 percent
7 cost of equity capital --
8 DR. RICHARD DERRIG: Right. Plus -- plus
9 -- excuse me, plus the size effect of about 2 percent
10 now. So we're talking about eleven (11) to almost --
11 MR. TED ZUBULAKE: But -- but where is
12 the cost of debt capital factored in? Is it -- is it --
13 DR. RICHARD DERRIG: It gets -- that
14 gets factored in as 20 percent rate -- weight on actual--
15 MR. TED ZUBULAKE: Okay.
16 DR. RICHARD DERRIG: -- debt that's owed
17 by the companies --
18 MR. TED ZUBULAKE: Okay. I'm asking but
19 what is the weighted average then, please? What -- what
20 is the final target return -- target cost of capital that
21 reflects the weighting of the cost of debt and cost of
22 equity that goes into that IRR model?
23 DR. RICHARD DERRIG: You have it here. I
24 -- I forget the number but it's probably around ten (10),
25 between ten (10) and eleven (11).

1 MR. TED ZUBULAKE: But aren't you the one
2 that -- you -- you -- you run the model, right?
3 DR. RICHARD DERRIG: You know, we're 8 --
4 800 pages of numbers and I can't remember them all.
5 MR. TED ZUBULAKE: There's -- there's
6 no --
7 DR. RICHARD DERRIG: This time I know the
8 cost of equity is roughly eleven (11) and --
9 MR. TED ZUBULAKE: Okay.
10 DR. RICHARD DERRIG: -- and the small
11 size effect is one point nine (1.9) --
12 MR. TED ZUBULAKE: Okay.
13 DR. RICHARD DERRIG: -- I remember that
14 so we're now around thirteen (13) --
15 MR. TED ZUBULAKE: Okay.
16 DR. RICHARD DERRIG: -- and then weighted
17 with debt. Debt is about 5 to 6 percent and it's after
18 tax. You know, you can do the arithmetic.
19 MR. TED ZUBULAKE: Right.
20 DR. RICHARD DERRIG: The Commissioner
21 chooses to go much lower than that --
22 MR. TED ZUBULAKE: Okay.
23 DR. RICHARD DERRIG: -- because they use
24 the underestimate of -- of betas which --
25 MR. TED ZUBULAKE: Right.

1 DR. RICHARD DERRIG: -- Richard just
2 talked about and so they end up with, you know, a total--
3 MR. TED ZUBULAKE: Right.
4 DR. RICHARD DERRIG: -- return on capital
5 of about nine/nine and a half (9/9 1/2).
6 MR. TED ZUBULAKE: But -- but in your
7 opinion it should be closer to the ten/eleven(10/11)
8 range, is that what you're saying?
9 DR. RICHARD DERRIG: No. My opinion is
10 that it should be near thirteen (13) because it's eleven
11 (11) plus --
12 MR. TED ZUBULAKE: Sorry. I -- I with --
13 I'll stop. We're not -- obviously we're not
14 understanding each other.
15 THE CHAIRPERSON: All right. Jim, carry
16 on.
17
18 CONTINUED BY IBC:
19 MR. JIM RIVAIT: Okay. I'll pass it onto
20 Sharon.
21 DR. SHARON TENNYSON: May I just try to
22 draw this together, the -- the discussion of these cases
23 of different regulatory approaches in US jurisdictions.
24 Why -- why we brought these particular
25 case studies forward to you is that we see some

1 similarities between the regulatory systems in some of
2 these states and what happens in Alberta.
3 The states that we've looked at except for
4 Illinois have direct intervention in rate setting and in
5 some cases like Massachusetts in price setting.
6 They also tend to have social pricing
7 objectives so a concern with promoting universal coverage
8 which means that some groups of drivers receive rates
9 that promote that objective.
10 And the cautionary tale that -- that we're
11 bringing to you as you consider the appropriate rate of
12 return or profit setting of objectives in your regulatory
13 deliberations is that in these jurisdictions in which
14 we've seen these big problems, regulators have taken a
15 very conservative approach that have led to low rates of
16 return for insurers and -- and we think in many of these
17 cases rates of return that are below the competitive
18 level.
19 So this is how it relates to
20 considerations of how did the return -- how to determine
21 appropriate profit rates, how to determine return --
22 appropriate rates of return on equity, not in terms of
23 determining specific numbers but rather to point out that
24 taking overly conservative approaches can pass some
25 significant negative effects in a long term.

1 So the -- the lessons from these
2 jurisdictions that are brought out in these -- these
3 academic studies of these regulative markets are first of
4 all, that regulatory attempts to hold down prices by
5 holding down insurer profits adversely affect insurance
6 supply.
7 We see that in these markets in
8 Massachusetts. In the 1970's there were over a hundred
9 (100) insurers operating in the marketplace as Richard
10 tells you, by 2006 we have seventeen (17) insurers
11 willing to operate in that marketplace.
12 We see similar effects in New Jersey and
13 South Carolina although less dramatic in those cases.
14 The -- the point is is that capital demands are
15 competitive rate of return and if capital doesn't get a
16 competitive rate of return it seeks other markets.
17 And this is not something that is -- is in
18 a sense in the control of an insurance company, right?
19 An insurance company needs access to capital to operate
20 and it's the capital markets that are going to demand
21 that -- that competitive rate of return.
22 The second lesson that -- that I think
23 these case studies bring out is that regulatory pricing
24 that -- that leads to cross -- substantially cross
25 subsidized rates for some drivers leads the higher

1 insurance prices for all drivers.
2 Now this is a new recognition and it's
3 just coming out in the academic literature in the last
4 five (5) or six (6) years. We've known for a long time
5 that large residual markets are a marker of problems in
6 the market, right?
7 And -- and the, you know, competition is
8 somehow not working and until recently that's been the
9 extent of understanding.
10 There are a number of studies including a
11 case study of Massachusetts which I have -- which I think
12 you have a copy of which I did the case study of South
13 Carolina.
14 The New Jersey experience, studies in the
15 Workers Compensation Insurance markets in the United
16 States by Scott Harrington and Patricia Danzon and a
17 study that I'd done with co-authors comparing cross-
18 sectionally across US states auto insurance markets.
19 All are starting to -- to emerge with the
20 same results which is not just that large residual
21 markets are an indicator of some problem in the market
22 but in fact that large residual markets in turn cause
23 problems in the market.
24 So that -- that these types of attempts to
25 -- to hold down prices for some drivers that create large

1 residual markets ultimately backfire in the sense that
2 incentives are distorted, insurers' incentives are
3 distorted and drivers' incentives are distorted in ways
4 that lead to higher loss costs in the market as a whole.
5 And it becomes this vicious cycle, prices
6 are rising because losses are rising and there's this
7 pressure on prices, something has to be done from the
8 regulators' perspective but this -- this actually
9 promotes adverse results by -- by populating the residual
10 market.
11 So this is -- this is what we see in
12 recent studies of the impact of residual markets.
13 There's a causal affect, not just an indicator of
14 problems but that in and out themselves large residual
15 markets seem to cause additional problems in the
16 insurance market.
17 A third lesson that comes out from our
18 examination of -- of these case studies of US states, is
19 that the state that has significantly reformed their
20 regulations to ease the reins away from holding down
21 profits and extreme forms of social pricing have indeed
22 seen increased competition and lower prices.
23 We see this in South Carolina, we see this
24 emerging in New Jersey, we see it in the Massachusetts
25 experience although they didn't change the regulatory

1 system endures and which effectively the Commissioner set
2 a price ceiling even with nineteen/twenty (19/20)
3 insurance companies in the market.
4 Do you see companies filing rates below
5 that rate? If it's not their competitive rate,
6 competitive pressures will lead insurance companies to --
7 to price lower than -- than the regulated premium.
8 It's -- it's a difficult step, it's --
9 it's a risky step I think for regulators to do but the
10 experience of these states shows that loosening the reins
11 on regulation actually has beneficial effects in the long
12 run.
13 Now, this is also consistent with what's
14 going on in regulation in other markets and consistent
15 with economic theory of regulation. In other industries
16 even monopoly markets that are regulated.
17 Over the past twenty (20) or twenty-five
18 (25) years theory has demonstrated and experience has
19 demonstrated and empirical evidence has demonstrated a
20 benefit to trying to use the regulatory mechanism to
21 harness competition where that's available and where
22 that's possible rather than squashing it.
23 Even -- even amongst monopolies they have
24 some incentives to innovate if they have a short-term
25 opportunity to earn profits and that has been the move in

1 modern regulatory thinking to allow those forces of
2 competition and the -- the drive to earn some profits to
3 operate in the market and that that is ultimately
4 beneficial and healthy for the marketplace.
5 The -- the last point that I will make
6 here is that this final point, prolonged attempts to
7 unlink prices from the total cost of providing insurance
8 has significant negative impacts on consumers, insurers,
9 and government.
10 I want to focus on the consumer part of
11 this because this is what's especially worrying to me
12 from a public policy perspective.
13 Consumers in these markets that we --
14 we've discussed when the market unravels in a sense are
15 the ones that are most harmed. The industry is harmed,
16 sure, because they lose some opportunity to -- for a
17 profitable business but industry can seek out other
18 markets, right?
19 Companies that withdraw from Massachusetts
20 or South Carolina or New Jersey, they're not going out of
21 business, they're writing insurance somewhere else.
22 So companies can seek other provinces,
23 other states, other countries, other ventures to get
24 involved in if the market is regulated in such a way that
25 it's not profitable for companies to operate here.

