

## **2010 Annual Adjustment Review**

### **Alberta Automobile Insurance Rate Board**

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*A Submission by Insurance Bureau of Canada*

**May 28, 2010**



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## **Insurance Bureau of Canada**

*Insurance Bureau of Canada is the national industry association representing Canada's private home, car and business insurers. Its member companies represent 90% of the property and casualty (P&C) insurance market in Canada. In 2008, with invested assets in Alberta exceeding \$8.1 billion, the P&C insurance industry is a significant employer, providing over 16,000 jobs. Seventy-three private sector insurers in Alberta wrote approximately \$3.3 billion in automobile insurance premiums. They also paid out over \$1.8 billion in claims, including rehabilitation expenses to those injured in road crashes and other bodily injury incidents, replacement of stolen goods, and repairs to damaged property and vehicles. In 2008 (the latest year for complete tax data), the industry paid \$292.8 million in taxes and levies to the provincial government.*



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## **Introduction:**

This is the sixth year that the Alberta Insurance Rate Board (AIRB) has conducted a review of all-industry premiums for mandatory automobile insurance, and the sixth year that Insurance Bureau of Canada (IBC) has participated in the process on behalf of Alberta's property and casualty insurers. Our message this year is again twofold. First, we continue to advance our belief that the industry-wide adjustment limits the benefits consumers could enjoy from a more competitive pricing regime for auto insurance. With the conclusion of the constitutional challenge, we are hopeful that the review of the Premiums Regulation will now be renewed by the Alberta Government and will in fact lead to a more competitive and individual company-based review and approval of rate changes. Secondly, after many tumultuous years where uncertainty has reigned supreme in Alberta's auto insurance market, we are just now beginning to enjoy a period of normalcy, following the end of the protracted constitutional challenge. While consideration takes place on the shape of a new and, we hope, more market-responsive system for determining auto insurance rates, IBC urges the AIRB to exercise caution in making any adjustment to automobile insurance rates that could risk raising again a spectre of ongoing and future volatility in the cost of auto insurance to Alberta's drivers.

## **Moving from Turbulence to Normalcy:**

Since the Government of Alberta introduced reforms to its auto insurance system in 2004, it has been a challenging time to be in the ratemaking business for auto insurance. While periods of reform generally enhance the complexity of prospective ratemaking, a number of external factors have greatly exacerbated the level of uncertainty in Alberta's marketplace over the past six years. Insurers and the AIRB were, in turn, left in the difficult position of interpreting experience data, predicting future claims costs and determining rate adjustments in an extremely uncertain market environment.

For consumers, the threat of a constitutional challenge to the Minor Injury Regulation (MIR) since 2004 and the subsequent legal challenge commenced in 2006, sparked difficult choices. On the one hand, claimants were faced with the dilemma of not knowing whether to report their claims or to wait for the outcome of the legal process; whether to involve legal counsel



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or not; whether to settle their claims or wait. Meanwhile, drivers endured the continuous risk of calamitous increases in their insurance costs that would most surely have happened had the challenge been successful.

Throughout this period, insurers also faced unparalleled uncertainty as to their future operating environment. Would they confront an auto insurance market with or without a cap on non-pecuniary awards for people with minor injuries? Further, insurers were unsure of the cause of the decline in the frequency of minor injury claims being experienced and whether this was the result of the reforms or the uncertainty surrounding the MIR or other factors, and whether it would continue when the cap issue was finally resolved. Compounding the uncertainty was the fact that insurers could not know the magnitude of unreported claims and how to estimate for these. Also, they had no way to gauge what actual claims costs would be if the cap were removed.

In addition, dramatic shifts in Alberta's economy added more elements of ambiguity to the ratemaking process, as it went from experiencing unprecedented growth between 2004 and 2007 to sputtering over the past couple of years. For example, high gasoline prices, such as were seen in the first half of 2008, tend to reduce the amount people drive and thus accident exposure, making it difficult to discern underlying claims trends. Evidence that insurance fraud rises in periods of economic decline added a degree of further uncertainty to the future claims environment. Moreover, difficult economic times have a tendency to reduce accident exposure and the demand for auto insurance as people choose not to drive or to purchase less - or even no - coverage. Insurers and the AIRB have had to consider the impacts of such economic conditions on claims frequency and severity when determining premium adjustment factors over the past few years. And, for 2008-2009 both insurers and the AIRB had to attempt to predict what economic conditions would be in the future given rapidly changing conditions and the most serious downturn in world economies since the Great Depression.

