



777 Bay Street, Suite 2400 T: 416 863 1750
P.O. Box 121 F: 416 868 0894
Toronto, Ontario E: mail@facilityassociation.com
M5G 2C8

May 29, 2008

Mr. Del Dyck
Executive Director
Alberta Automobile Insurance Rate Board
200 Terrace Building
9515 – 107 Street
Edmonton, Alberta T5K 2C3

*Delivered via email airb@gov.ab.ca
Original to follow by courier*

Re: Annual Review of Automobile Insurance Premiums for Basic Coverage

Dear Mr. Dyck,

Please find enclosed the required signed original and twelve copies of the Facility Association submission to the Alberta Automobile Insurance Rate Board's Annual Review of Automobile Insurance Premiums for Basic Coverage.

Attending at our presentation on behalf of Facility Association will be:

David Simpson, President & CEO

Norman Seeney, Vice President Finance & CFO

Please also find enclosed a signed disclosure form.

With respect to our presentation needs, we will be using a laptop-driven PowerPoint presentation to highlight facts and themes from our submission. A projector (with USB cable connectivity) and screen are all that we need. We will email the presentation to you a week before the Hearing as requested in your letter to me of May 14th.

If you require anything further in the interim, please let me know directly.

Yours truly,

A handwritten signature in blue ink, appearing to read 'David J. Simpson', written over a light blue horizontal line.

David J. Simpson, M.B.A., FCIP
President & CEO

c.c.: Robert Wesseling, FA Board Chair

Alberta Automobile Insurance Rate Board

Annual Review of Automobile Insurance Premiums for Basic Coverage

June 17, 2008



Submission

A handwritten signature in black ink, appearing to read 'David J. Simpson', written over a horizontal line.

David J. Simpson, M.B.A., FCIP
President & CEO

1 **EXECUTIVE SUMMARY**

2

3 In 2007, \$382.4M in written premium and over 221,000 exposures were transferred to the
4 Alberta Risk Sharing Pools (RSP)s administered by the Facility Association. Taken together,
5 these two residual markets remain among the largest in North America on a percent of market
6 basis.

7

8 Although the financial performance of the RSPs appears to have improved, it is extremely
9 important to recognize that the financial results as shown do not include any estimate of the
10 change to claims liabilities resulting from the striking down of the Minor Injury Regulation.
11 Facility Association is working with our consulting actuaries and our member companies to
12 develop estimates of those impacts.

13

14 Given the uncertainty and volatility represented by the RSPs, Facility Association supports
15 initiatives to keep the RSPs as small as possible and that allow companies to respond flexibly
16 from a pricing standpoint to accommodate their own particular needs.

17

18 **SIZE**

19

20 As always, there are two ways to talk about the size of RSPs premium volume and exposure
21 count. For calendar year 2007, premiums written through the two RSPs totaled \$382.4M or
22 17.6% of private passenger written premiums in Alberta.

23

24 In 2007, we saw an overall increase in premiums transferred to the RSPs of just under \$2M.
25 We saw premium volume decrease by about \$6.6 M in the Grid RSP and increase by about
26 \$8.5M in the Non-Grid RSP.

27

28 In terms of premium-based market share, the RSPs combined declined from 18.5% in 2006 to
29 17.6% in 2007. That reflects a decrease for the Grid RSP of 0.9% and an increase of 0.2% for
30 the Non-Grid RSP.

31

Alberta Risk Sharing Pools – Market Share (Written Premium Basis)						
Year	Total		Grid RSP		Non-Grid RSP	
	W. Prem	Mkt Share	W. Prem	Mkt Share	W. Prem	Mkt Share
2005	\$427,561,427	22.1%	\$370,649,344	19.2%	\$56,912,083	2.9%
2006	\$380,543,231	18.5%	\$309,538,332	15.1%	\$71,004,099	3.5%
2007	\$382,378,719	17.6%	\$302,904,752	14.0%	\$79,473,967	3.7%

32

33 Looking at the size of the Pools from an exposure count perspective, (exposure defined as one
 34 car insured for one year) a total of 221,445 exposures were transferred to both RSPs in 2007,
 35 down from approximately 231,000 in 2006 and 262,000 in 2005. We continued to see a shift
 36 in composition as the number of exposures transferred to the Grid RSP dropped by
 37 approximately 11,000 to 154,000 and in the Non-Grid RSP rose by approximately 2,000 to
 38 68,000.