1 Consumers don't have that option. If
2 regulation operates in a market in such a way as to
3 stifle competition and if that produces high prices, lack
4 of availability, little choice for consumers, poor
5 service for consumers, consumers are stuck with that
6 because they don't have that mobility. They're stuck
7 with the auto insurance market that they have in the
8 place that they live.
9 And so the real public policy concern here
10 over -- over the long haul from my perspective is -- is
11 what does this mean for consumers? So I think that's...
12
13 CONTINUED QUESTIONS BY BOARD:
14 MR. DAVID WHITE: And I have one (1) --
15 THE CHAIRPERSON: Sure.
16 MR. DAVID WHITE: -- one (1) comment,
17 sir, one (1) question.
18 We just did a review of optional coverage.
19 We don't regulate optional coverage and hopefully we
20 won't end up regulating optional coverage but we see a
21 lot of surplus premium in there.
22 That's, you know, there's a competitive
23 market there supposedly but it doesn't seem to be
24 functioning very well.
25 It's the optional side of the coverage,

1 why --
2 DR. SHARON TENNYSON: I'm going to leave
3 it to people --
4 MR. DAVID WHITE: You can't --
5 DR. SHARON TENNYSON: -- who focus on
6 numbers that -- I mean I don't know what you mean by you
7 see a lot of surplus premium there, right? I'm -- as --
8 as a matter of faith I'm going to tell you I don't
9 believe there's surplus premium there, right?
10 MR. DAVID WHITE: Well,...
11 DR. SHARON TENNYSON: That's my faith,
12 but I don't know how you want to measure that.
13 MR. JIM RIVAIT: Let Richard Gauthier
14 take a crack at it.
15 MR. RICHARD GAUTHIER: For a -- a second
16 and I'll -- I'll tell you what my interpretation on that
17 is and I don't think an insurance company looks at
18 optional coverages as a -- as a competitive subset;
19 that's not what -- they -- they look at a policy and what
20 they charge the policy which is the combination of all
21 coverages combined, okay?
22 So I think you -- you've got to be careful
23 to say, Well, I have a -- you know, the back wheel of my
24 car a competitive market because I can pick the tire,
25 whichever tire ---

1 MR. DAVID WHITE: I can appreciate --
2 MR. RICHARD GAUTHIER: -- I've got to get
3 the front tires too, you know.
4 MR. DAVID WHITE: I can appreciate that
5 but Ted did a study for the Board and presented a report
6 that showed there was a lot of --
7 MR. TED ZUBULAKE: Redundancy.
8 MR. DAVID WHITE: They're charging a lot
9 more -- high profits and optionals are the coverage.
10 MR. RICHARD GAUTHIER: The optionals --
11 MR. DAVID WHITE: And we have a concern
12 that -- is there a bit of gamesmanship here where you're
13 -- there's more premium to be taken on the optional side
14 to make up for what they think they should be making on
15 the mandatory side?
16 And we -- we have some concerns in this
17 area and, you know, this -- it's not a regulated part of
18 the market so why isn't there more competitive pricing?
19 It's a mystery to me.
20 MR. RICHARD GAUTHIER: The issue there is
21 a -- I don't think it's appropriate to look at the subset
22 of coverage. I think you have to look at the entire
23 policy and the fact that they're making more money on one
24 (1) cover versus another.
25 MR. DAVID WHITE: But it's fairly

1 consistent is what we're saying.
2 MR. RICHARD GAUTHIER: Fair enough. I
3 think you -- still -- I still make my point. You have to
4 look at it on the entire policy and, yes, I mean does
5 that mean that, you know, in -- in any process you would
6 look at if someone has only mandatory coverages versus
7 having full coverages what does that mean because nobody
8 buys optional coverages only.
9 MR. DAVID WHITE: No.
10 MR. RICHARD GAUTHIER: Right.
11 MR. DAVID WHITE: You buy mandatory and
12 optionals, almost a misnomer, unless you're driving an
13 old wreck or you're going to buy a car or lease a car you
14 have to have optional coverage anyway so I mean we say
15 it's optional but really in the real world it's pretty
16 mandatory for most people.
17 MR. RICHARD GAUTHIER: But you have
18 options in regards to the deductibles.
19 MR. GRANT KELLY: It's kind of hard to
20 answer the question being that we haven't seen the study
21 but one (1) of the -- if -- Mr. Zubulake's now -- one (1)
22 of the core things that comes from the other
23 jurisdictions is that the assumptions that go into the
24 model and I'm sure in the analysis there's an assumption
25 about how much capital is needed underwriting profit

1 provisions over investment allocation, all those things,
2 and those individual assumptions can be aggressive,
3 average, conservative and that matters.
4 I'm sure if we took a look at this study
5 we'd come out with different assumptions.
6 MR. DAVID WHITE: I would imagine the
7 methodology is fairly consistent to what we use for
8 mandatory so, Ted -- Ted would have to speak to that.
9 MS. JANE VOLL: That's exactly the point,
10 Mr. White, is that every company and there's a company
11 actuaries coming in might be in a better position to
12 elaborate more but every company has its own modelling
13 process on which it puts its premiums, its surplus ratio,
14 its return on investment, its required cost of capital,
15 and the prices that it wants to do to -- to compete in
16 the market.
17 MR. DAVID WHITE: No, and -- and we hear
18 that during the annual review process every year so...
19 MS. JANE VOLL: Okay. And -- and all of
20 those -- there's a range of -- of reasonable assumptions
21 that an actuary can pick in there and -- and what we're
22 trying to bring into this discussion is that -- and I
23 think Richard Derrig had a good example -- is that in
24 competitive markets companies have incentives all on
25 their own accord -- accord to have price equal marginal

1 costs and to do better than the next guy.
2 And if they're pricing their product in a
3 way that it's -- it's -- they're going to lose customers,
4 you know, it's not going to meet their costs -- it
5 doesn't last. In the long run price equals marginal
6 costs and it will get there.
7 And I think one (1) of the issues we're
8 hoping to expose here is that when any government body
9 and we deal with a number of them has one (1) formula and
10 it includes one (1) actuary's assumptions, it looks like
11 that is the read of the market, but you know, another
12 actuary could put in a different set of assumptions and
13 say, oh, no, that is the read of the market and another
14 actuary the same.
15 So while one (1) analysis and -- and again
16 having not seen it but my experience dealing in other
17 provinces in these types of matters is that one (1) --
18 even the same model but with a certain set of assumptions
19 and it can lead one to conclude prices are too high and
20 then the exact same model, different set of assumptions,
21 can lead one to understand that prices are -- are not too
22 high.
23 And -- and the experience in Massachusetts
24 was in that duelling actuary business where you say the -
25 - the rates should be high, this variable should be low,

1 it -- it can lead to a consistent picking up the lower
2 range of those values and a consistent over time long run
3 under estimation of the price. So there's...
4
5 CONTINUED BY IBC:
6 MR. JIM RIVAIT: We've got to -- got to
7 finish up some other parts but I hope the -- the examples
8 certainly not Alberta, none of them Alberta, they all
9 have characteristics that I -- I think are important for
10 us to learn from in various places.
11 So I guess the question is how -- how does
12 this relate to the mandate of -- of the Board? I mean
13 your mandate is to set maximum premiums. You know, how
14 can you do that in a way to support a competitive market?
15 That's the only question that we're
16 trying to get at and I'm going to pass it on to Richard
17 Gauthier to talk a bit about how we can get at some of
18 that.
19 So -- oh, sorry, are you on, Richard,
20 there? Did you want to say something, Jane? Sorry. I'm
21 sorry.
22 MS. JANE VOLL: No, I think just the --
23 the Richard Derrig outlined four (4) different options
24 for you there, you know, a competitive market, low -- a
25 model where you pick the low end of all the parameters

1 and decide that that's the rate which would be like
2 Massachusetts.
3 You can do an average type of approach or
4 the recommendation from these experts based on their
5 academic work and our recommendation is to use your model
6 and pick the parameter for each of those variables at the
7 range that it's going to lead to an effective market
8 ceiling.
9 And what that will do is -- is allow for
10 the competition below that ceiling and -- and foster all
11 of the innovation and all those competitive forces which
12 we spent the first half of the afternoon talking about
13 working in your favour to bring choice and lower prices
14 and -- and product variety for the consumers.
15 So, over to Richard to talk about the
16 specific recommendations then towards creating an
17 effective market price ceiling or maximum price...
18 MR. RICHARD GAUTHIER: My turn? I'll
19 start, I do shop for insurance and I do make a difference
20 between this insurer -- this insurer as to which one I
21 want to pick and I do not pick the lowest price; I can
22 tell you that.
23 That being said, I think you asked four
24 (4) questions. What is the appropriate ROE? How do we
25 reconcile this into a level of premium and calculation

1 techniques, et cetera?
2 I think you -- it's been alluded all the
3 way through this -- this presentation that you -- at the
4 core of all these discussions are actuary -- are
5 actuaries. You've got actuarial models. You've got
6 actuarial assumptions. You've got actuarial judgment.
7 And what is an actuary? An actuary is a
8 professional is bound by -- that's bound by a series of
9 professional rules, of standards of practice, et cetera.
10 So you have a discipline. Some call it a science; others
11 call it voodoo science or whatever you want to call it.
12 It's a decision of looking in the future.
13 It's -- it's certainly well-structured,
14 well-looked at in terms of standards of practice and it's
15 -- it's a difficult field to get into because in the
16 setting of insurance premiums is a very complex process
17 that englobes a significant number of parameters.
18 This being said I think on pages sixty-one
19 (61), slide sixty-one (61), what you have there is a
20 formula for required underwriting margins and -- and
21 there are as many formulas as there are actuaries. Now,
22 some people will expect size -- five (5) and six (6)
23 minus one (1), other expresses at two (2) plus three (3),
24 et cetera.
25 So -- so therefore, here's one (1) and the