Finally, the all-time low interest rates that followed the global economic downturn dramatically changed the investment environment. As insurers' investment returns are



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closely tied to interest rates, the average 9.1 per cent return on investment that insurers realized between 1990 and 2002 has been declining, and was at about half that level in the most recent years. The changing investment environment and uncertainty around future returns, in turn, highlighted the importance of underwriting results.

The combination of the constitutional challenge, volatile gasoline prices, the economic downturn, and record low interest rates increased the complexity of predicting claims frequency and severity, expected return on investment, and the cost of capital, and made rate setting an extremely risky endeavour over the past six years.

At the same time, the IWA process itself poses a significant challenge for the AIRB as it attempts to determine an appropriate adjustment for basic auto rates in a May to July timeframe for rates to come into effect in November, and remain in place for the following twelve months. And, the predictions on which the adjustment is based are the result of an analysis of just available auto claims data for the previous year. In the best of times, the IWA rate setting exercise would be an extremely difficult one. In the uncertain auto regulatory environment and volatile economy of the past few years, it should have come as no surprise that the AIRB's and IBC's actuaries have sometimes arrived at very different conclusions as to the appropriate rate adjustment. To be sure, they did come to agree on many of the key assumptions involved, including the cost of the future health levy, industry expenses and interest rates. However, for some critical factors that have been most susceptible to the kinds of data interpretation and forecasting uncertainty described above, their analyses have incorporated different assumptions. This was inevitable given both the uncertain environment and IBC's concern that, in a one-size-fits-all process, a single adjustment factor can produce premium inadequacy for companies whose individual situations do not conform to the industry average.

In our view, a very unfortunate casualty of the IWA process during years of extreme uncertainty has been public confidence in the way insurance premiums are supposed to be established. Although the Board knows well the complexities involved in prospectively arriving at insurance rates that will cover the future cost of insurance claims and expenses,



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including a margin for profit, the general public does not. Similarly, in the maelstrom of controversy over the Minor Injury Regulation, IBC's annual reminders of the degree to which the constitutional challenge had placed at risk the affordability and availability of automobile insurance was understandably received by the media and public with a mixture of surprise and perhaps disbelief. This is a legacy of the constitutional challenge and the IWA process that will take time to overcome.

Happily, it would appear that we are now entering a more stable environment for auto insurance in Alberta. The Supreme Court of Canada's decision not to grant leave to appeal the MIR's constitutionality has removed the most significant factor affecting market uncertainty from the ratemaking process. Gasoline prices have become more stable. Alberta's economy is showing signs of recovery. And, interest rates appear poised to rise through the year and start to bring insurer investment returns back towards more normal levels.

Almost six years after the rules governing auto insurance were reformed, the pricing of auto insurance can begin to be done with greater predictability in claims trends and market conditions. However, it is still the case that the experience data that forms the basis for forecasting future cost trends remains distorted by the unique effects on claims reporting patterns that we believe occurred as a result of the turbulent events of the recent past.

### **Responsible Reserving:**

Since the reforms of 2004, insurers and the AIRB were forced to determine rates and rate adjustments for a future market without the certainty of knowing whether the costs of minor injuries would be contained by the cap on non-pecuniary awards. When the MIR was overturned, some experts concluded that Alberta's basic coverage was underpriced by 25 per cent.<sup>1</sup> Had the subsequent appeal not been successful, industry would have faced

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<sup>1</sup> Remarks by Superintendent Julie Dickson, Office of the Superintendent of Financial Institutions Canada, to the Langdon Hall Property and Casualty Insurance Industry Forum in Cambridge, Ontario on Thursday, May 22, 2008.



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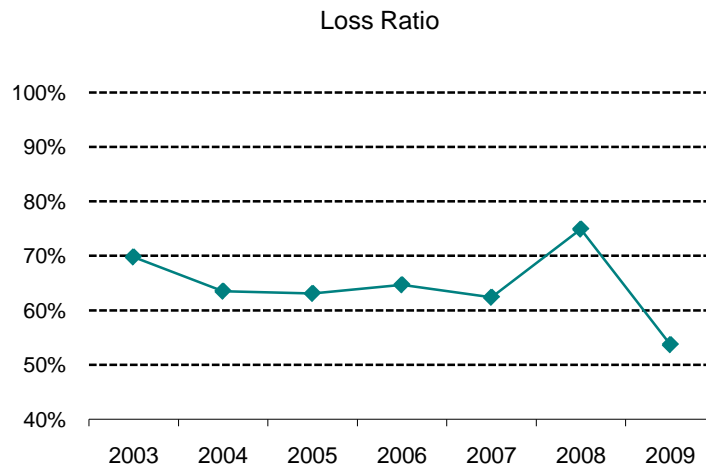
skyrocketing claims costs, and, in the absence of defensive action by insurers, possibly in some cases threatening insurer solvency.