39

Alberta Risk Sharing Pools – Market Share (Written Exposure Basis)						
Year	Total		Grid RSP		Non-Grid RSP	
	W. Exp	Mkt Share	W. Exp	Mkt Share	W. Exp	Mkt Share
2005	262,031	13.9%	207,381	11.0%	54,650	2.9%
2006	230,568	11.5%	164,643	8.2%	65,925	3.3%
2007	221,445	10.5%	153,649	7.3%	67,796	3.2%

40

41 As we have noted before, according to the most recent data, on a percent of market basis, the
 42 Alberta RSPs are among the largest auto insurance residual market mechanisms in North
 43 America, behind only the Nunavut, the Northwest Territories, and North Carolina.

44

45 **FINANCIAL PERFORMANCE**

46

47 It is not unusual for financial results of RSPs to be volatile. The following table summarizes
 48 the financial results of the RSPs for the fiscal year ended October 31st. The data is taken from
 49 our annual audited financial statements.

50

Alberta Risk Sharing Pools - Excess/(Deficiency) of Revenue over Expenses (\$'000)			
Period	Grid RSP	Non-Grid RSP	Combined
2005 (13 months)	\$(93,902)	\$(28,038)	\$(121,940)
2006	\$8,498	\$(30,562)	\$(22,064)
2007	\$93,357	\$(9,422)	\$83,935
Total	\$7,953	\$(68,022)	\$(60,069)

51

52 It is **extremely** important to note that, because of the time frames involved, it was a practical
 53 impossibility for us to obtain a reasonable estimate of the change to the claims liabilities for
 54 the RSPs resulting from the striking down since inception of the Minor Injury Regulation
 55 (MIR) by the Court of Queen’s Bench. As a result, both the audit and actuarial opinions for
 56 the Alberta Grid RSP, the Alberta Non-Grid RSP and Facility Association Residual Market
 57 Segment were qualified to state that the impact of the February 8, 2008 decision was not
 58 considered in the determination of the actuarial liabilities.

59

60 We expect that when we have the estimates of the impacts of the striking down of the MIR
 61 they will very likely be material and negative.

62

63 Similarly, the accident year loss ratios underlying our statement amounts, highlighted in the
 64 table below, do not reflect the impact of the striking down of the MIR.

65

Alberta Risk Sharing Pools – Undiscounted Estimated Ultimate Loss Ratio (ELR)					
Period	----- Accident Year -----				
	2004	2005	2006	2007	2008
Grid RSP					
As at Oct 31 2005	82.3%	82.5%			
As at Oct 31, 2006	69.2%	73.7%	76.3%		
As at Oct 31, 2007	51.7%	57.3%	65.5%	69.1%	
As at Apr 30, 2008	51.7%	57.3%	65.5%	69.0%	69.1%
Non-Grid RSP					
As at Oct 31 2005	173.7%	123.4%			
As at Oct 31, 2006	204.2%	107.8%	103.8%		
As at Oct 31, 2007	210.5%	94.0%	89.8%	100.0%	
As at Apr 30, 2008	210.5%	94.1%	89.8%	99.8%	97.8%

66

67 **PROCESS FOR ESTIMATING MIR STRIKE DOWN IMPACT**

68

69 We are in the process of having estimates of the changes to the claims liabilities resulting
70 from the strikedown of the MIR developed for the RSPs (and the Residual Market Segment)
71 to ensure that we are able to issue unqualified statements for fiscal 2008, and perhaps even
72 more importantly, able to include those estimates as soon as we can in the sharing reports we
73 provide to members monthly. It is proving to be far from a trivial exercise.

74

75 As a first step, we set up a roundtable discussion with the Appointed Actuaries from the major
76 Alberta RSP users and our Servicing Carriers with our Consulting Actuaries to assess what
77 kind of detailed information is likely to be available. This group was also asked to share their
78 views on the industry-wide impact of the decision.

79

80 From that discussion, our consulting actuaries are developing a survey to be sent to all
81 companies writing automobile insurance in Alberta requesting detailed claims information
82 that will allow the Valuation Actuary to determine a reasonable estimate of the liabilities
83 associated with this decision. The information requested will be both qualitative and
84 quantitative in nature.

85

86 The analysis performed by the Valuation Actuary will be reviewed our Actuarial Committee
87 the results will be shared with the Audit Committee and the Auditors.

88

89 **FINANCIAL IMPACT ON THE INDUSTRY**

90

91 It is very important to understand that per Generally Accepted Accounting Principles, our
92 financial statements can only show the results of our own operations. Things look somewhat
93 different from the member company perspective, as they have to include health levies,
94 premium taxes, investment income, income tax effects and the cost of capital as they
95 incorporate their share of RSP amounts into their own statements.