1 reason why we put it there is because we want to dispel a
2 certain amount of -- a certain misconception that props
3 up from time to time.
4 The first one (1) is when we're going to
5 talk about underwriting profit we're going to make sure
6 that we all talk about the same thing, the definition of
7 terms. Okay? It's an extremely important item to
8 consider and you have an actuary on your Board that can
9 make sure that when submissions are provided to you, that
10 the definition of the terms are consistent across the
11 entire...
12 I understand that it was maybe some of
13 that this morning. So let's make sure we have the
14 correct definition of terms and -- and the -- the -- so -
15 - so that's my first point.
16 My second point is there are -- an
17 insurance contract is simply a series of cash flow
18 premium up front, losses at the back end being paid. In
19 order to (sic) this enterprise to work insurer has to put
20 capital in it and -- and we can get to what level of
21 capital they're going to need and that capital required
22 needs to be rewarded.
23 And -- and in -- in the concept of -- of a
24 competitive marketplace some insurer may require a higher
25 return on equity than others. Some insurer may say I

1 have a -- a -- there is a consumer out there that's
2 willing to pay for added services or claim services of a
3 certain kind and if I charge that price which would imply
4 a higher return on equity, this customer will be happy
5 and I will be happy.
6 There is a lot of comfort to be taken in
7 saying a target ROE is "X" and we all agree on that but
8 there is no target ROE per se; it's -- it's always a -- a
9 trade-up between what the consumer wants to buy and
10 services they want to buy and what the company cost of
11 capital is.
12 And -- and therefore, you know, I think
13 we've got to be -- we've got to be careful that even in a
14 universe where you have perfect information, you will
15 have different potential return on equity because
16 different insurers will require different things and will
17 address different markets.
18 The -- the second thing that I wanted to
19 show -- to show that exemplify here is that the -- the
20 policyholder pays its premium up front obviously and the
21 claims are coming later.
22 So therefore, significant amounts of cash
23 -- cash or investment are accumulated and investment on
24 that cash which I would call policyholder funds are
25 credited in this formula or in any formula that your

1 actuary should review. There is the -- the building of
2 the cash or the investment from the pol -- from the fact
3 that the premium is paid upfront and the claims are paid
4 later, that building up of cash generates investment
5 income, and that investment income is credited to the
6 policyholder, okay?
7 So that's -- that's important to say.
8 Some people believe that the entire
9 investment income goes to -- to the company. And -- but,
10 on the other hand, in order to support that enterprise
11 there is equity that the -- the capital market are put in
12 this insurance business, and that equity needs to be
13 rewarded. Okay?
14 And that reward comes from the
15 underwriting profit and the return investment on the
16 invested equity while it's supporting the business. And
17 that's what we have in this formula here.
18 And I think the -- the thing that I want
19 to -- that we have identified earlier is that in -- in
20 the premium we have kind of four (4) big components.
21 You've got the claim cost, you've got the operating
22 expense, you've the return on equity and -- I missed one
23 (1), sorry, I said four (4) -- and the effect of changes
24 in legislation when they occur.
25 And the reason we -- and each time you

1 throw fifty (50) actuaries -- you've got sixty-five (65)
2 companies here competing in this province, so you
3 probably have effectively forty-five (45) actuaries doing
4 rates because not all companies have actuaries and --
5 like you have, so you probably have forty-five (45)
6 answers.
7 So there is -- there is in the rate-
8 making exercise an enormous number of assumptions that
9 need to be made. And each actuary will have its own view
10 as to which assumption is a reasonable one.
11 And it's very difficult -- there is no --
12 there is -- how can I say -- there is only a range of
13 reasonable answers for any one of those assumptions. You
14 can decide -- you can weave through each range of those
15 assumptions. You can weave a series of selections that
16 will lowball the result and you can weave a series of
17 reasonable assumptions that are going to highball, if you
18 want, the results. Okay?
19 So -- and this is according to what
20 everybody in this range of assumptions is acting in good
21 faith. So, therefore, my point here is in doing your
22 actuarial -- in selecting values, is that you need to
23 have the -- the opinions or the views of a number of
24 actuaries, of all the actuaries. In fact, every time you
25 did all your filings coming into the firm you had the

1 views of all the actuaries out there. And that -- those
2 views have value.
3 And I know that it's very comforting to
4 take those views and compare it to a single value and
5 say, What's the distance, and -- and, you know, but there
6 -- it's not -- first, it's dangerous because to a certain
7 extent it's the value to which you're comparing it to or
8 you're trying to review the people to is wrong, you've
9 created a fair amount of havoc in the market. Okay?
10 So you've got to be careful that when
11 you put -- pick your -- your assumptions, for example for
12 claim, that when you pick those assumptions you pick them
13 in the range of values that is congruent with the goals
14 you have. And if you have a goal that the -- I'm
15 basically suggesting here, of setting a ceiling, a
16 maximum ceiling, make sure that it's an effective -- an
17 effective ceiling.
18 So this is what, you know, in the rate-
19 making process you have here a slide on claim cost and
20 the claim cost is the most significant factor and -- and
21 I've said my piece about the assumption that -- that
22 needs to be put into the assessment of that claim cost
23 next year. There is no second chance.
24 When an actuary sets its claim cost for
25 next year, it's set. We're not going back next year and

1 say, Hey I missed, okay, I need to make up. Okay.
2 It's always forward-looking, and your
3 actuary stated it's always a forward-looking process, you
4 know. And, you know, it's like a dice. The average is
5 three and a half (3 1/2). Well, throw your dice, you're
6 never going to get three and half (3 1/2), you'll get
7 three (3) or you'll get four (4). Okay?
8 The -- so there is no second chance
9 here. So, therefore, you need to, because there's no
10 second chance, because the insurance companies are
11 introducing certainty in the cost in how they hand of the
12 consumer, they need to get their return on equity on that
13 cost as well.
14 Operating expense, which is the second
15 thing, which is any operating expense in its entirety.
16 I'm very broad when I say expenses. We've got -- we've
17 got commissions, loss adjustment expense, internal loss,
18 et cetera, is there. Well, each insurer has a unique
19 cost structure. That cost structure is optimized for the
20 way they do work.
21 So if I had, for example, the one that I
22 brought in, I have an insurer who differentiates itself
23 by the claim services they provide. And by that
24 differentiation I have therefore a cost structure that is
25 unique to them, because they need the personnel to get

1 the -- to get the caseload that permits a fast claim
2 service.
3 I am willing as a consumer to pay more for
4 that. And I'm probably paying more than what it's
5 costing the company because they're probably making a
6 higher return equity by that, and I'm happy with this a
7 consumer, okay?
8 So there is no unique cost structure. So
9 when you -- if you decide that you want to create rates
10 for the average insurer, there is no average insurer,
11 okay? They all have their particularities, either in
12 distribution, or whether in their operating or -- or
13 their operating management and the goals they want to
14 achieve with the consumer.
15 Again, this unique cost structure to each
16 insurer, it would be nice to have a single number but
17 there is no single number.
18 Profit provision, cost of capital and
19 gearing ratio. As I said, in the formula -- in the set,
20 we have claim costs that are subject to -- to a lot of
21 assumptions, we have operating costs that are pertinent
22 to -- that are specific to each insurer. The third one
23 is profit provision.
24 I mentioned already that the cost of
25 capital demanded by shareholder of a policyholder is in

1 fact -- it's not in the control of the actuary, it's an
2 input into the actuary process.
3 The cost of capital is not in the Board's
4 control. What's in the Board control is the allowed cost
5 of capital. But the cost of capital is established
6 overall by capital markets. And, therefore, the allowed
7 cost of capital that will be made into a ratemaking
8 process will dictate the availability of insurance or the
9 availability of capital to this business.
10 And in the example I gave the cost of
11 capital for an insurer that decides to innovate and give
12 good claim service could be -- it could be rewarded more
13 than the average.
14 The second one is the ratio; how much
15 capital does it require to support the premium. Again
16 here that would be nice to have a single number but there
17 is no single number. I have -- if you have an insurer
18 who, for example, insures a group of insured that is very
19 stable, year in, year out, they renew 90 percent of their
20 book of business.
21 So I'm the actuary for this insurer here
22 and I'm saying, I know which book of business I have to
23 price next year because 90 percent of my -- my insured
24 are renewing, and that have five (5) years history that's
25 -- it's always the same people. For that insurer I have

1 a much better view of what the price is going to be for
2 that -- that portfolio.
3 If I'm another insurer and I specialize in
4 risks that are less -- that are less predictable -- I'll
5 use the term residual market for a moment if you don't
6 mind, but -- risks that are, what I would call, riskier
7 than others, either because of their claim history, their
8 driving history et cetera, rate history, some of those
9 insurers -- the renewal ratio, you know, is twenty (20).
10 I can do a rate for next year but the rate
11 Im doing for next year are for, you know, 80 percent of
12 what I insure next year I don't have them in my book, I
13 don't have the information, I'm betting. I'm making a
14 much more serious bet here than the guy, the other
15 company that has a 90 percent renewal ratio.
16 So I have a much -- much more difficult
17 bet to make. And they -- and these people are offering a
18 service that is necessary for -- necessary for the
19 society. And because they're taking a bigger risk they
20 either should be more rewarded for taking a bigger risk -
21 - we all -- we are all familiar with more risk, more
22 reward -- or because it's more up and down they will
23 require more capital to support that business because the
24 uncertainty around the result is much bigger than it is
25 on the company that has a 90 percent renewal ratio.

