2017 Automobile Insurance Review
Exhibit - #6
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Annual Industry-Wide Adjustment of Rates for Basic Coverage

Effective November 1, 2005

Re: Section 4 of the Automobile Insurance Premiums Regulation

Alberta Automobile Insurance Rate Board

Board Decision Report

Order No: 01-05

July 27, 2005

Alberta
AUTOMOBILE INSURANCE
RATE BOARD

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1.0 BACKGROUND

1.1. LEGISLATIVE AND REGULATORY AUTHORITY

The Automobile Insurance Rate Board (AIRB) was established on October 1, 2004 under Section 653(1) of the *Insurance Act* (the Act) and is mandated under the Act and the *Automobile Insurance Premiums Regulation* (the Regulation) to: annually determine if rates for basic coverage[1] should be changed through an industry-wide review; monitor optional coverage; review and approve rating programs for new insurers granted a license to sell automobile insurance in Alberta by the Superintendent of Insurance; and fulfill the duties and responsibilities carried out by the previous Automobile Insurance Board regarding non-private passenger insurers.

Section 4 of the Regulation requires that the Board announce on or before August 1 of each year whether premiums for basic coverage for private passenger vehicles are to be adjusted effective November 1. The Board must consider:

a) Industry wide loss costs
b) Administrative expenses, which may include:
    - Commissions and profit (commissions), license and fees, premium tax, and other operating expenses;
    - Federal, provincial, and municipal taxes;
    - General expenses
c) Other industry wide costs relevant to the costing of premiums for basic coverage for private passenger vehicles.
d) Any other criteria recommended by the Superintendent and approved by the Board

Under d) above, the Superintendent of Insurance asked the Board to consider an appropriate provision for profit in setting the rates.

[1] Basic coverage is the third-party liability and accident benefits portion of an automobile insurance policy.

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1.2. Recent Legislative Reforms and Government Actions

In 2003 the Alberta Government enacted Bill 53, *the Insurance Amendment Act*, which provided for:

- a cap on pain and suffering for minor injuries at $4,000;
- the elimination of the double-recovery of compensation from more than one source;
- the determination of wage loss based on net, rather than gross, wages; and
- the increase of medical/rehabilitation benefits under accident benefits to $50,000

As part of the reforms, the Government also ordered premiums to be frozen on October 30, 2003.

The reforms set out in Bill 53 became effective October 1, 2004, with the exception of the consideration of collateral sources and the determination of wage loss based on a net, rather than gross, wages, which became effective January 26, 2004. Also on October 1, 2004, the Government introduced the grid rate system, which set maximum premiums to be charged for basic coverage, and established two risk sharing pools. Government also mandated a 5% rate reduction for basic coverage under the grid.

In April 2005, the Government mandated a rate reduction for basic coverage of at least 6% by July 1, 2005. This reduction, however did not apply to the grid rates.

1.3. The Mercer Report

On May 31, 2005, Mercer Oliver Wyman (Mercer), the Board's actuary, released a report titled, "Actuarial Analysis for Industry-wide Rate Level Adjustment Effective November 1, 2005" (Mercer Report). The Mercer Report presents Mercer's analysis and findings regarding the private passenger insurance rates being charged in Alberta for basic coverage, and is intended to provide the Board with information to help it carry out its mandate with respect to the annual uniform industry-wide rate level adjustment for private passenger vehicles.

Based on the actuarial analysis, the Mercer Report found that for private passenger automobile insurance policies to be written during the period November 1, 2005 through October 31, 2006

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(hereafter referred to as policy year effective November 1, 2005), the industry average street premium for basic coverage will exceed the required average premium for basic coverage by 8.2%.

Indicated Industry-wide Rate Level Adjustment
Policy Year Effective November 1, 2005
Private Passenger Automobile
Table 1

Policy Year Nov 1-05 to Oct 31-06	TPL and Accident Benefits	Indicated Rate Level Adjustment
Required Avg. Premium	$589	
Average Street Premium	$642	-8.2%

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2.0 PUBLIC MEETINGS

2.1. NOTICE

On April 20, 2005 the Board published notice of public meetings to be held in Edmonton and Calgary June 27 to 30, 2005 for the purposes of determining if rates for basic coverage should be adjusted on an industry-wide basis effective November 1, 2005. All interested parties were invited to submit a letter of intent to the Board by May 12, 2005. In addition to the notice, the Board placed newspaper ads in Edmonton, Calgary, Medicine Hat, Lethbridge, Red Deer, Grande Prairie and Fort McMurray on April 30, May 2, 4, 26, 27, 28, and June 24 and 25.

2.2. PRESENTATIONS AND WRITTEN SUBMISSIONS

The Board received 23 letters of intent to participate in the public meetings. 19 requested the opportunity to make a presentation during the public meetings, 3 asked to submit a written submission and 1 party decided to withdraw from making a presentation. All parties that requested to make a presentation were scheduled a time slot, provided in advance with a copy of the Mercer Report and the Rules of Procedure for the public meeting, and asked to ensure that their comments were relevant to the annual adjustment process.

2.3. PUBLIC MEETINGS

The public meetings were held over 4 days, June 27 and 28 in Edmonton at the Sutton Place Hotel and June 29 and 30 at the Best Western Port O'Call in Calgary. The Board was assisted by Mr. Jack Donahue, Board Legal Consultant, Mr. Ted Zubulake, Managing Director of Mercer Oliver Wyman and Board Actuary, Mr. Peter Thomas, Executive Director and Secretary to the Board, and Board staff Ms. Susan Steeves, Ms. Sophie Baran, Mr. Colin Leschert, Ms. Sonya McAdam and Ms. Kaitlyn Rosko.

The following parties made presentations at the public meetings:

1. Alberta Civil Trial Lawyers Association
2. Allstate Insurance Company
3. Canadian Direct Insurance

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4. Co-operators General Insurance Company
5. Dominion of Canada General Insurance Company
6. Independent Insurance Brokers Association of Alberta
7. ING Canada
8. Insurance Bureau of Canada
9. Marilyn Burns, Alberta Alliance Party
10. Mercer Oliver Wyman (AIRB Actuary)
11. Merle Taylor, Consumer Representative on the AIRB
12. Norma Nielson, University of Calgary
13. Peace Hills Insurance Company
14. RBC Insurance
15. Rick Miller, MLA for Edmonton Rutherford
16. Ross Bucsi, Palliser Insurance Agency Ltd.
17. Royal & Sun Alliance Insurance Company of Canada
18. TD Meloche Monnex
19. Wawanesa Mutual Insurance Company

The following parties made a written submission to the Board, which were tabled publicly on June 29th in Calgary:

1. Canadian Association of Direct Response Insurers
2. Facility Association
3. State Farm Mutual Automobile Insurance Company

All information submitted to the Board as part of the public meeting process has been posted its website: www.airb.gov.ab.ca. Transcripts of the proceedings are also posted on the website.