In the face of the uncertainty surrounding the challenge to the MIR, insurers responded by fulfilling their obligations to their customers, shareholders, and the federal solvency regulator. In short, they took steps to cover the potential liability, in the event the challenge was ultimately to succeed. From the survey of insurers by the Superintendent earlier this year, the AIRB may have a more precise picture of the industry's reserving actions than we do. However, our understanding is that, in general, companies increased their capacity to respond to their bodily injury claims following the Wittmann decision in February 2008, albeit with considerable variation within the industry. What specific actions individual companies needed to take to meet responsible reserving practices in light of the cap challenge would have depended upon many factors unique to each company, such as the probability they assigned to whether the challenge would be successful, their mix of personal and commercial business and volume mix by province as well as their ability to draw on Canada-wide reserves to respond to this Alberta issue. Moreover, it is important to understand that, despite increased reserve levels, companies still carried considerable exposed risk during this period, risk that could only have been covered by drawing down capital in the event the MIR was permanently struck down. For consumers, insurers' reserves strategies and their assumption of greater risk to their capital meant that their interests were protected in any outcome on the constitutional question while, in the meantime, they continued to be offered auto insurance at affordable prices and without restrictions on availability.

Supported by IBC, the Government of Alberta was able to successfully defend the MIR in the courts of law and, in our view, public opinion. The subsequent release by insurers of the portion of reserves that had been put aside to cover future claims costs in the event that the MIR was permanently struck down brought a significant decline in Alberta's auto direct loss ratio in 2009. Because this was a one-time "statistical" event, it masks the true underlying trend in the loss ratio. The following chart illustrates the one time effect of the reserve build up and subsequent release on loss ratios as a result of the successful conclusion of constitutional challenge.



### Alberta- Total Auto Loss Ratio



Source: IBC with data

In this year's notice to stakeholders on the IWA, the AIRB stated that one of the three issues it would explore would be the "estimate of ultimate bodily injury claim costs for past years in light of confirmation of the Minor Injury Regulation cap on non-economic damages". Although recognizing that the Premiums Regulation permits the Board to consider "any criteria recommended by the Superintendent and approved by the Board" in its annual adjustment decision, we do not agree that it is appropriate to incorporate a look-back at the extraordinary one-time 2009 reserve release in determining what the average premium for mandatory insurance should be for the twelve-month period beginning November 1, 2010. To do so would introduce a radical departure from the known principles of insurance ratemaking as a prospective process, and set a troubling precedent for the Board in the conduct of any future responsibilities in relation to companies' rate applications. Moreover, to do so at a time when the underlying loss trends remain so unclear would risk a return to instability in the price and supply of auto insurance in Alberta.



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As the Board knows, the 2009 reserve release was not part of a trend, but rather marked the one-time conclusion of an extended period of extraordinary risk that Alberta's auto insurance industry shared with its customers. Moreover, even if the AIRB wanted to factor in the reserve release when it sets the indicated rate change for 2011, the one-size-fits-all format of the IWA would make it difficult if not impossible to do so fairly, given that insurers reserve differently and release reserves based on their own individual company experiences.

To conclude this section, we believe that it would be inappropriate to incorporate the one-time reserve release as a factor in determining a 2010 industry-wide adjustment.

### **Moving Forward:**

Ratemaking is serious business for insurers and the AIRB. In order to stay in business, insurers need to establish prices that will settle future claims, pay administrative expenses, meet solvency requirements, and earn an appropriate return for their investors. Because premiums are the major source of revenue to pay these obligations, inadequate pricing of rates has serious consequences for policy holders. For its part, the AIRB also seeks to set a reasonable rate for basic coverage that ensures consumers have access to an affordable and stable automobile insurance system. Rate boards around the country, which handle single-insurer adjustments, have similar mandates and goals.

As a general principle, IBC holds the view that the more open a jurisdiction's laws and market conduct rules are to letting competition determine prices, the greater are the potential benefits to the public, as manifest in lower premiums for good drivers, strong disincentives against risky driving behaviour, and increased product innovation and consumer choice. This view is consistent with the ongoing movement in much of the world towards more market-oriented mechanisms for establishing auto insurance premiums. There is a growing body of empirical evidence supporting this direction, as was demonstrated at the invitational seminar on insurance rate regulation, put on by the C.D. Howe Institute in Toronto last January, and where several representatives of the AIRB and Superintendent's office were able to attend.