1 So, therefore, again, it would be very
2 comfortable to say, you know, I have one cost of capital
3 and I have one gearing ratio. But it's -- in fact, it's
4 not the case. It's not -- there are very solid reasons
5 why it shouldn't be.
6 Here, in the gearing ratio, which is the
7 premium to surplus/premium to equity ratio, again, in --
8 in the framework that they're proposing of -- of setting
9 a maximum rate, okay, they're proposing a gearing ratio
10 of one point three (1.3). Again, this is in the context
11 of setting a maximum rate, okay? That's what they're
12 proposing.
13 The next thing that I want to point out is
14 why, you know, I think it's important to have the -- the
15 relationship of what that means in that gearing ratio, is
16 there's, on page 66 or on -- on the slide called "Impact
17 of Gearing Ratio", you have a table there that shows
18 underwriting profit provision as a percent of premium
19 depending on -- on various gearing ratio.
20 The thing that you should be aware of and
21 the thing that's important to -- to understand too, is
22 the lower the gearing ratio, the closer to one (1), the
23 more secure is the promise to the policyholder. And
24 there are some insured out there, and I'm one of them,
25 because maybe I have more knowledge, but, you know, I

1 want my claim paid, so I'm going to go for it and insure
2 highly leveraged. There is absolute value in this, value
3 that should be compensated.
4 So here you have a table that shows some
5 underwriting profit depending on various gearing ratios.
6 The -- I mean, there are some
7 recommendations by IBC here that state that their
8 analysis of industry practices suggest that one point
9 three (1.3) to one (1) or lower would be appropriate for
10 a competitive ceiling. And again this is a -- a number
11 and it's a number that is set relatively low because it's
12 set in the -- in the context of a maximum price.
13 And the reason why we -- the reason why it
14 becomes difficult to -- to regulate price, because as
15 soon as you want to regulate the price there is a
16 tendency to say there's only one (1) good answer. There
17 isn't only one (1) good answer; there is a variety of
18 answers, there is a range of reasonableness. And the
19 market as a whole should fall within a certain range of
20 reasonableness of -- of a certain price.
21 But that doesn't mean that if I cut that
22 market into different segments that the parameter that
23 goes into the pricing of each of the segments should be
24 the same, because the risk of certain segments is
25 different. Because what each insurer -- insured asks

1 from its insurer is also different. So that's -- that's
2 my -- so, therefore, although there's comfort, it's not
3 necessarily appropriate, okay?
4 So I -- I suggest here that in looking at
5 those -- at those items and within the framework of
6 establishing a maximum rate, that the Board looks at
7 what's being proposed here in the -- by all the
8 submissions by insurance companies in their rate filing,
9 decide what's an appropriate range, and be setting a
10 maximum rate to make sure that we're not looking at the
11 average but we're looking at the top end of the range, so
12 that we establish a maximum rate that is an effective
13 maximum that will permit most of the market to play under
14 and have the competitive market play its role.
15 And I think at this point we're going to
16 go further into the cost of capital.
17 DR. RICHARD PHILLIPS: So that's back to
18 me. I was asked to talk a little bit about some research
19 that I had done looking at investigating the cost of
20 capital for property casualty insurers based on US data.
21 Just to make sure that we're clear on the
22 definitions here, the -- the numbers I'm going to show
23 you are based on market data, so this is publicly traded
24 data. This is not book value data looking at GAP
25 accounting statements for example, or statutory insurance

1 accounting statements. These are actual return data from
2 the stock market. So we're trying to inter what the
3 global competitive markets are saying is the cost of
4 capital for this industry.
5 This is an expectation, I think as you
6 heard a minute ago. This is a target, this is not the
7 actual cost of capital that we're looking for all
8 insurers to hit every single year on the dime. This is a
9 risky business and sometimes you're going to make more
10 money than the cost of capital, sometimes you're going to
11 make less money than the cost of capital.
12 So let me just -- again, the two (2)
13 points are that this is a target and that these are
14 market value numbers and -- which are a little bit
15 different than a lot of the book value numbers which you
16 may have seen before.
17 The dominant asset pricing model that
18 gives us the cost of equity capital for -- for a stock of
19 a company has been the capital asset pricing model. This
20 model was developed in the late 1960's and in the early
21 1970's. And it -- it actually says two (2) things; that
22 if I'm going to make an investment in a stock which is an
23 investment in a company, then the return that I'm looking
24 for on that investment has two (2) components.
25 The first component is just a component

1 for the time value of money. It's the risk free rate of
2 interest. It's -- if I could invest in Government Bonds
3 that have no default risk and that have cash flows that
4 are known with certain over the next period of time, then
5 that would be the amount of return that I would expect to
6 make in that risk free investment.
7 Stocks are not risk free investments,
8 however, so we need to compensate for the risk associated
9 with a stock that's beyond just the risk that's
10 associated with just the time value of money.
11 That comes from the second component in
12 this equation here. There's two (2) pieces of it.
13 There's the -- what's known as the CAPM data. This is a
14 firm, specific number. It -- the beta measures the
15 riskiness of this company relative to the other
16 investment opportunities for stockholders.
17 So if you have a beta of one (1) for your
18 firm, it means that you are of average risk, measured
19 relative to the overall marketplace. If you have a beta
20 greater than one (1), it means that you're considered to
21 be a higher risk investment than the overall marketplace
22 and therefore you should have a higher expected return on
23 your investment. A beta less than one (1) would be a
24 lower risk investment.
25 So, it's a firm, specific number that we -

1 - various methodologies have been developed to try to
2 estimate what that number is for a specific company or
3 for a specific industry, and I'll talk a little bit about
4 that in a minute.
5 The second piece that's multiplied times
6 the beta is a market-wide number; that the number that's
7 there is the amount of return you would expect if you
8 invested in the marketplace about the risk free rate of
9 interest.
10 So, if -- again, so if you have a beta of
11 one (1) and you have an expected market return net of the
12 risk free rate, then the overall return then for the
13 market is just going to be the expected market return on
14 average. And so we're going to raise and lower the
15 expected return on individual investments relative to how
16 risky they are, compared to the other investment
17 opportunities.
18 A reasonable question you might ask is:
19 Does the theory work? Is this a good thing to base our
20 recommendations to you and for you to accept?
21 And, what I',m showing you here is a chart
22 that comes out of a paper by a Professor at the
23 University of Chicago named John Cochrane.
24 And what he's showing you here is about
25 fifty (50) years' worth of data where, on an individual

1 basis, he has calculated the beta for every stock that's
2 ever traded in the United States and then he has also
3 looked at the returns on those stocks and done that over
4 this fifty (50) year time period.
5 So it's just a -- I mean, there's five (5)
6 or six (6) or seven thousand (7,000) publicly traded
7 companies at any one time in the United States and he's
8 looked at this over fifty (50) years. But this is an
9 absolutely immense data set. And he's done this on a
10 monthly basis, so you can imagine how many observations
11 are in here.
12 The bottom line of what you would like to
13 see if the capital asset pricing model works is that the
14 higher the estimated beta for these companies, therefore
15 the riskier they are relative to the overall marketplace,
16 the higher the expected returns. And that's what he's
17 showing here in this chart, is just these -- along the X-
18 axis he is plotting the average beta for these firms
19 after they've been split up into ten (10) categories,
20 based on how big they were.
21 So, he'd looked at the market
22 capitalization of small companies and he takes the
23 average beta for those small companies and he looks at
24 that along the Y-axis of the average return that those
25 small companies earned, okay?

1 So we basically got ten (10) scatter plots
2 up here. You're looking at the average beta across
3 different size categories and what you'd like to see is
4 that, as you get to higher average betas, you get to
5 higher average returns. And that's exactly what you see
6 in this chart.
7 And so you could look at this chart and
8 say, Wow, the theory works really well. It plots
9 extremely well. The problem is the black line there is
10 the theoretically correct -- if the capital asset pricing
11 model worked perfectly, all those scatter plots would lie
12 along that black line or they would just be randomly up
13 and down along the black line there.
14 And what you'll actually see is that the
15 scatter plots, as you go further out along the X-axis
16 there, the scatter plots tend to get above the black line
17 until you get to the furthest one, and, in fact, it's
18 quite a bit above the black line.
19 And so kind of in the early -- or in the
20 1970's and early into the 1980's, financial economists
21 frankly had a lot of arrogance. They said, Wow, we
22 really created a theory that's beautiful and we've got a
23 lot of empirical data that says, you know, and it worked
24 pretty darn well.
25 And a lot of what happened in the 1980's

1 and into the early 1990's was that people started to
2 recognize that, well, these anomalies kind of popped up
3 that these scatter plots or various other more
4 sophisticated tests don't quite tell the full story.
5 There's something else going on here.
6 And the something else that's going on,
7 there are two (2) anomalies, there's a whole host of
8 anomalies and I could talk to you until about eight
9 o'clock this evening about all of the anomalies, and I
10 don't think you want to do that.
11 But there's a -- there's two (2) anomalies
12 that have dominated this literature that people just
13 can't make go away. No matter what they do to develop a
14 more sophisticated estimation methodology or a different
15 data set or looking at it internationally versus just the
16 US or whatever they try to do, they can't make two (2)
17 special anomalies go away.
18 And those two (2) anomalies are related to
19 firm size, that the capital -- the beta from the capital
20 asset pricing model doesn't seem to capture all of the
21 return that you would expect for small companies versus
22 large companies. And what the capital asset pricing
23 model seems to do is under-estimate the market beta for a
24 small company.
25 In other words, small companies tend to

1 earn returns higher than you would predict if you just
2 were to measure their capital asset market beta. And, in
3 fact, the small company portfolio is actually that last
4 blue dot that's kind of out there by itself. It's
5 earning a monthly return that's about 1 1/2 percentage
6 points higher than it should be based on what the theory
7 is.
8 The other anomaly that people can't get to
9 go away is what's known as the financial distress or the
10 value effect, which is that value companies tend to earn
11 higher average returns than what we call growth
12 companies.
13 And I'll give you an example of a growth
14 company. A growth company would be Google, for example,
15 It has tremendous growth opportunity. It has price
16 earnings ratios that are very, very high. It has what
17 the -- these, you know, financial analysts call a book to
18 market ratio which is very, very low because the book
19 value of the assets of Google are fairly small and the
20 market capitalization of Google is gigantic.
21 So, growth companies tend to earn a little
22 bit less than you would expect, just based on the capital
23 asset pricing model, and value companies which have book
24 to market ratios fairly close to one (1), tend to earn
25 higher returns than you would expect based on the capital