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3.0 ACTUARIAL EVIDENCE AND ANALYSIS

3.1. OVERVIEW OF MERCER'S ANALYSIS AND FINDINGS AT PUBLIC MEETINGS

Mr. Zubulake, Managing Director of Mercer, presented the Board with Mercer's findings and an overview of Mercer's analysis at the June 27, 2005 public meeting in Edmonton. He commented on the key issues contained in the Mercer Report and highlighted several points for the Board to consider. These were:

- The industry-wide adjustment applies to policies written in the policy year effective between November 1, 2005 and October 31, 2006. Mercer refers to this period as the policy year effective November 1, 2005. This is in contrast to insurance industry financial results, which are typically presented on an accounting year basis, which is the year when claim payments, claim reserves, or changes in reserves are recorded in a company's financial statements. Since claim payments and changes in claim reserve estimates occur over a period of time following the year in which the insurance policy was written, an insurer's reported financial results are affected by claim activity over a period spanning many policy years. A policy year will reflect the experience of policies with an effective date in the given year, regardless of when payments are made toward the policy. The difference between policy year and accounting year explains in part why findings presented by Mercer and other actuaries may appear to be inconsistent with recent financial results reported by the insurance industry.

- Virtually all of the numbers presented to the Board by Mercer or by other parties, whether on a policy year basis or on an accounting year basis, are either estimates or based on estimates. Insurers will not know for certain what their costs will be for the claims of drivers they insure in 2005 for some time as it takes several years for all claims that occur to be reported and settled.

- The data upon which the Mercer based its analysis and findings includes all insured drivers in the province, including those in the Facility Association and those in the Risk Sharing Pools.

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- The latest claim data that was provided to Mercer was of December 31, 2004. Having the industry's claim experience over the first six months of 2005 would have been helpful as it would have provided important information that would have removed some of the uncertainty in the Mercer estimates.

- There are three components to the premium charged by insurance companies:
    1. a provision for claims that must be paid, which represents about two-thirds of the premium dollar;
    2. a provision for insurance company expenses, which represents about one-fourth of the premium dollar and;
    3. a provision for profit.

Mercer projected the total of the three components, on average, for polices that will be sold in the future between November 1, 2005 and October 31, 2006. This is referred to as the "required average premium." This "required average premium" was compared to the average premium currently being charged by insurers, which Mercer refers to as the "street premium." The percentage difference between Mercer's estimate of the required average premium and Mercer's estimate of the street premium represents Mercer's estimate of the adequacy of the industry-wide rates on average.

3.2. Estimate of the Required Average Premium

3.2.1. The Provision for Claims

The provision for the cost of paying claims is the largest component of the premium dollar and the most difficult to estimate. The best indicator of what the provision for claim costs should be is claim costs in the recent past, adjusted for environmental changes. Mercer considers recent past experience in a two-step process:

1. First, estimate what the ultimate claim costs will be over the recent past, which Mercer has defined as the policy years 2000 through 2004. Mercer applied generally accepted actuarial techniques to do so.

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2. Second, adjust the estimated ultimate claim costs by policy year to reflect environmental changes that have occurred that would cause the claim costs for the policy year beginning November 1, 2005 to be different than the estimated claim costs for the policy years 2000 through 2004. The two major environmental changes that Mercer reflects are: the insurance reform (Bill 53) and loss trend.

Regarding the insurance reform, Mercer states that it expects Bill 53 will cause bodily injury claim costs to reduce and accident benefits claim costs to increase. Since most of the historical experience in policy years 2000 through 2004 occurred before Bill 53 was enacted, Mercer adjusted its ultimate cost estimates for these policy years to reflect the estimated effects of Bill 53.

The second adjustment, referred to as loss trend, recognizes that all else being equal, the cost to pay claims should increase over time due to general cost inflation. The loss trend adjustment also recognizes changes that may have taken place to cause increases or decreases in the rate of claim severity or claim frequency.

Mercer adjusts for the environmental changes mentioned above in its analysis. Making these adjustments resulted in five separate estimates of what the average claim cost component will be for the policy year beginning November 1, 2005 - one estimate for each of the five years in the experience period considered by Mercer. Mercer selected the best estimate from among the five estimates, which was an average of the five estimates, with most of the weight given to the policy year 2004 and 2003 estimates.

3.2.2. The Provision for Expenses

Mercer selects an expense provision of 23% of premium based on the insurance industry's actual expenses over the years 1999 through 2003 as reported through the industry's statistical agent, the Insurance Bureau of Canada (IBC). Insurers report their expenses to the IBC on a voluntary basis, and 2003 is the latest year for which this expense experience is available. Mercer accepts this published expense information as being representative of all companies operating in Alberta and as being accurate.

3.2.3. Profit

Mercer uses the same profit provision, which was used in setting the initial grid rates, which is 5% of premium, less a provision for the investment income estimated to be earned by insurers on the premiums that they collect.

3.2.4. Mercer Finding – Required Average Premium

Mercer found that the required average premium for basic coverage (which is the total of its selected claim cost, expense, and profit provisions) is $589.

3.3. ESTIMATE OF THE STREET PREMIUM

Mercer suggests that the introduction of the Grid system, which limits the premiums that companies can charge, has made the estimation of the street premium more difficult than would typically be the case. Mercer's estimate is based on average premium information provided by the statistical agent and on the analysis performed by KPMG LLP for Alberta Finance, dated December 2004, on the impact of the Grid System on basic coverage rates. Mercer also considered the October 1, 2004 5% premium roll-back and the mandated 6% premium reduction effective July 1, 2005.

3.3.1. Estimate of the Industry-Wide Adjustment

Mercer's initial estimate of the street premium was $642, which, when compared to Mercer's estimate of the required average premium of $589, suggests that the average street premium is 8.2% higher than what is needed to provide for the claim cost, expenses, and profit provision estimated by Mercer for the policy period beginning November 1, 2005.

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4.0 KEY ISSUES FROM PUBLIC MEETINGS

Several key issues surrounding the Mercer Report emerged from the submissions from other parties. These issues are:

- frequency trend,
- legislative adjustment,
- health services levy,
- expense provisions,
- profit margin, and
- projected street premium.

4.1. FREQUENCY TREND

4.1.1. Discussion of Issue

Loss trend is an aspect of ratemaking that entails a considerable degree of judgment, and indications for change in premium level are very sensitive to the selections for loss trend. It follows that the selection of these critical factors can be the source of considerable debate.

Briefly, there are two components to loss trend: 1) severity trend, which reflects change in average cost per claim over time, and 2) frequency trend, which reflects change in the claim incident rate over time. Loss trend is the term generally used to reflect the combined factor for severity and frequency trends.