96

97 The following table illustrates what an adjusted operating result might look like from the
98 industry's perspective.

99

ALBERTA RISK SHARING POOL
SUMMARY OF OPERATIONS - INDUSTRY IMPACT FOR ILLUSTRATION PURPOSES
ADJUSTED OPERATING RESULT

	GRID RSP				NON-GRID RSP			
	<u>Total</u>	<u>Oct-07</u>	<u>Oct-06</u>	<u>Oct-05</u>	<u>Total</u>	<u>Oct-07</u>	<u>Oct-06</u>	<u>Oct-05</u>
	(Amounts in \$000's)				(Amounts in \$000's)			
Net Operating Result (per Financial Statements)	7,953	93,357	8,498	-93,902	-68,022	-9,422	-30,562	-28,038
Adjustments :								
Premium Taxes Paid Directly by Member	-30,687	-9,291	-9,264	-12,132	-6,000	-2,134	-2,674	-1,192
Health Levies Paid Directly by Members	-29,970	-13,495	-10,291	-6,184	-6,096	-2,789	-2,741	-566
Discounting of policy liabilities	33,754	-1,533	15,117	20,170	9,702	169	6,379	3,154
Investment Income	42,686	21,495	15,250	5,941	6,120	3,459	2,095	566
Net Adjustment	<u>15,783</u>	<u>-2,824</u>	<u>10,812</u>	<u>7,795</u>	<u>3,726</u>	<u>-1,295</u>	<u>3,059</u>	<u>1,962</u>
Adjusted Net Operating Result	23,736	90,533	19,310	-86,107	-64,296	-10,717	-27,503	-26,076
Income Tax on net Operating result	<u>6,604</u>	<u>29,061</u>	<u>6,492</u>	<u>-28,949</u>	<u>-21,454</u>	<u>-3,440</u>	<u>-9,247</u>	<u>-8,767</u>
Operating Result Before Cost of Capital	17,132	61,472	12,818	-57,158	-42,842	-7,277	-18,256	-17,309
Deemed Cost of Capital	<u>-57,872</u>	<u>-20,617</u>	<u>-23,774</u>	<u>-13,481</u>	<u>-10,963</u>	<u>-5,342</u>	<u>-4,296</u>	<u>-1,325</u>
Combined Net Operating result	<u><u>-40,740</u></u>	<u><u>40,855</u></u>	<u><u>-10,956</u></u>	<u><u>-70,639</u></u>	<u><u>-53,805</u></u>	<u><u>-12,619</u></u>	<u><u>-22,552</u></u>	<u><u>-18,634</u></u>

100
101

Assumptions:

<u>Adjustments</u>	<u>Source</u>	<u>Assumption</u>
Premium Taxes Paid Directly by Members	Insurance Bureau of Canada	n/a
Health Levies Paid Directly by Members	Alberta Finance, Tax and Revenue Administration	n/a
Discounting of policy liabilities	Eckler Ltd.	Discount rate 4.15% Risk free rate of return, based on a portfolio of Government of Canada bonds, for which the dates and amounts of maturities were matched to the expected payout of policy liabilities.
Investment Income	Eckler Ltd.	Investment Rate 3.5% Estimated industry investment yield
Income Tax on net Operating result	Eckler Ltd.	Used KPMG published rates.
Deemed after tax Cost of Capital	Facility Association Accounting Committee	Deemed after tax Cost of Capital 10% Surplus based on 1.5:1 ratio

102
103

104 Following up on our undertaking of last year, we have calculated what loss ratios would lead
105 to a “break even” result for the industry when company cost factors are included. Because
106 company cost factors are dynamic and can change substantially from year to year, so can the
107 break even loss ratio. We calculated the “break even” loss ratio for 2005 to be approximately

108 51.32%, for 2006 approximately 65.55% and for 2007 approximately 69.86% for the Grid
109 RSP. For Non-Grid RSP, the calculated “break even” loss ratio for 2005 to be
110 approximately -19.27%, for 2006 approximately 57.63% and for 2007 approximately 62.04%
111

112 It’s also important to note that RSP results may impact different companies in different ways,
113 depending on such things as the relative experience of what they transfer to the Pools versus
114 the experience they get back from the Pools, and we would encourage the Board to bear that
115 in mind as individual company rate filings are being considered.

116

117 **CONCLUSION**

118

119 In our presentation before the Board last year, we stated that we think that all major
120 stakeholders share the same goal: a healthy competitive market where consumers benefit from
121 multiple insurance providers competing for their business. We also spoke of insurers having
122 18.5% of their revenue base behaving in a way that’s largely beyond their control and that
123 could be expected to behave in a volatile and uncertain way. We also said that as a result,
124 there was a risk that insurers might have a different view of the marketplace (either as a
125 participant or potential entrant) than they would if they had greater control over their
126 underwriting and rating practices and ultimately this could lead to a loss of competitive choice
127 for consumers.