1 asset pricing model.
2 You can see that graphically in the next
3 scatter plot. What I've shown here -- there are -- there
4 are two (2) economists that have kind of written an
5 entire series of papers that have documented these
6 effects and are really considered the worldwide experts
7 on -- on this model. It's a gentleman named Eugene Fama
8 who's at the University of Chicago and another gentleman
9 named Kenneth French who's at Dartmouth University.
10 And this scatter plot that I'm showing you
11 here comes from their paper from 1996 which was published
12 in the Journal of Finance, which is the premiere journal
13 -- academic journal for asset pricing -- empirical asset
14 pricing for the financial markets.
15 And what you'll see on the scatter plot is
16 that I've just lined up the betas along the two (2)
17 dimensions; growth versus value companies, and then small
18 companies versus large companies. And on the -- the
19 vertical axis I've just plotted what the market beta is
20 for these companies, just based on the capital asset
21 pricing model.
22 And what you can very plainly see in the
23 growth dimension, for example, is that growth stocks have
24 a beta that's too high and they're not actually earning
25 those returns that are associated with it, and the value

1 stocks are in the other dimension.
2 And what you can't see and I -- we should
3 have re-oriented this a little bit, is that the small --
4 there's another dimension in the small to large, which is
5 also going in that same direction where the premiums were
6 not being picked up by just estimating the capital asset
7 pricing model.
8 And so what Fama and French have done in a
9 whole series of models is that they've proposed a three
10 (3) factor model which supplements the capital asset
11 pricing model for two (2) additional factors; one (1)
12 which is associated with size and one (1) which is
13 associated for this financial distress or value factor.
14 And they suggest estimating the following
15 model as a -- that it corrects a lot of the anomalies
16 that are left over from the capital asset pricing model.
17 And when you do this and you look at that
18 same scatter plot which I just showed you a minute ago,
19 you can see that the market data essentially becomes kind
20 of random across this growth and size dimension, that
21 it's actually a fairly flat -- we don't see this pattern
22 anymore in the -- in the adjusted market data once you
23 control for the size and the growth factors.
24 And then the whole -- in this whole series
25 of research these -- these two (2) economists have shown

1 that this explains the majority of anomalies that have
2 been discussed in the literature over the past fifteen
3 (15) years.
4 What a professor colleague of mine, David
5 Cummins, and I did was we wanted to think about the
6 Fama/French model and to kind of zoom in on the property
7 casualty industry, and to think about does the size
8 factor and does the value or the financial distress
9 factor play an important role in the cost of capital for
10 property casualty companies specifically, because that's
11 our primary research interest, but in general for
12 financial services companies, do these two (2) factors
13 play an important role in determining the cost of capital
14 for these types of companies.
15 We wrote that paper and it was published
16 last year. And I think you heard this morning that we
17 were very pleased to find out that we were earlier this
18 summer given an award for the -- one of the best paper
19 awards for the journal that it was published in last
20 year; in the Journal of Risk in Insurance.
21 And so I'd like -- what I'd like to do
22 today is to show you a little bit of how the results that
23 come out of the Fama/French model for property casualty
24 companies in the insurance industry, based on US data.
25 The other innovation that we have in the

1 paper that we've published in -- in 2005, was innovation
2 that we call full information beta. And the reasonable
3 question for you to ask is: What is the cost of capital
4 for the property casualty insurance industry?
5 And of the ways to go to do that would be
6 to say, Well let's just go find a whole bunch of
7 companies that only write property casualty insurance,
8 they don't do anything else, just property casualty
9 insurance, and we'll just estimate what the cost of
10 equity capital is for those firms.
11 Well, the problem is the firms that write
12 property casualty company for insurance are often engaged
13 in lots of other businesses. For example, many of them
14 are engaged in life insurance. Many of them in the US
15 and Canada and in Europe are also now engaged in banking
16 or they're engaged in health insurance.
17 And the question is: If you want to
18 estimate just the cost of capital for property casualty
19 insurance, because that's your mandate, to oversee
20 property casualty insurance, do you want to focus on just
21 those companies that do property casualty insurance and
22 throw away all the information that's available from
23 firms that are writing both property casualty as well as
24 engaging in other lines of business, or do you want to
25 somehow try to incorporate that information in.

1 And what research has shown is that if you
2 adopt the first strategy, which is you just throw away
3 all the multi-line insurers, the problem is those guys
4 tend to be the larger insurers, the more efficient
5 insurers, and what you're left with lots of times are the
6 more inefficient or the smaller companies. And we've
7 already shown you there's a small size effect here and if
8 you only look at the small companies you're going to
9 overestimate the cost of capital because they tend to be
10 smaller firms.
11 And so the problem is that you're throwing
12 away a lot of information and you're actually getting a
13 biassed view of the information that's left over for you
14 to look at. And so the full-information beta methodology
15 allows you to incorporate the entire data set, all firms
16 that are publically traded, and then allows you, from
17 that information, to basically extract the information
18 for a particular industry.
19 The underlying idea is very simple. The
20 beta for an individual company, Beta I, is just a
21 weighted average of all the betas from the industries
22 that that firm participates in mult -- weighted by how
23 much it participates in those different industries. Let
24 me give you an example.
25 If you had a -- in a multi-line insurance

1 company that was half life insurance and half property
2 casualty insurance, then it's individual beta would be
3 one half of the weight times a property casualty industry
4 beta, and one half of the weight times a life insurance
5 industry beta, okay?
6 An so the methodology that Professor
7 Cummings and I developed, allows you to decompose all of
8 the individual company betas into weighted average of the
9 industry betas and then you can extract all of those
10 industry betas without throwing away information.
11 This is a tremendous advantage. I'll give
12 you an example. Just in the property casualty business,
13 if you only wanted to look at US companies that solely
14 focus on automobile insurance and property casualty, you
15 would probably have maybe ten (10) to fifteen (15)
16 companies, depending upon the year.
17 In the United States there are, for this
18 sample, if I include just property casualty companies
19 that have a significant percentage in automobile
20 insurance writings, which is at -- I define is at least
21 40 percent premium volume in auto insurance, that fifteen
22 (15) number becomes ninety-eight (98) companies over the
23 time period of my sample.
24 And if you're willing to expand that to
25 include all publicly trade companies, that number, just

1 for insurance, expands out to a hundred and fifty (150)
2 companies. But by the time we fully implement the full
3 information beta technology we are incorporating over
4 five thousand (5,000) companies in any given year into
5 this analysis, and then extracting those industry betas.
6 So, for example, we don't have to throw
7 away an IAG which has both a large life insurance
8 operation, a large property casualty insurance operation,
9 a large capital markets operation, and oh by the way
10 they're also one of the largest aircraft leasing
11 companies in the world as well. So we don't have to
12 throw away that observation in order to be able to
13 implement our methodology.
14 We also don't have to throw away General
15 Electric, which at this time period was a large financial
16 services company, insurance company, as well as a turbine
17 manufacturing company.
18 So -- so what we're doing here is we are
19 trying to capture the idea that capital markets are
20 allowing you to allocate capital across all of these
21 companies without just subsetting it to just the smallest
22 and most specialized of those firms in any one industry.
23 The report that I've prepared for you
24 looked at the years 1997 though 2006. So I looked at ten
25 (10) years of data. I implement the methodology in two

1 (2) different ways. I implement the Fama/French model
2 just on a sample of property casualty insurance companies
3 that have significant automobile insurance business.
4 There are ninety-eight (98) companies that I've included
5 in that sample and they are listed in the report, in one
6 of the appendices.
7 And then the other methodology that I
8 employed as a check and to try to bring in all these
9 other observations without having to throw away a lot of
10 information, is the full information beta sample. This
11 is all companies with equity traded on the US exchanges,
12 whether that be the NASDAQ, the American Stock Exchange
13 or the New York Stock Exchange.
14 And with the methodology we're able to
15 extract -- basically I can extract any industry beta
16 you're looking for. The one that you're -- the one that
17 you're particularly interested in here is for the
18 property casualty insurance industry beta, and that's the
19 one I'm extracting and showing you here, in the report.
20 I need to -- in order to be able to
21 implement this methodology once I've estimated all of the
22 different -- the market -- the individual market beta,
23 the size factor for these companies and the value factor
24 for these companies, I also need to know, well, what's
25 the risk-free rate of interest that I'm going to use, and

1 what are the expected market premiums for market, for
2 size and for the value?
3 And Richard Derrig has a very nice paper
4 which I think also won an aware somewhere recently, where
5 he talks I think about thirty (30) different ways -- is
6 that right?
7 DR. RICHARD DERRIG: There's -- if you do
8 all of them there's more than that, many more.
9 DR. RICHARD PHILLIPS: Okay. There's
10 lots of ways to estimate these market size and value
11 expected risk premiums. I have picked what I think is
12 the easiest to explain, I think what's used most common
13 in corporate finance applications both within academics
14 as well as within companies, and I've just said, Let's
15 take the longest time series of data that I can find and
16 I'm just going to take the simple average.
17 The time series that I've taken here are
18 monthly data from July of 1926 through June of 2006. So
19 that's a -- eighty-one (81) years worth of data on a
20 monthly basis. To get -- to get an annual number out of
21 that we just multiplied the monthly number by twelve
22 (12). And these are the risk premiums for market size
23 and value that we get from that calculus.
24 Over this ten (1) year time period I
25 calculate the cost of capital given the two (2) beta