No issues were raised with the severity trends that were selected by Mercer. However, some of the parties voiced different views regarding the selection of the frequency trends.

Mercer estimated the frequency of claims arising from policies written in the twelve-month period dating from November 1, 2005 will compare to previous years. Mr. Zubulake presented a chart displaying the industry's bodily injury claim frequency rate since 1990. The chart depicts a pattern of increasing frequency rates through the first six months of 1998, and then decreasing rates through 2004. In reflecting this pattern of declining frequency rates, Mercer made the assumption that between the end of 2004 and through the policy period beginning November 1, 2005, the rate of decline in the industry's bodily injury claim frequency rate would reduce by half. A similar assumption was made for property damage and accident benefits coverages.

The Mercer Report commented on the declining frequency trend and its assumption regarding future frequency trend rates as follows:

> *"The declining claim frequency rate is not unique to Alberta; this has been the general pattern throughout Canada. We are not aware of any studies that have been conducted as to the reasons for this pattern, but explanations that have been offered include: better driving habits (including greater usage of seat belts), safer vehicles (i.e., more cars with air bags and better braking systems), better road conditions, a decline in mileage driven due to the rise in gasoline prices, an increase in the number of vehicles owned per household (resulting in lower per vehicle usage), and a reluctance on the part of insureds to file minor claims for fear of large premium increases or cancellation of coverage. No one can say for certain whether or not the declining frequency rate will continue through policy year effective November 1, 2005. It could continue at the same rate, the rate of decline could accelerate, or the rate of decline could lessen or possibly reverse and frequency rates to begin to increase.* ***It is our opinion, based on a review of longer term frequency rate patterns that it is reasonable to assume that the pattern of declining claim frequency rates will begin to moderate, and we judgmentally reduced our selected frequency loss trend rate by half for each of the basic coverages or subcoverages, except funeral benefits and death benefits, for the period beginning October 1, 2004 (the period that we refer to as the "future" trend period).*** *As our findings are quite sensitive to the future frequency trend rates we have selected, the Board should give particular consideration to more current information or additional insights on claim frequency patterns that may be presented by other interested parties at the Public Meetings." (pp 11 –12)*

Some parties opined that basing trend on a longer period, such as ten years, was a more sound approach. The reasoning was that the longer term smoothed out short-term fluctuations for improved stability, whereas trend factors based on a short term could result in volatility.

Moreover, where Mercer assumed that declining frequency rate would moderate, some other parties suggested that claim frequency would either flatten or abruptly increase. Early 2005 claim experience was cited in support of a flattening or slight increase in frequency trend. These parties largely attributed the decline in frequency that the industry has been experiencing over

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the past several years to fear of increased rates or loss of coverage, which, in turn, discourages reporting of claims. Stating that, in their opinion, these conditions no longer exist, these parties believe that claim frequency will begin to increase. Royal Sun Alliance also stated there is a correlation between the economy and claim frequency, and that the current prospering Alberta economy will promote an increased use of vehicles, causing the claim incident rate to increase. Other insurers suggested:

> *"Although Mercer selected higher (less negative) projected frequencies than the historical trend, the selected frequencies are still optimistic considering the uncertainty in future results and the fact that frequency is currently low with respect to historical levels. Projected flat frequency may be more reasonable at this time."*
>
> *State Farm Mutual Automobile Insurance Company*

> *"It has been well publicized that insurers have seen a reduction in the frequency of automobile claims in the recent past. Wawanesa experienced this reduction also, but has more recently seen a stabilization if not a small increase in frequency of claims. Although it is early it can reasonably be predicted that this trend will continue in the future."*
>
> *Wawanesa Mutual Insurance Company*

> *"Claim frequency increased by 8.1%. Had the 2004 frequency for the same period applied, case level incurred losses would have been 7.5% lower on a year-to-date basis."*
>
> *TD Meloche Monnex*

If the Board does not accept Mercer's assumption that declining frequency rate would moderate by half, and instead chose to accept that the claim frequency trend would flatten, Mercer advised the Board that their estimate of the industry-wide rate level indication would change to +4.2%, or rates would need to be increased by approximately 4%. Alternatively, if the Board were to accept that frequency rates would continue as present without change, (meaning frequency would continue to decline at its current rate) Mercer advised that their estimate of the industry-wide rate level indication would change to – 9.3%, or rates could be decreased by approximately 9%.

4.1.2. Board Position

The Board recognizes that frequency trend is a key issue.

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The Board has given due consideration to the information presented at the public meetings and in written submissions suggesting that claim frequency rates have begun to increase in 2005. The Board is of the view that this information is largely anecdotal and that the data provided to the Board by several insurers may not be representative of the experience of the entire industry. The Board also notes that IBC's actuary has accepted Mercer's estimate of the claim cost provision, which reflects the assumption it has made on claim frequency rates, as being reasonable.

The Board also notes that the rate level indications developed by Mercer are sensitive to the assumption made about future claim frequency rate. There is a considerable amount of uncertainty surrounding frequency trend. It is important to note that it is possible that claim frequency could remain unchanged for the coming year. In this case the estimated industry-wide rate decrease indication could be greater than what Mercer's has estimated.

While the Board finds that Mercer has not made unreasonable assumptions in tempering of the declining claim frequency rates, (which is essentially an averaging of the claim frequency trend pattern that the industry has experienced in Alberta since 1998 with the longer term flat trend rate pattern), the Board notes it could be equally true to assume that claim frequency trends will continue to decline as at present. As a result, the Board finds that claim frequency rates will temper, but at a rate somewhere between the current rate and the rate estimated by Mercer.

4.2. LEGISLATIVE ADJUSTMENT

4.2.1. Discussion of Issue

The data used in the Mercer Report was based on information compiled from the IBC and findings presented in the KPMG Report. The KPMG Report provided estimates of the loss costs savings resulting from the reform to the automobile insurance system, estimating that third party liability costs (excluding the Health Services Levy) will reduce by 24% and Accident Benefits costs will increase by 65%.

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In his presentation to the Board, Mr. Miller, IBC's consulting actuary noted that his analysis of the very early data that has emerged under Bill 53 finds that the KPMG Report may have underestimated the effect of the reforms on bodily injury coverage claim costs and overestimated the effect on the accident benefits coverage claim costs.

Other parties commented that the KPMG Report relied on limited studies and old data from another province and as a result, its findings, and hence those of Mercer, may not be reasonable.

> *"As stated in the KPMG report, the historical experience of New Brunswick and Nova Scotia may not be representative of current experience in Alberta or predictive of future experience due to differences in the economics, legal claims, insurance, weather, and other factors."*
>
> *Alberta Civil Trial Lawyers Association*

Other parties felt that the true impact of the reforms and the grid are currently unknown primarily due to the lack of data available post-reform and the short time period since the reform. They argued that reliable statistics on the industry experience should be collected before any further decisions are made (which could take anywhere from 3 to 5 years to get fully developed actuarial data).