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We appreciate that, in Alberta today, there is not yet a comfort level among politicians and regulators with leaving competitive forces alone to determine auto insurance rates in the market. Still, we believe that consumers stand to benefit from a move to a more competitive pricing system, whereby, in the first instance, rate approvals are based on the circumstances of individual companies rather than through the IWA mechanism. In this respect, we acknowledge the AIRB's public support for such an approach, described in their 2008 Annual Report as "a file and approve process where the Board will review companies on an individual basis to determine if rate changes are appropriate and fair". In explaining the reasons for the Board's position, the Chairman stated that, "The Board believes that this new system will reduce uncertainty in the market and, thereby, support greater competition resulting in improved premiums for consumers over the longer term"; a position that was reiterated by the Chairman the AIRB's 2009 Annual Report.

IBC understands that at this point the matter is in the hands of government. However, we hope that the Board will find opportunities to convey to the government our shared support for a timely move towards a more competitive system for establishing auto insurance premium levels in Alberta. A more competition-based filing system would be able to take into account the diversity of insurers with different business models and, by incorporating a simplified filing approach, would permit companies to undertake more maintenance-type filings and move quickly to react to changes in market conditions. In the end, consumers stand to benefit from more stable and affordable auto insurance which is the inevitable outcome of a system that encourages and strengthens the competitive market forces that are the hallmark of success throughout most of Canada's economy.

In summary, we applaud the Board's support for a more competitive system for determining auto insurance rates in Alberta and are hopeful that the coming year will see the implementation of such a system.

### **The 2010 IWA process:**



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Although IBC has never supported a one-size-fits-all rate adjustment process for all companies in the Alberta auto industry, we have participated in the past AIRB hearings as we felt compelled to bring to the AIRB average-rate indications that addressed the extraordinary risks to insurer solvency and the stability, affordability, and availability of auto insurance posed by the threat and subsequent challenge to the MIR over the past six years.

As in past years, IBC has again engaged consulting actuary, Ron Miller, to conduct an actuarial analysis to analyze cost trends, average premium levels, and other factors having a potential effect on average premium adequacy over the next eighteen months. Using the same analytical models and methodologies as in previous years, Mr. Miller has concluded that, if an all-industry adjustment were again to be ordered to take effect on November 1, 2010, then a rate increase would be warranted. Some of the reasons provided for this conclusion are:

- The Property Damage claims cost trend is increasing at the rate of about 10 per cent per year;
- After contracting by 2.5% last year, the Alberta economy is forecast to increase by 2.6% in 2010 and 2.9% in 2011, with employment forecast to increase by 15,000. With these developments increases in driving exposure can be expected from the low levels experienced during the recession;
- Last year's AIRB direction to lower premiums for mandatory product is in the process of working its way through the system, lowering the average street premium;
- Annual inflation in Alberta is expected to be 2 per cent.

While we are happy to share the general conclusions of Ron Miller's analysis, we are not recommending a specific all-industry adjustment factor based on his review and analysis of the relevant data. There are two very important and inter-related reasons for this. In the first place, with the constitutional challenge now finally put to rest, it is no longer necessary for IBC to advocate, through the IWA process, for accommodation of the enormous risk to



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insurance companies – and ultimately the driving public – posed by the risk of losing the challenge.

Secondly, our member companies have concluded that, especially with the threat of the cap challenge behind us, the differences among them – in terms of customer profiles, loss experience, profitability and other indicators of their competitive industry – are simply too great to permit them to come to agreement on a single adjustment factor that would be appropriate for all companies and all premiums for the mandatory auto insurance product sold in Alberta beginning November 1, 2010. In coming to this conclusion, the companies reflected on the fact that the all-industry loss experience data for the past few years has undoubtedly been affected by the various sources of uncertainty described earlier in this submission, but in ways and to degrees that it is still too early to fully understand. In the circumstances, they observed that a single all-industry adjustment factor could at best only be guessed at, while it would almost certainly result in premium levels that would be too low for some companies' indications and too high for others'.

Against this background, IBC believes that an industry-wide adjustment should not be attempted at this time. As to the implications of this for the Board's 2010 IWA decision, we think that the public interest is best served by holding the line on an industry-wide adjustment, particularly as a new system has been recommended to allow individual insurers to bring forward rating proposals based on solid data that reflects company-level experience.

Finally, IBC is, of course, anxious to review the recommended rate indication from the AIRB's actuary when it becomes available. We have asked Ron Miller to provide IBC with an analysis of the Oliver Wyman report and, if warranted, will provide commentary on it during our presentation to the board on June 15.

**Recommendation:**



Make no industry-wide adjustment at this time and maintain current rates for mandatory auto insurance. Companies with experience indicating a rate adjustment can avail themselves of the Regulation's Section 6 mechanism to apply for a change to their rating programs for mandatory insurance.

We look forward to discussion with the Board of matters raised by this year's IWA at the hearing on June 15 in Calgary.