1 samples that I talked about earlier, on an annual basis
2 from 1997 through 2006, so I get ten (10) -- ten (10)
3 observations. And then the advice that I give to
4 companies is that there is going to be random variation
5 from year to year.
6 And so I always suggest that you take the
7 most recent five (5) years and just average that number
8 until you get some sort of -- we're not just picking a
9 high number this year and a low number next year but
10 we're trying to smooth out this process a little bit over
11 time.
12 Based on that analysis the five (5) year
13 average numbers ending in 2002 through to 2006 for the
14 two (2) different methodologies based on US data are
15 shown here in the -- in the table. They range from about
16 19 percent to about 15 percent. The average of the -- of
17 -- over the entire ten (10) year cycle is around 17
18 percent.
19 The -- I would tell you that this is an
20 average for an average company operating a property
21 casualty insurance in the United States with an average
22 asset mix of a property casualty company operating in the
23 United States with an average book of business with --
24 for a property casualty company in the United States for
25 the full information beta methodology because it includes

1 all firms.
2 For the Fama/French model where I've just
3 narrowed it down to companies that have automobile
4 insurance as their primary business, it would be the
5 average book of business for that type of a company.
6 But again, there's a lot of heterogeneity
7 in the business models of companies that have at least 40
8 percent of their premium ridings in automobile insurance.
9 Some of them are special -- non standard auto riders for
10 example which would be very different than an Amica
11 insurance company for example. No, Amica's not publicly
12 traded but a different model.
13 Some of them would be both like health and
14 multi-line insurance companies so again we tried to
15 narrow it down a little bit but again this is -- this is
16 for an average risk company operating in the United
17 States.
18 In Canada, I think -- I don't know a lot
19 of the business models of the sixty-five (65) firms that
20 are operating here. I would suspect that most of those
21 companies are smaller just given the population of the
22 country of Canada versus the population of the United
23 States which is approaching 300 million people today.
24 And so at a -- at a minimum they would be
25 a little bit smaller and so a size premium would probably

1 kick in here a little bit. But I also understand the
2 asset mix is not very heavily weighted towards equities
3 and property casualty insurance in the United States.
4 Very little equity -- is this right?
5 Very little equity investment by property
6 casualty companies here in Canada. In the United States
7 that number is probably on average 20 percent -- 25
8 percent something like that.
9 So I think you have -- I think this is a
10 very rough ballpark and you would want to try to move it
11 in directions based on how you think the industry here is
12 a little bit different than the industry in the United
13 States.
14 MS. JANE VOLL: If I may for a moment.
15 We're almost finished, there's just after this, the --
16 the investment variable that you wanted some input on and
17 Richard will take you there.
18 The upshot of this is -- you've heard our
19 -- our theme that in setting maximum prices you will have
20 an actuarial formula and you will have the opportunity to
21 choose where in the range is right for you to be in
22 setting the maximum.
23 And there will be a different cost of
24 capital for every firm in -- in the market right now. In
25 our view based on and as you know, the research is still

1 in the works but based on -- in the US research our
2 understanding of a size adjustment the fact that what
3 Richard Phillips gave you were averages and we are
4 recommending a ceiling that you would want to find
5 yourselves in the range of a 17 percent ROE at least to
6 be capturing the ceiling type of cost of capital and then
7 allowing for the full competition below that.
8 As -- as you saw even average cost of
9 capitals were -- were higher than that for US insurers
10 and -- and the seventeen (17) may be on the low side.
11 But that's our recommendation for a first shot at trying
12 to establish an effective ceiling rate, effective maximum
13 price, that's what we would recommend.
14 And our view validated by academic
15 research in the field and capital market practice.
16 Richard explains a little more fully how this converts
17 into your percent of premium formula and that was one (1)
18 of your questions, so if you don't mind in the interest
19 of time if we went straight on from that.
20
21 CONTINUED QUESTIONS BY BOARD:
22 MR. TED ZUBULAKE: Just for clarification
23 on the recommended 17 percent, going back to the question
24 I asked earlier. Is that a cost of equity capital, is
25 that -- is that an average cost of capital, does that

1 reflect the average --
2 DR. RICHARD PHILLIPS: Hmm hmm.
3 MR. TED ZUBULAKE: -- debt cost -- the
4 cost of debt --
5 DR. RICHARD PHILLIPS: Well --
6 MR. TED ZUBULAKE: There's no compass
7 there.
8 DR. RICHARD PHILLIPS: Let me answer that
9 question. It -- that is an industry average equity cost
10 of capital number.
11 MR. TED ZUBULAKE: Okay.
12 DR. RICHARD PHILLIPS: For individual
13 companies it will vary depending upon lots of factors.
14 And it does not include -- so it's not a weighted average
15 cost of capital. There is no attempt in that --
16 MR. TED ZUBULAKE: Right.
17 DR. RICHARD PHILLIPS: -- to determine
18 how much debt any of those companies have, nor have I
19 even attempted to try to figure out what the cost of debt
20 would be for those companies.
21 MR. TED ZUBULAKE: But -- but --
22 DR. RICHARD PHILLIPS: An internal rate
23 of return model for those companies would take this
24 number as an input but its capital structure and its cost
25 of debt and its marginal tax rates would all have to be

1 inputted into that in order to determine an underwriting
2 profit margin from that.
3 MR. GRANT KELLY: Just to make sure that
4 -- under the Federal Insurance Act, there are limitations
5 on the amount of debt equity that P&C insurers are
6 allowed to have.
7 We're the only nation in the G-7 that has
8 those particular restrictions. It's 2 percent or less,
9 so the difference between the equity cost of capital and
10 a weighted average cost of capital is a bit of a red
11 herring in --
12 MR. TED ZUBULAKE: Yeah.
13 MR. GRANT KELLY: -- this particular
14 case.
15 MR. TED ZUBULAKE: So it's -- so for your
16 17 percent or so recommendation is -- is a recommended
17 cost of equity capital or recommended weighted average
18 cost of capital?
19 MS. JANE VOLL: It's a recommended target
20 ROE for you to work with and that includes the entire
21 cost of capital.
22 And given that insurers here really only
23 have one (1) source of capital, equity capital, it --
24 MR. TED ZUBULAKE: It makes no
25 difference.

1 MR. GRANT KELLY: It makes no difference.
2 MS. JANE VOLL: Not really.
3 MR. TED ZUBULAKE: Okay. Thank you. I
4 just wanted to clear that up.
5 MS. JANE VOLL: Okay.
6 DR. RICHARD PHILLIPS: I should make one
7 (1) more point. We've done some work with some companies
8 I know of filings that have been made in regulatory
9 settings within the United States where this methodology
10 has been adopted and to date it hasn't been challenged
11 and I think that's very different than saying that it's
12 been approved.
13 I don't think -- I think the -- the
14 companies that have used this or that I'm aware of using
15 the methodology that Professor Cummins and I wrote up,
16 have -- have applied for this and successfully used it in
17 a variety of -- of rate hearings and in different
18 regulatory regimes.
19 I don't want to say that any state has
20 gone so far as to approve it but -- but they have allowed
21 the overall rate filings to go forward in these numbers
22 and numbers like these to be used based on the individual
23 companies own recommendations.
24 MR. TED ZUBULAKE: And it's IBC's
25 recommendation of -- for the next industry-wide

1 adjustment or is that for -- forever?
2 I mean, that is a --
3 MS. JANE VOLL: We get to this a little
4 later --
5 MR. TED ZUBULAKE: Okay.
6 MS. JANE VOLL: Our market conditions
7 change and it -- it does -- as Richard showed his up cost
8 of equity capital has changed from 2002 to 2006.
9 So if you were to try to set an effective
10 ceiling and one (1) of the variables you put in that was
11 a target cost of capital, you might want to come back and
12 check to see if it's still the right value for that
13 variable to still produce an effective ceiling in light
14 of current market conditions.
15 So you'd probably want to come back and --
16 and -- and look at whether the value that you're choosing
17 for that field is right.
18 MR. TED ZUBULAKE: So is IBC recommending
19 a methodology for choosing a target return, or is it
20 recommending a specific target return?
21 MS. JANE VOLL: We recommend that you use
22 seventeen (17) -- consider using seventeen (17). We
23 think it will help you choose an effective ceiling rate
24 and then we -- and we also advise you that the rate can
25 change over time.

1 MR. TED ZUBULAKE: How would the Board
2 know if rates have changed?
3 MR. GRANT KELLY: There's a couple --
4 MS. JANE VOLL: It -- I think the
5 discussion of what the Board would be doing going forward
6 is subject to the premium regulation review next Fall and
7 there might -- that might be a better opportunity for a
8 more fulsome --
9 MR. TED ZUBULAKE: I'm just trying to
10 understand what the 17 percent means.
11 What is your -- IBC's recommendation?
12 MS. JANE VOLL: That is our
13 recommendation. Put seventeen (17) --
14 MR. TED ZUBULAKE: For the next
15 industry --
16 MS. JANE VOLL: -- cost of capital --
17 MR. TED ZUBULAKE: The next industry-
18 wide --
19 MS. JANE VOLL: -- in your formula.
20 MR. TED ZUBULAKE: -- adjustment.
21 MS. JANE VOLL: For the next industry-
22 wide adjustment.
23 MR. TED ZUBULAKE: Thank you.
24 MR. LEWIS KLAR: Can I ask you a question
25 about that box? This is from a complete non-economist so

1 the question may be stupid, but that seventeen point six
2 seven (17.67) is an average of those five (5) previous
3 years?
4 DR. RICHARD PHILLIPS: Yes.
5 MR. LEWIS KLAR: And I notice each year
6 it's -- it's -- has it been decreasing each year or --
7 DR. RICHARD PHILLIPS: Yes.
8 MR. LEWIS KLAR: Is there any explanation
9 for that?
10 DR. RICHARD PHILLIPS: There are lots of
11 theories in the literature about why -- what's happening.
12 I'll give you the dominant one (1).
13 It's well --it's becoming fairly well
14 documented that what an economist calls the idiosyncratic
15 risk of stocks in increasing over time. Idiosyncratic
16 risk is the risk that can be diversified by shareholders
17 across -- across capital markets.
18 And that's a trend that's been continuing
19 for about ten (10) to fifteen (15) years now.
20 So, part of what you're saying here is
21 just that -- what the capital asset pricing model
22 predicts is that idiosyncratic risk is not compensated in
23 the marketplace; it's only what they call market
24 systematic risk that's compensated.
25 But I think part of what you're saying