> *"Given the scale of the changes introduced into this market just 9 months ago and given the system has not had time to produce definitive statistics to verify or discredit the assumptions which have been made; and given the fact the market is already starting to soften and companies have taken steps to increase consumer choice; it is my contention any further mandated price reductions could be harmful and premature."*
>
> *Ross Bucsis (Palliser Insurance Agency Ltd.)*

> *"Therefore, a reasonable approach for the Board would be to enable insurance companies the opportunity to assess the true impact of the Grid before recommending any further rate reductions."*
>
> *Allstate Insurance Company of Canada*

> *"It is respectfully submitted that it is very difficult for the AIRB to make informed decisions with respect to premium rates for Alberta's drivers without detailed information regarding the claims experience for Albertans."*
>
> *Alberta Civil Trial Lawyers Association*

4.2.2. Board Position

The Board recognizes that the rate indications developed by Mercer are sensitive to the assumptions made about the impact of the reforms on future claim costs. The Board agrees that it is too soon to determine what the full effect of reforms will be. However, the Board notes that while some presenters took exception to the KMPG Report and its findings, no alternatives were offered for the Board to consider.

The Board finds Mercer's reliance upon the findings of KPMG is reasonable. The Board also anticipates that experience that emerges under the reformed system will be given appropriate consideration in the determination of future industry-wide adjustments.

4.3. HEALTH SERVICES LEVY

4.3.1. Discussion of Issue

Auto insurers are required to repay the province's costs of providing health care to people who are injured in automobile accidents. Each year the Government of Alberta, in consultation with automobile insurers, sets aggregate assessment levels for the industry. Mercer estimated the impact of the Health Services Levy in its calculations to determine overall rate adequacy.

Several presenters at the public meetings suggested that Mercer did not properly recognize the timing of when the Health Services Levy is paid in its calculations. Mr. Zubulake said that Mercer agreed with this suggestion and advised the Board during his public presentation that correcting for the timing of the levy causes Mercer's rate level indication estimate of –8.2% to increase slightly (that is, a lower reduction would be indicated).

Moreover, the Board has been notified by the Superintendent of Insurance that the Government will increase the health levy to $75 million in 2006, an increase of 15$ million. This change will also have an impact in decreasing the overall rate level indication in the Mercer Report.

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4.3.2. Board Position

The Board agrees with Mercer's correction to change the manner in which it reflected the timing of the Health Services Levy. The Board also agrees that the actual 2006 Health Services Levy that will be implemented by the Government should be reflected in Mercer's analysis. The Board notes that the result of making these changes will cause Mercer's estimated rate level indication of -8.2% to decrease slightly, resulting in a smaller rate reduction.

4.4. EXPENSE PROVISION

4.4.1. Discussion of Issue

The expense provision represents the portion on premium that covers the insurer's operating expenses. Mercer selected an expense provision of 23% as the amount it believed would be required by insurance companies on average in Alberta for the policy year beginning November 1, 2005. Mercer's selection assumes that for every $1 received in premium, on average $0.23 is used to cover insurance companies' operating expenses, including commissions, license and fees, premium tax, and other operating expenses.

Mercer's selected provision is based on expense information received from the IBC for the years 1998 to 2003 for the companies operating in Alberta.

Several presenters expressed the view that the expense provision selected by Mercer may be too low. The reasons cited include:

1. More recent data compiled by IBC (which had not been made available to Mercer), suggests the industry's expenses in 2004 have increased;
2. The fixed nature of certain expense costs, coupled with the recent industry-wide rate reductions in Alberta, suggest a higher expense provision;
3. More of the expenses incurred by insurers should be allocated to basic coverage, which would cause the expense provision to increase; and
4. The new grid system has caused companies' operational expenses to increase.

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TD Meloche Monnex perceived the 23% estimate by Mercer as inadequate; according to their suggested estimations it should be 27%. This 4% increase was partially due to an increase in the expense ratio for mandatory coverage, and the effect of recent rate reductions. Other parties suggested that insurance companies were facing higher operating costs as a result of the new grid system. Still other parties are of the view that it is appropriate to allocate a greater proportion of the expenses to basic coverage. Their rationale is that fixed expenses are incurred with the issuance of any policy and, therefore, should attach to basic coverage; otherwise, those drivers that do not purchase full coverage are not paying a proportionate share of these costs.

> *"Commission reduction, along with government mandated automobile insurance premium decreases, have direct financial consequences for insurance brokers whose role it is to serve the consumer in acquiring and maintaining automobile insurance contracts. Brokerage costs have not gone down – in fact they have increased. Auto insurance reform has been and continues to be costly to administer."*
>
> *Independent Insurance Brokers Association of Alberta*

> *"Underwriting staff indicates a similar doubling of their effort on new business transactions. In the previous environment, underwriters handled 12 auto new business applications in an hour, on average. In the take-all-comers environment, this has reduced to 6 applications per hour due to the rating complexity, the additional time needed to review reports and the amount of follow-up required to obtain additional information and/or resolve conflicting information."*
>
> *Dominion of Canada*

4.4.2. Board Position

The Board notes that the rate indications in the Mercer Report are sensitive to the expense provision selection.

Following the Public Meetings, the Board was provided with preliminary survey expense information that the IBC compiled for 2004. After a review of this new IBC information, Mercer is of the opinion that it does not reflect an accurate picture of industry expenses in 2004 as the survey information is more heavily weighted to direct writing insurers as opposed to insurers with independent agents. As a result, Mercer does not believe the preliminary survey data to be an accurate reflection of the expenses of the entire Industry. The Board agrees.

In selecting the expense provision, Mercer selected a somewhat higher "other operating expense" provision than suggested by the historical data that it considered. Mercer did so, in part, in recognition of the fixed nature of certain expenses. The Board agrees.

The Board acknowledges the perspective that companies must, to a large extent, incur the same processing expenses regardless of whether the policyholder purchases any or all of the optional coverage, and consequently, that more of the expenses incurred by companies should be allocated to basic coverage. However, the Board points out that it is not the general practice of insurance companies to record or report expenses separately by coverage, nor is it general practice to record expenses by province or by line of business. Rather, insurance companies typically record expenses on a company-wide basis and then allocate expenses to the provincial and line of business level. Such expense allocations are judgmental, and any further attempt to allocate expenses to the coverage level would be subject to further judgment. The Board also notes that should more of the expenses be allocated to basic coverage, there is no assurance that the expense provisions considered by insurers in pricing optional coverages will be correspondingly reduced.

The Board finds that the information provided by companies regarding the higher expenses that they are incurring under the grid system to be largely anecdotal and may not be representative of the experience of the industry. It is also possible that if higher expenses are in fact being incurred, they may be a result of short-term start-up costs that are not expected to continue for the policy year beginning November 1, 2005.

The Board finds that Mercer's selection of a 23% expense provision to be reasonable, and encourages the IBC, the industry's statistical agent, to be in a position to provide the Board and its actuary with more timely and complete expense information in the future.

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4.5. PROFIT

4.5.1. Discussion of Issue

The Board directed Mercer to use a profit provision of 5% (less anticipated investment income on cash flow arising from insurance operations) in its analysis. A 5% profit provision on premium was selected because it was consistent with the selection made in developing the premium grid implemented in October 2004. Three basic questions were raised during the public meetings concerning the issue of the provision for profit:

1. Should the provision for profit, which is expressed as a percentage of premium, be directly selected, or, should it be derived from a selected a target return on equity (i.e., capital) that explicitly reflects the investment income earned by insurers on equity and a selected ratio of premium to equity?
2. What should the selected profit margin or target return on equity be?
3. What investment rate should be assumed for purposes of reflecting the investment income earned by insurance companies?

Most presenters generally expressed the view that deriving the profit margin from a selected target return on equity is the more common practice followed by jurisdictions that regulate automobile insurance rates. They also commented that a target return on equity is a meaningful metric to insurance company management/owners and to the financial markets.

Alternatively, a profit margin offers certain advantages: it would not be necessary for the Board to deal with the issue of how to convert a target return on equity into a return on premium, and the Board would not find itself in a position of, in a sense, regulating how companies invest their capital. Further, the Board's responsibility is to determine an industry-wide adjustment for basic coverage only; a target return on equity approach is less meaningful when only a portion of the automobile insurance product is considered.

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The presentations by insurance companies suggested target after-tax returns on equity of between 10% and 16% and expressed the view the 5% profit provision used by Mercer equates to a target return on equity that falls below this range.

> *"The appropriate rate of return, at the end of the day, is that which will convince shareholders to continue to maintain their investment in the industry in light of its inherent volatility. Measured alongside other financial institutes, an insurer's ROE must maintain an acceptable and sustaining level to not only attract but also sustain capital investment. We suggest that in today's environment, the appropriate ROE for consideration is 13%."*
>
> *Royal and SunAlliance Insurance Company of Canada*

> *"The Alliance objects to the insurance industry using this mandatory product as the basis to generate massive profits that do not in turn benefit the people of Alberta."*
>
> *Marilyn Burns, Alliance Party*

In other jurisdictions, such as Newfoundland and New Brunswick, separate hearings have been devoted exclusively to the issue of the profit provision in automobile insurance rates. Newfoundland recently decided on a target after-tax return on equity of 10%. In recent public hearings in New Brunswick, Dr. Kalymon, a highly respected economist and professor at the Ivey School of Business at the University of Western Ontario, gave an opinion that the target return on equity should be within the range of 8.5% - 9.5%.

The IBC, in their presentation to the Board, reported that the industry average ROE in 2004 was 17.6% but the average from 1997 to 2003 was 8.3%. When asked why the industry requires an after-tax return as high as 16% in light of these results, Dr. Norma Nielson, the Interim Director of the Risk Studies Centre at the Haskayne School of Business at the University of Calgary:

> *"Well, the market produced ten. And I think as Jane Voll indicated earlier, we can set the target at one level and what we actually are able to produce is another. I think if you set the target at ten it's unlikely that every company out there is going to be able to do it. They're going to have other types of uncertainties and foul ups and inefficiencies that keeps them from reaching the target. So the target may, perhaps, rightfully belong higher than the average and you still may end up with an average of ten if you have allowed thirteen or fourteen or fifteen because some companies are better at what they do than others. And that's also a feature of the competitive market."*

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Regarding the investment rate that should be reflected in estimating the investment income earned by companies, many of parties were of the opinion that the 5.2% investment rate used by Mercer to measure the investment income attributed to policyholder funds may be too high, stating that policyholders should only be "credited" with an investment return equivalent to the risk-free yields of 3-5 year Canadian bonds. They are of the view that a more appropriate number for cash flow arising from operations would be between 3.1% and 3.3% based on the current three year Canada bond average. Ron Miller, IBC's consulting actuary, in his comments before the Board at the public meeting, indicated that he selected the three-year bond average reflective of the average time between receiving the premium and meeting claim and expense obligations or basic coverage.

Those that take the position that Mercer's selected investment rate may be high are, in a sense, suggesting that insurance company investment returns can be allocated between returns on policyholder funds and returns on equity. But, insurance companies do not segregate their investments in this manner; therefore, any such allocation is arbitrary. Further, insurance companies do not restrict their investments to low risk Canadian bonds. They also invest in equities that are expected to generate higher returns. A review of the average returns by the industry over the past several years supports this.

The Board also takes note that in his New Brunswick testimony, Dr. Kalymon states:

> *"It is my assessment that the Return on Investments should reflect the full range of investment instruments which are available and generally used by insurance firms. The portfolio of investments by insurance firms can include corporate bonds, common shares, preferred shares, real estate and mortgages as well as Government Bonds. Such alternative investments have differing levels of return. Market average risk investments are expected to yield 9.08% under present market conditions, and five year Government of Canada Bonds currently are yielding 3.63%. Assuming that 25% of investment portfolios are invested in equity of average risk and 75% in five year Government Bonds, implies an average return on invested capital of 4.99%."*

Dr. Kalymon's position and suggested return is very much in line with Mercer's.

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4.5.2. Board Position

The Board recognizes that some consideration should be given to the historical profitability of the insurance industry and makes note of the preliminary financial results compiled by IBC that indicate a net income of approximately $50 million through the first quarter of 2005. The Board further notes that the allowance for profit, whether it is selected directly or is derived from a selected target return on equity, is a highly controversial issue. The Board appreciates the many differing views held by experts on the issue of a profit provision in automobile insurance rates, and recognizes that this issue has not been given its due airing before the Board. Therefore, the Board will give more appropriate and fuller consideration to the profit issue in the future.

In the interim the Board finds the approach of using a selected profit margin to be appropriate; the selection of a 5% profit margin to be appropriate; and the use of a 5.2% investment rate to be appropriate.

4.6. Estimation of Street Premium

4.6.1. Discussion of Issue

The final key issue considered by the Board relates to concerns raised regarding Mercer's estimate of the street premium.