1 here may be that effect. It's a very slow trend that's
2 taking place.
3 I think the other thing that's taking
4 place here a little bit is an internet bubble effect
5 where you had kind of a large run up in prices very, very
6 quickly in the late 1990's that which kind of over half
7 of -- the first half of 2000 and into 2001 and 2002 and
8 2003.
9 Kind of -- there was a -- a -- I guess you
10 could call it a regime shift in the capital markets and
11 investment opportunity sets for investors and I think
12 part of what you're saying here is that as well.
13 MR. LEWIS KLAR: Is it your -- would you
14 make an educated guess as -- if you had a guess between
15 2007 and 2012 that it would become random again and that
16 trend would continue?
17 DR. RICHARD PHILLIPS: You're asking me
18 to predict if there's going to be an asset bubble again
19 in the future.
20 I'd love to know the answer. Because I
21 would have changed my stock portfolio allocations in 2001
22 if I knew that.
23 MR. LEWIS KLAR: Because there is a huge
24 difference between the 2002 one and the 2006 one.
25 DR. RICHARD PHILLIPS: Oh, yeah. No,

1 there certainly is.
2 MR. LEWIS KLAR: And if it continued or
3 stayed down that seventeen point six seven (17.67) would
4 be high.
5 DR. RICHARD PHILLIPS: Hmm hmm. Yeah, oh
6 definitely. And I think -- but the recommendation here
7 is that if you're trying to set a ceiling, which is what
8 the IBC is trying to recommend, then I think what they're
9 trying to say is well, we definitely, you know, do we
10 really want to hang out at the low number or do we want
11 to pick something that's a little bit, you know, more on
12 the -- more on the range or maybe at the higher end of
13 that.
14 DR. RICHARD DERRIG: Can I add a little
15 bit to that? Because we've been looking at these numbers
16 for a long, long time and one (1) thing that happened at
17 the beginning of the 2000's is, (a) 9/11 and,(b) the
18 bubble.
19 And what happened is that when you started
20 just looking at the market beta which is the first of his
21 three (3) terms but it's the only term we have, it went
22 way down and this was noted by researchers in the UK that
23 that calculation which is a fixed calculation, sixty (60)
24 months we do our progression, we look the number.
25 You can see in Richie's table and his

1 report they're coming down and the problem is, that
2 that's not the right estimate unless you end the other
3 two (2) terms.
4 So, in Massachusetts and, in reply to your
5 question, we try to say, sure that's coming down. That's
6 not what people who look at the industry believe, because
7 it's biassed low, because of the change in the market
8 that you're looking and what you'd see in his numbers is
9 that's gone down, but the other factors are now more
10 important and it actually makes a lot of sense.
11 Think of the bubble going down; companies
12 have much less assets. They have more possibility of
13 financial distress, therefore that third factor goes up.
14 The size -- the size was always there.
15 It's never been given to us in Massachusetts, so we get
16 the low end of the beta and we get no zero on size and we
17 get zero on -- on financial distress.
18 But, if you go to professional stock
19 analyst like Value Line, that only provide data to the
20 public about investments and historical information, as I
21 said in my report, their latest estimate for the property
22 casualty insurance industry in the United States is
23 somewhere between 12 and 16 percent rate of return, and
24 the sixteen (16) is on the five (5) year going forward.
25 So, the whole overall estimate is

1 increasing but, unfortunately, this restricted one (1)
2 dimensional view of the beta is going the opposite way
3 and unless you do the corrections which the theory tells
4 you and his numbers show you, you don't get the right
5 answer.
6 And so that's why it looks like it's a
7 different number, it's because it really is, as because
8 there's three (3) factors that determine what capital
9 providers will look at for the property casualty
10 industry.
11 Not only relationships to the market as a
12 whole, which is the original CAPM for which Richard
13 forgot to tell you there are several Nobel prizes given
14 for that, but also the size.
15 Smaller companies are riskier and
16 therefore the market demands more in turn from them and
17 then finally financial distress is endemic to the
18 property casualty industry.
19 And so it makes a lot of sense that the
20 capital providers would want a return for the fact that
21 they are going to go out there and they're going to put
22 their capital at risk and it's a measurement of how much
23 risk is really out there that's not connected to the
24 market.
25 You know, for example, the hurricanes, the

1 two (2) consecutive years of hurricanes in Florida, that
2 had nothing to do with the stock market, nothing.
3 But where are we? We're somewhere over
4 $100 billion that went out the door.
5 So, it's that kind of thing that's
6 measured by these -- the distress factor that doesn't
7 show up in the single CAPM beta which then, if you ignore
8 them, you get a much lower estimate which is where we are
9 in Massachusetts.
10 MR. TED ZUBULAKE: A clarification. I
11 thought the chart that was up there was -- included all
12 three (3) factors?
13 DR. RICHARD DERRIG: His does, ours
14 doesn't.
15 MR. TED ZUBULAKE: But his is the one we
16 were looking at, the one that's the decline -- the
17 Fama/French, going from nineteen (19) down to fifteen
18 (15).
19 DR. RICHARD DERRIG: Right --
20 MR. TED ZUBULAKE: It includes all three
21 (3) factors --
22 DR. RICHARD PHILLIPS: Yeah, it does.
23 Richard's talking about what they allowed in
24 Massachusetts --
25 MR. TED ZUBULAKE: Massachusetts, I

1 understand.
2 MS. JANE VOLL: And also the value line
3 estimate which was the go forward, someone asked what
4 would be your prediction for '07 and '08 and Richard
5 Derrig was saying the -- the -- the stock analysts are
6 saying twelve (12) to sixteen (16) and that --
7 DR. RICHARD DERRIG: That twelve (12) is
8 -- is 2006, fourteen (14) is 2007 and sixteen (16) is
9 five (5) years.
10 MS. JANE VOLL: Okay, so there is --
11 there's a go forward trend up that I think was -- he was
12 trying to make that point and answer back in earlier
13 question on Massachusetts --
14 MR. TED ZUBULAKE: Yeah --
15 THE CHAIRPERSON: Okay, we're going to
16 have to carry on; we;'re running out of time here.
17 MR. TED ZUBULAKE: Just quickly, but what
18 beta are you using in those -- in your calculations to
19 get the seventeen (17) -- get those --
20 DR. RICHARD PHILLIPS: These are all
21 three (3) the market size and financial distress.
22 MR. TED ZUBULAKE: Oh, they vary?
23 DR. RICHARD PHILLIPS: Yeah.
24 MR. TED ZUBULAKE: Okay.
25 DR. RICHARD PHILLIPS: They vary by

1 company, so -- so you can estimate them individually for
2 each company.
3 MR. TED ZUBULAKE: But the -- the cap in
4 the market beta, is that about point eight (.8) overall
5 average? we heard earlier --
6 DR. RICHARD PHILLIPS: It depend -- it
7 varies from company --
8 MR. TED ZUBULAKE: Okay, just --
9 DR. RICHARD PHILLIPS: I can tell you
10 what the average was for the companies in my sample.
11 MR. TED ZUBULAKE: Yes.
12 DR. RICHARD PHILLIPS: Hmm.
13 MR. TED ZUBULAKE: Is that -- is this in
14 your paper? You don't need to --
15 DR. RICHARD PHILLIPS: Yeah, it's in
16 table 2 of my paper.
17 MR. TED ZUBULAKE: Okay, thank you.
18 THE CHAIRPERSON: Go ahead, Ted. We're
19 going to have to move along a little bit because we only
20 have so much time in this room.
21 MS. JANE VOLL: Okay, so just to make one
22 (1) point of distinction, insurers in Canada get their
23 money from capital markets equity so equity is the
24 important market.
25 When you flip over to looking at how they

1 invest their money, how they invest premiums, now we're
2 talking about bonds, because they don't really invest in
3 equities.
4 They get their monies from equity markets,
5 but when it comes time to investing premiums between the
6 time you get them and pay out claims, now we're talking
7 about bond markets.
8 So just to make a point of distinction
9 there and Richard is going to talk a little bit about
10 that, 'cause you wanted input on ROI.
11 MR. RICHARD GAUTHIER: Thank you. We --
12 just talking about ROI, as I mentioned earlier, there is
13 a cash flow process to an insurance transaction, premium
14 up front, claim paid later and as a result of that, there
15 is significant funds that are being accumulated by the
16 insurance company in the form of investment.
17 Those funds I will call, due to the
18 delayed independent payment of premiums collected and
19 payment of claims, I call that policyholder funds.
20 Those policyholder funds are going to
21 collect interest. The question is, what is the interest
22 rate that I should -- that I should impute to this for
23 the benefit of the policyholder. In other words, what is
24 the credit for that investment income that I should give
25 to the policyholder?