The average street premium estimated in the Mercer Report was based on the reported average written premium for the first half of 2004. (Additional industry information did become available on June 17, 2005 after the Mercer Report was released.) The premium was then adjusted for the anticipated premium drift as a result in changes in the limits of liability coverage, the grid rate system and the premium rollbacks. The recently announced 6% reduction (applying to non-grid risks) was applied to the system by estimating that 10% of risks are placed on the premium grid, equating to an actual reduction on the entire system of 5.4%. Mercer assumed that 10% of the risks were on the premium grid based on information received from six large insurers in Alberta. Mercer recognized that the all-comers rule could affect the average street premium, but since that information was not available to them, it was not considered.

The Mercer Report contains a minor technical error that relates to the manner in which the mandated 6% rate reduction is reflected. Correcting for this causes the Mercer Report's indication to become lower (i.e., a larger rate reduction).

At the public meetings and subsequent to the release of Mercer's report, the IBC reported an error in the average premium data it had provided to Mercer. On June 17, 2005 the IBC released the corrected data and provided "fast-track" data to its consulting actuary, Mr. Miller, but due to an oversight, did not release this information to Mercer. Mr. Miller reflected the corrected data in his analysis that was presented at the public meeting. The Board asked the IBC to provide Mercer with the corrected data so that it could be reviewed and reflected in their analysis.

Following the public meetings, the IBC provided Mercer with the corrected premium data, which was reviewed for reasonableness, and, following discussions with representatives from IBC and Mr. Miller, Mercer concluded that the updated data is appropriate for its use, and that in doing so, its estimate of the street premium changes from $642 to $625.

4.6.2. Board Position

The Board recognizes that the initial premium data provided by the IBC to Mercer was found to be incorrect, and accepts the fact that the corrected data must be considered by Mercer in estimating the street premium.

4.7. Revised Rate Level Indication

As a result of input received at the public meetings, Mercer has advised the Board that after reflecting the aforementioned changes: the timing of the health services levy, the newly announced health services levy for 2006, the manner in which the mandated 6% rate reduction was reflected, and the corrected premium data provided by the IBC, that its estimate of the industry-wide rate level indication decreases from -8.2% to -2.7%. %. However, Mercer

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acknowledges that this number represents their "best estimate," around which there are a range of numbers that could be as equally valid depending on the assumptions that are accepted.

4.8. THE GRID

During the Board's public meetings many presenters suggested that Government needed to review the premium grid and the surcharges and discount levels in the Regulation. This review was needed to ensure that drivers placed on the grid were priced appropriately to ensure that a large proportion of grid risks were not being ceded to risk sharing pool. On July 22, 2005, the Minister of Finance, the Honourable Shirley McClellan wrote to the Board Chair and asked the Board to review this issue and report back to her with recommendations.

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5.0 ORDER NO: 01-05

ANNUAL ADJUSTMENT OF RATES EFFECTIVE NOVEMBER 1, 2005

In accordance with Section 4 of the *Automobile Insurance Premiums Regulation,* the Board hereby orders that the rates under rating programs for basic coverage (third party liability and accident benefits) of private passenger vehicles be reduced uniformly on an Alberta industry-wide basis by 4.0% effective November 1, 2005.

The Board has considered all of the oral and written information presented through the public meeting process, including the analysis and findings presented by its actuary, Mercer Oliver Wyman, in coming to its decision.

Ratemaking is an exercise that relies on past experience to predict future experience. Actuarial Science provides a reasoned outlook, but a prediction can only represent a "best estimate." The immaturity of data for the new automobile insurance system means that the assumptions made to estimate premium requirements for the upcoming period are subject to more supposition than in situations where there is comparable historical data available. The indications for change to premium level are very sensitive to changes in assumptions such as how the frequency and severity of claims will change in the future as compared to the recent past. As reported in the discussion of these various factors earlier in the report, there is no single correct value; rather, there is a range of reasonable values. As there is a range of reasonable values for some variables, it follows that there is a range of reasonable conclusions.

In this regard, the Board has chosen to deviate from the overall rate level indicated by its actuary in arriving at its decision. In particular, the Board has chosen to do so over the issue of claims frequency rates. While Mercer's suggested that decreasing claims frequency rates would mitigate and slow by half, the Board is of the opinion that frequency rates will continue to decline at a more optimistic rate, somewhere between Mercer's estimate and current trends. If claim frequency remains at it current rate, Mercer's estimated industry-wide rate level indication

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decreases from -2.7% to –9.3%. As a result, the Board finds that it is reasonable to assume that claims frequency will most likely continue to decline at a rate somewhere in between. It is largely based on this factor that the Board has arrived at a 4.0% reduction.

The Board notes 2 other issues that influenced its decision:

1. The industry's profits through 2004 and the first quarter of 2005. It is of the opinion that a 4.0% reduction is reasonable, conservative and acceptable in light of these profits; and

2. That the annual adjustment represents an industry average, and is based on an average premium. As a result, there will be companies within the Alberta market-place that will be able to absorb at least a 4% decrease, while there will be others that will have some difficultly. However, the Board points out that under Section 6 of the *Automobile Insurance Premium Regulation*, insurers have the opportunity to petition the Superintendent of Insurance to request that the Board review their rating program if they cannot absorb the 4.0% reduction.

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6.0 APPENDIX A - AUTOMOBILE INSURANCE PREMIUMS REGULATION

Part 1, Section 4

4(1) On or before August 1 in each year, the Board may adjust uniformly on an Alberta automobile insurance industry-wide basis, in accordance with the criteria described in subsection (3), the rates under rating programs for basic coverage of private passenger vehicles.

(2) In accordance with the procedures of the Board, the Board may hear representations with respect to an adjustment under this section.

(3) The criteria for an adjustment are

(a) the Alberta automobile insurance industry-wide loss costs, as that term is understood by the Board, for basic coverage for private passenger vehicles;

(b) the administrative expenses relating to basic coverage for private passenger vehicles, on an Alberta automobile insurance industry-wide basis, that the Board considers appropriate to consider, which may include commissions, federal, provincial and municipal taxes and general expenses, as reported in the annual returns submitted by insurers to the Superintendent or a similar regulatory authority in another jurisdiction;

(c) other Alberta automobile insurance industry-wide costs or expenses that the Board considers appropriate relating to basic coverage for private passenger vehicles;

(d) any other criteria recommended by the Superintendent and approved by the Board.

(4) An adjustment under this section is effective November 1 of the year in which the adjustment is made by the Board.

(5) Notwithstanding subsection (4), if the Board increases the rates under a rating program for basic coverage in respect of private passenger vehicles, the increases may be applied by an insurer over a period of not more than 3 years commencing November 1 of the year in which the adjustment is made by the Board.

(6) Information about adjustments under subsection (1) must be made publicly available in a manner satisfactory to the Superintendent.

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7.0 APPENDIX B – PRESENTATION SCHEDULE FOR PUBLIC MEETINGS

Monday, June 27, 2005 – Edmonton
The William Tomison Room, Sutton Place Hotel, 10235 – 101 Street
9:00 am - 10:30 - Mercer Oliver Wyman
10:30 - 12:00 - Peace Hills Insurance
1:00 - 2:30 - Alberta Civil Trial Lawyers Association
2:30 - 4:00 – The Dominion of Canada General Insurance Company
4:00 - 5:30 pm - Co-operators General Insurance Company

Tuesday, June 28, 2005 - Edmonton
The William Tomison Room, Sutton Place Hotel, 10235 – 101 Street
9:00 am - 10:30 – Wawanesa Mutual Insurance Company
10:30 - 12:00 - TD Meloche Monnex
1:00 - 2:00 - Rick Miller, MLA for Edmonton Rutherford
3:30 - 5:00 - Canadian Direct Insurance
5:00 - 6:00 pm - Marilyn Burns

Wednesday, June 29, 2005 – Calgary
The Red Baron Room, Best Western Port O'Call, 1935 McKnight Blvd. N.E.
9:00 am - 12:00 - Insurance Bureau of Canada
1:00 - 2:00 – Merle Taylor, Consumer Representative Automobile Insurance Rate Board
2:00 - 3:30 - Norma Nielson, University of Calgary
3:30 - 5:00 - Allstate Insurance Company of Canada
5:00 - 6:00 pm - Ross Bucsi, Palliser Insurance Agency Ltd.

Thursday, June 30, 2005 - Calgary
The Red Baron Room, Best Western Port O'Call, 1935 McKnight Blvd. N.E.
9:00 am - 10:30 - Independent Insurance Brokers Association of Alberta
10:30 - 12:00 - ING Canada
1:00 - 2:30 - RBC Insurance
2:30 - 4:00 pm - Royal & SunAlliance

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8.0 APPENDIX C - DEFINITIONS OF KEY TERMS

To assist the reader in his or her understanding of our report, in this section we define and explain several of the technical terms that we use throughout our report.

8.1. AUTOMOBILE INSURANCE COVERAGES

We begin with a general description of the insurance coverages. We note that throughout this discussion of the insurance coverages, the term "insured" is generally used to mean the family of the owner of the policy, as well as any passengers or other drivers using the car with the owner's permission.

Third Party Liability (TPL) There are two parts to this mandatory coverage:

Bodily Injury (BI) coverage protects the insured against liability arising from an accident that causes bodily injury to another person. Coverage amounts available in Alberta range from the legal minimum of $200,000 per claim to well over $2,000,000 per claim.

Property Damage (PD) coverage protects the insured against liability arising from an accident that causes damage to the property of another person.

Accident Benefits (AB)
This coverage provides for such items as reimbursement of lost income, medical care costs, and funeral costs; it also provides benefits to the dependants of a deceased insured.

Underinsured Motorist (UIM)
This optional coverage protects the insured if he or she is caused bodily injury by an at-fault driver who is insured, but who does not have sufficient insurance to cover the liability; in this case the insured collects, from his or her own insurer, the amount of the damage that is in excess of the at-fault driver's liability coverage and up to the limit of UIM coverage purchased.

Collision
This optional coverage generally provides coverage (subject to a deductible) for damage to the insured's vehicle arising out of a collision.

Comprehensive
This optional coverage generally provides coverage (subject to a deductible) for damage to the insured's vehicle arising out of a peril other than collision (e.g., theft, vandalism, flood, hail, fire, etc.).

All Perils
This optional coverage combines the coverages for both collision and comprehensive into one coverage, subject to a common deductible level.

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Specified Perils
This optional coverage, like collision and comprehensive, provides coverage (subject to a deductible) for specific perils to the insured's vehicle.

8.2. Other Terms

Accident Year
The year in which an incident that gives rise to a claim occurred, regardless of when the claim is actually reported to an insurance company. For example, a claim reported on January 15, 2003 for injuries suffered in an automobile accident that occurred on December 15, 2002, is considered to be an accident year 2002 claim.

Allocated Loss Adjustment Expense (ALAE)
ALAE is the claim and settlement expense that can be associated directly with individual claims (e.g., legal expenses). (See ULAE)

Base Rate and Rate Differentials
Insurers generally determine the premium for a particular insured by multiplying a base rate by a series of rate differentials (or rate factors, or rate relativities) that reflect the particular characteristics of the insured. The terms rate differentials, rate factors and rate relativities are used interchangeably. Typically, there is one base rate for each combination of coverage and rating territory. For example, assume a base rate for the TPL coverage of $200 in Territory #1 and a base rate for the TPL coverage of $300 in Territory #2. Also assume the rate differential for a married male driver, age 40, is 1.25. The TPL premium for this driver would be $250 in Territory #1 ($200 times 1.25) and $375 in Territory #2 ($300 times 1.25).

Case Reserve
The Case Reserve is the provision established by insurance companies for the payment of future losses and claim related expenses associated with a particular claim.

Claim Frequency
Claim Frequency is the average number of claims that occur in a year, per insured vehicle. Claim frequency is a measure of the incidence of automobile claims. For example, if an insurance company provided insurance on 100 vehicles in year 2002 and 5 TPL claims occurred during 2002, the company's TPL claim frequency for 2002 would be 5 percent

Claim Severity
Claim Severity is the average reported incurred loss and ALAE per claim. Claim severity is a measure of the average cost of automobile claims. For example, if the 5 claims in the previous example resulted in a total incurred loss and ALAE of $100,000, the claim severity would be $20,000.

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Claim Count Development
Claim Count Development refers to the change in the number of reported claims for a particular accident year over time. (See Loss Development)

CLEAR
CLEAR refers to Canadian Loss Experience Automobile Rating, a system of categorizing Private Passenger vehicles, by make and model-year, for physical damage coverage rating purposes. CLEAR was developed by the Vehicle Information Centre of Canada (VICC), a part of the Insurance Bureau of Canada. CLEAR considers such elements as the repairability and damageability of the make and model-year. (See MSRP)

Combined Ratio
Combined Ratio is another common measure of premium adequacy. This is the sum of the loss ratio plus the expense ratio (operating expenses divided by written premium). A combined ratio in excess of 100 percent is an indication of premium inadequacy, before consideration of profit and investment income.

Earned Premium
Earned Premium is the amount of written premium that is associated with the portion of the policy term that has expired. For example, assume an automobile policy with a 12-month term is sold on January 1 for $1,000. The amount of earned premium would be $500 on June 30

Exposure Unit
A measure of loss potential. In Private Passenger automobile insurance, the exposure unit that is commonly used is the number of insured vehicles. For example, all else being equal, it would be expected that the cost to an insurance company to insure 50 cars would be twice the cost to insure 25 cars.