1 Given that the policyholder enters through
2 the transaction for the purpose of minimizing risk, it
3 would be -- it would be counterproductive to be -- for
4 the policyholder -- its investment and its premium while
5 it's sitting there waiting to pay a claim.
6 So, we suggest that the -- and that the
7 value of the investment yield to be addressed on the
8 policyholder funds would be a risk free yield.
9 MR. TED ZUBULAKE: What about the
10 capital?
11 MR. RICHARD GAUTHIER: On the investment
12 of the capital of the company which is a different issue
13 here --
14 MR. TED ZUBULAKE: But it's part of --
15 you got to factor that in, right?
16 MR. RICHARD GAUTHIER: You have to factor
17 the fact that the -- the equity -- the equity of the
18 company also is going to be invested and those aren't our
19 policyholder funds --
20 MR. TED ZUBULAKE: Right --
21 MR. RICHARD GAUTHIER: They are
22 shareholder funds.
23 MR. TED ZUBULAKE: But -- but --
24 MR. RICHARD GAUTHIER: Which could be
25 invested in riskier investment which may therefore

1 receive higher yield but then there's also -- they have
2 to accept bigger risk. But on policyholder fund we're
3 saying risk free
4 MR. TED ZUBULAKE: But --
5 MR. GRANT KELLY: But the -- though, if
6 your Board is going to do a ceiling, investors --
7 investors in the insurance field -- sorry -- there's
8 asset risk which is what happened in investment markets
9 and then there's insurance risk. So there are companies
10 in the market place that are not willing to accept any
11 asset risk on these investments.
12 So they're wanting -- they just don't want
13 to. Their shareholders are saying, insurance is risky
14 enough. I don't want to go there.
15 So as you're going to the ceiling, it's
16 not appropriate for the Board in setting that ceiling to
17 force investors to get risk that they are not willing to
18 accept.
19 So our ceiling recommendation is that the
20 assumption is you have to take the conservative
21 investment portfolio and assume that the marketplace
22 ceiling is based on not accepting extra investment asset.
23 So that's the --
24 MR. TED ZUBULAKE: It seems to me that in
25 arriving at that 17 percent, Professor Phillips took into

1 consideration the -- I mean the investments earnings of
2 companies. Companies do invest in more than risk free
3 securities.
4 And based on that 17 percent was -- fell
5 out of the model. Now you're saying take that 17 percent
6 but --but only -- only assume a risk free -- risk free
7 securities in -- in converting that to a profit margin.
8 That doesn't seem to make sense.
9 MS. JANE VOLL: I think the -- one (1) of
10 the -- one (1) of the questions here to consider is
11 whether your formula is representing a -- a typical
12 company or a model company in which you need all of those
13 variables to hold together in some -- in -- in a
14 consistent manner or whether your selection of those
15 variables at the top end to set a maximum is to establish
16 a ceiling; not that you're trying to replicate the
17 activities of any individual insurer but you're trying to
18 say, well, for some insurers, they chose the -- they
19 follow this conservative approach.
20 We don't want to shut them out of the
21 market, so we take the conservative value of that
22 variable here.
23 Next variable, and look at them in
24 isolation.
25 It is -- we've put it on the table. There

1 are other ways to look at this, Ted, and make an offer to
2 put that together and you can choose a different
3 assumption for risk free or a different gearing ratio and
4 -- and all of that -- all of that is up to the Board to
5 decide.
6 We are just trying to illustrate that for
7 this variable, if you want to pick a value that's
8 consistent with ceiling, we would recommend this risk
9 free orientation.
10 But there's a lot of other --
11 MR. TED ZUBULAKE: It's --
12 MS. JANE VOLL: A lot of other
13 considerations that you can make. We just are trying to
14 be consistent with the ceiling message.
15 MR. TED ZUBULAKE: And we just -- we
16 touched on but we kind of skipped over it, but how -- how
17 is the recommending gearing ratio arrived at, the one
18 point three (1.3)?
19 Where does that come from?
20 MR. GRANT KELLY: We did a survey of IBC
21 member companies and then there was a range of gearing
22 ratios.
23 I also made -- OSFI capital levels are
24 synonymous with solvency regulations. So, we -- the
25 second part of our comment was that you should consult

1 with OSFI before you determine the appropriate gearing
2 ratio --
3 MR. TED ZUBULAKE: And is this --
4 MR. GRANT KELLY: -- regulated in the
5 Province that has the solvency.
6 MS. JANE VOLL: When the solvency
7 regulator looks at a company writing auto insurance, they
8 have in mind how much capital they think is required to
9 underwrite that line of business, given the amount of
10 regulatory risk in each province et cetera, et cetera.
11 So, there is at least one (1) other
12 regulator looking at how much capital should be in -- in
13 that area and it would be something to look at.
14 But we -- we look at the OSFI value and we
15 also looked at a survey of companies, we said, you know,
16 you need to be in the -- in the one (1), one point three
17 (1.3) one point five (1.5) range if you want an effective
18 ceiling.
19 Can you find an actuary who'll justify two
20 (2)? Absolutely. But we're talking about a value that's
21 consistent with being a --
22 MR. TED ZUBULAKE: Just for
23 clarification. Is that one point three (1.3) intended to
24 be for private passenger automobile based on the
25 mandatory coverages in Alberta, or is that a -- a --

1 MS. JANE VOLL: This one --
2 MR. TED ZUBULAKE: -- P&C company that --
3 that's what the survey question asked.
4 MR. GRANT KELLY: Yes.
5 MR. TED ZUBULAKE: So is this --
6 MR. GRANT KELLY: The mandatory coverages
7 in Alberta.
8 MR. TED ZUBULAKE: Okay.
9 MS. JANE VOLL: Okay. So our
10 recommendation is a conservative approach to the
11 investment variable because then you won't be shutting
12 out companies who do take that conservative approach to
13 investments.
14 Riskier ones will be allowed to have a
15 rate and compete below that and -- and it's consistent
16 with the ceiling approach.
17 I -- I'd like to suggest that we go
18 quickly over the fair value accounting point and
19 entertain questions later. It's discussed in our paper.
20 THE CHAIRPERSON: I agree. We have to
21 shut down --
22 MS. JANE VOLL: Yeah.
23 THE CHAIRPERSON: The building shuts down
24 at 5:00. We can stay, but it's --
25 MS. JANE VOLL: Yeah.

1 THE CHAIRPERSON: Other rooms are locking
2 up and so on at five o'clock.
3 MS. JANE VOLL: So the -- our line --
4 MR. LEWIS KLAR: We're locked in until
5 6:00 the next morning. It opens again at 6:00 tomorrow
6 morning, so we can leave then.
7 MS. JANE VOLL: Okay, so this is -- we're
8 two (2) slides away from completion.
9 The bottom line is if you put in a
10 ceiling, as we said, each there's a number of variables
11 in that pricing equation, there's a range of reasonable
12 assumptions that you can make.
13 If you put in something that's consistent
14 with a maximum price, consistent with an effective
15 ceiling that leaves lots of room for competition below,
16 you're looking at assumptions like cost of capital,
17 target ROE, if you will, of 17 percent and as an ROI of
18 four point two five (4.25); a premium equity ratio of one
19 point three (1.3) to one (1) -- one point five (1.5) if
20 you like.
21 For illustrative purposes we took the loss
22 ratio from last -- recent hearings just to fill that
23 value in and a claim duration, a tax rate, that gives you
24 an underwriting profit margin, you know, of nine (9).
25 Now, you can tweak each of these

1 assumptions and you'll get eight (8) or seven (7) or ten
2 (10) or -- or whatever but what we are wanting to
3 illustrate is that if you choose values consistent with a
4 ceiling you're looking at something in this order of
5 magnitude.
6 And that answers your final question on
7 how does the target ROE convert into a percent of premium
8 profit margin.
9 And so there you are in the eight (8) --
10 eight (8) to ten (10) range and -- Jim...?
11 MR. JIM RIVAIT: Well, I mean obviously
12 the themes that we tried to cover off, competition is the
13 best regulator of price and profit and -- people accept
14 that.
15 It's -- I think it's been proven to be --
16 but -- and through the literature and through our experts
17 that it's a reasonable assumption. Experience in other
18 jurisdictions, I think, and I do apologise if anyone
19 takes any -- any one of those as Alberta.
20 They're characteristics of all those
21 systems that I think we can all learn from.
22 And I know we've had some specific
23 recommendations that you have heard and I want to thank
24 you for your indulgence and I -- I want to thank our
25 folks that came a long way to speak to try to contribute

1 to this process, and if there's any other questions...?
2 THE CHAIRPERSON: I want to thank you,
3 Jim. It's been a very full afternoon. I'll tell you, we
4 heard a lot of information.
5 When we looked at your list, of course,
6 you know that Canada was built on great waves of
7 immigrants from the United States and thought maybe the
8 republic -- we thought maybe the Republicans were coming.
9
10 (BRIEF PAUSE)
11
12 THE CHAIRPERSON: Now we have --
13 MR. LEWIS KLAR: It's snowing like crazy
14 out there.
15 THE CHAIRPERSON: Thank you very much. I
16 have one (1) second here for -- two (2) minutes, he tells
17 me.
18
19 (BRIEF PAUSE)
20
21 MR. CHRIS TOWNSEND: Thank you very much,
22 Mr. Chair. I just promised this morning in response to
23 one (1) of Ted's questions to reconcile between the
24 profit margins as they were stating and the profit margin
25 as I was -- the underwriting profit margin as I was

1 stating it.
2 And I think the simple answer is that, as
3 I said in my testimony, we compose our profit margin of
4 three (3) our return on equity of three (3) components;
5 one (1) a return on the capital itself, one (1)
6 underwriting margin and one (1) the present value of
7 money.
8 And, in essence, the formula used in the
9 rate-making approach you're using has only one (1) -- has
10 only two (2) sources, the return on the equity itself and
11 an overall combined return on all the other factors.
12 So, our two (2) factors, an underwriting
13 profit and the time value of money really need to be
14 combined to be comparable to the number you have and as a
15 close approximation, simply add the two (2) together.
16 It's not exactly correct, but it's
17 probably close enough.
18 Adding the two (2) together in the example
19 I gave you, we get the 12 percent number required to get
20 our 15.6 percent on equity.
21 THE CHAIRPERSON: Thank you.
22 MR. CHRIS TOWNSEND: Thank you, Mr.
23 Chair.
24 THE CHAIRPERSON: Thank you, all. Board
25 members you can leave your books in here. This will be

1 locked at five o'clock.
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3 --- Upon adjourning at 4:55 p.m.
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8 Certified Correct,
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13 ____________________
14 Sue Zaharie
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