Health Services Levy
As per Provincial legislation, a levy is paid by each insurer to achieve a target amount set by Government. IBC calculates and provides the level as a percentage of earned third party liability premiums. Under the legislation, the Government has no subrogation rights against the at-fault parties who are insured by policies of TPL insurance; but instead, collects the levy.

Loss Cost
Loss Cost is the average incurred loss and ALAE in a year per insured vehicle. The loss cost is the product of claim frequency and claim severity. Using the above example, a claim frequency of 5 percent, multiplied by a claim severity of $20,000, produces a TPL loss cost of $1,000.

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Loss Development

Loss Development is the amount by which reported incurred losses and ALAE for a particular accident year change over time. The two main reasons why reported incurred losses and ALAE amounts change (or develop) over time are:

a) Reported incurred losses and ALAE only include case reserve estimates on claims for which the claim adjuster has knowledge, i.e., case reserves are only established on the claims that have been reported to the insurance company. Since typically some period of time elapses between the time of the incident and when it is reported as a claim, the number of reported claims for an accident year would be expected to increase over time. Claims that are reported after the close of an accident year are referred to as "late-reported" claims; and

b) Reported incurred losses and ALAE also develop because, for a number of reasons, the initial case reserves established by claims adjusters, can not fully and accurately reflect the amount the claim will ultimately settle at. This pattern of under-reserving and over-reserving is common within the insurance industry (although the degree to which reported incurred losses and ALAE are under-reserved or over-reserved varies by company, jurisdiction, line of business, etc.). We further note that, over time, the percentage by which reported incurred losses and ALAE develop for a given accident year should decline. This is because as accident years become more mature (i.e., become older), fewer and fewer reserve estimates are adjusted to reflect newly reported late claims, actual payments, and additional information that becomes available to the claims adjuster.

Loss Ratio

Loss Ratio is defined as reported incurred losses and ALAE divided by earned premium. This is the common measure of premium adequacy. A loss ratio that exceeds a company's break-even loss ratio (100 percent less budgeted expenses) would suggest premium inadequacy.

Loss Reserving Methods: Incurred Loss Method and Paid Loss Method

Loss reserving methods are often based on historical data grouped into a triangle format. A common approach is to have the rows represent the accident years, and the columns representing the value of the loss at specific dates, such as 12 months, 24 months, 36 months etc., from the beginning of the accident year. The historical changes in the loss data from period to period is reviewed to estimate a pattern to predict how current accident years losses will change over time as claims are settled and closed. The Incurred Loss Method refers to the triangle method of analysis, based on reported incurred losses. The Paid Loss Method refers to the triangle method of analysis, based on paid losses.

MSRP

MSRP refers to the Manufacture's Suggested Retail Price, and is a system of categorizing Private Passenger vehicles, by make and model-year, for rating purposes for physical damage coverages, according to the original price of the vehicle. (See CLEAR)

<u>Operating Expenses</u>
Insurance company expenses, other than ALAE and ULAE, are typically categorized as Commissions, Other Acquisition, General, Taxes, Licenses, and Fees.

<u>Paid Losses</u>
The total aggregate dollar amount of losses paid on all reported claims as of a certain date.

<u>Premium Drift</u>
Premium Drift is a more general term, and refers to the changes in the amount of premium collected by insurance companies that is attributed to the purchase of newer and more expensive cars (i.e., rate group drift) as well as to changes in the amount of insurance coverage that is purchased (e.g., the purchase of higher limits of liability coverage would increase the amount of premium collected by insurance companies, while the purchase of higher physical damage deductibles would reduce the amount of premium collected by insurance companies). (See Rate Group Drift)

<u>Rate Group Drift</u>
Rate Group Drift refers to the amount of additional premium collected by insurance companies that is attributed to the purchase of newer and more expensive cars by insureds. The premiums charged by insurance companies are higher for newer and more expensive cars. Therefore, as insureds purchase newer and more expensive cars, the amount of premium collected by insurance companies increases. (See Premium Drift)

<u>Ratemaking Methods: Pure Premium Method and Loss Ratio Method</u>
The Pure Premium Method of ratemaking develops indicated rates that are expected to provide for the expected losses and expenses, and provide for the expected profit.
The Loss Ratio Method of ratemaking develops indicated rate changes rather than indicated rates

<u>Rating Territory</u>
Automobile premiums vary by the principal garaging location of the vehicle. Based on Insurance Bureau of Canada's automobile statistical plan, Alberta is currently divided into three areas, or rating territories, of principal garaging location; and, therefore, has three separate sets of rates depending upon which of the three territories the vehicle is principally garaged. (see Statistical Territory)

<u>Reported Incurred Loss</u> The sum of:

(a) the total aggregate dollar amount of losses paid on all reported claims as of a certain date (referred to as the valuation date), and

(b) the total aggregate dollar amount of losses set in reserve by the claim adjusters on each open claim (referred to as "case reserves") as of a certain date (the same evaluation date as for the paid loss amounts).

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For example, if two claims were filed against an insurance company, one that settled for $50,000 and the other that was open with a paid amount of $25,000 and a "case reserve" (i.e., the claim adjuster's estimate of the dollars still to be paid on the claim) of $30,000, then the total reported incurred loss on the two claims would be $105,000 (the sum of $50,000, plus $25,000, plus $30,000).

<u>Reserve</u>
A Reserve is the aggregate provision identified by an insurance company for the payment of future losses and claim related expenses associated with claims that have been incurred.

<u>Surplus</u>
The excess of the assets of an insurance company over its liabilities.

<u>Statistical Territory</u>
Automobile premiums vary by the principal garaging location of the vehicle. Alberta is divided into four statistical territories, of principal garaging location. Specific statistical territories are grouped together to represent a specific rating territory. In some cases there is one statistical territory in a rating territory, in other cases the rating territory is comprised of two or more statistical territories. (see Rating Territory)

<u>Total Return on Equity</u>
Total Return on Equity (ROE) refers to an insurer's profit as a percentage of its surplus, where profit is the sum of (a) underwriting profit, and (b) investment income earned on both the underwriting operations of the company and on the surplus carried by the company.

<u>Underwriting Profit</u>
Underwriting Profit is defined as earned premium, less reported incurred losses and ALAE, less ULAE, less operational expenses.

<u>Underwriting Profit Margin</u>
Underwriting Profit Margin is the provision that is included in the insurance premium for underwriting profit to be earned by the company.

<u>Ultimate Incurred Loss</u>
An estimate of the total amount of loss dollars that will ultimately be paid to settle all claims that occur during a particular accident year.

<u>Written Premium</u>
Written Premium represents the total amount of premium charged by an insurance company for the insurance policies it has sold. It is generally measured over a one-year period.

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Unallocated Loss Adjustment Expense (ULAE)
ULAE is the claim and settlement related expense that cannot be associated directly with individual claims (e.g., claim adjuster salaries). (See ALAE)

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