128

129 With the strikedown of the MIR there is clearly an even greater degree of uncertainty in the
130 marketplace than there was last year. With that in mind, we support measures that keep the
131 RSPs as small as possible so that the volatility they induce into the market does not expose
132 companies to significant financial risk. That is, with relatively small RSPs, large percentage
133 changes in loss ratios do not translate into large dollar impacts. We would suggest the best
134 way to do that is to ensure that the price protection provided by the grid is tightly focused and
135 that insurers be allowed to charge adequate rates for risks not targeted by the grid.

136 **APPENDIX I: RISK SHARING POOLS BACKGROUND, AUTHORIZATION &**
137 **OPERATION**

138

139 **BACKGROUND**

140

141 Facility Association is an administrative mechanism that administers involuntary residual
142 market automobile insurance on behalf of the voluntary/private sector automobile insurance
143 industry across Canada. Created by the industry and empowered by statute, Facility
144 Association's mission is to guarantee the availability of automobile insurance coverage for
145 consumers who require it to legally operate their vehicles. Facility Association has a full-
146 time staff of twenty-five people and fulfils its mandate via a network of outsourcing
147 arrangements.

148

149 In Alberta, Facility Association administers the Alberta RSP (in reality, two Pools – one for
150 Grid and the other for Non-Grid risks) for private passenger vehicles. It also administers the
151 traditional Residual Market for non-private passenger vehicles and a very small “Residual
152 Market Segment” (with very tightly defined risk criteria) for private passenger vehicles.

153

154 Because all licensed automobile insurers must participate in the residual markets
155 administered by Facility Association according to specified sharing formulas, their financial
156 results are subject to greater volatility and uncertainty than would otherwise be the case.
157 Participation in the Residual Market also imposes additional costs on Facility Association
158 member companies for such expenses as premiums taxes, health levies, and the cost of
159 capital members must maintain to support residual market premiums.

160

161 **THE RESIDUAL MARKETS - AUTHORIZATION**

162

163 In Alberta, Facility Association administers the RSPs and Residual Market as authorized by
164 its Plan of Operation, which is approved by the provincial Superintendent of Insurance. (The
165 Plan may be viewed and downloaded at www.facilityassociation.com.) All companies
166 licensed to sell automobile insurance in Alberta are required to abide by the provisions of
167 the Plan.

168

169 For risks ceded to the Alberta RSPs, the Plan requires Facility Association to maintain and
170 report separate financial results for those risks that are subject to the premium grid and those

171 that are not. This creates the need for two RSPs, commonly referred to as the Grid RSP and
172 the Non-Grid RSP. Both are for private passenger automobiles only. All financial results of
173 the Alberta RSPs and the traditional Residual Market are assigned to member companies
174 based on their participation in the Alberta automobile insurance market. That is, they are not
175 spread across the other jurisdictions Facility Association serves.

176

177 **THE RISK SHARING POOLS - OPERATION**

178

179 Essentially, a RSP is a residual market that acts as an industry-wide reinsurance mechanism
180 that is largely invisible to consumers and intermediaries. A consumer buys insurance in the
181 normal way, and the application is forwarded to a company underwriter. The underwriter
182 assesses the risk, decides whether to keep it on the company's own books or to transfer the
183 risk to the RSP, subject to the operational rules and eligibility guidelines of the Pool.

184

185 For both Alberta RSPs, companies receive an expense allowance to cover costs such as
186 those incurred for acquisition, policy issuance, policy administration and claims servicing.
187 That expense allowance is set annually by the Facility Association Board of Directors in
188 consultation with the Superintendent. For both Pools, companies are required to submit
189 100% of all premiums for all coverages on a policy and are eligible for 100%
190 reimbursement of eligible claims and related expenses. Financial results (top **and** bottom
191 lines) of the Pools are shared among companies based on the proportion of a company's
192 private passenger automobile exposures not ceded to a RSP divided by the number of
193 industry private passenger automobile exposures not ceded to a RSP. As Facility
194 Association is simply an administrative mechanism, all companies receive a monthly report
195 reflecting the operations of the Pool, providing them with the amounts they are then required
196 to book into their own financial statements.

197

198 The two Pools differ primarily in the number of risks companies can transfer to each. For
199 the Grid RSP, companies can transfer eligible risks without limit. This lack of limit is based
200 on the philosophy that companies are required to accept risks for which they have no control
201 over price and, therefore, little or no control over the financial results of that business. In a
202 general way, the size of the Grid RSP will be a function of how companies view the
203 adequacy of the grid premium for a given risk. If the grid premium is approximately the
204 same as the company's own risk-based premium, the company might prefer to keep the risk

205 on their own books. The upper limit to the size of the Grid RSP is, of course, a direct
206 function of how many risks in the province are impacted by the grid.

207

208 For the Non-Grid RSP, companies can transfer up to 4% of written exposures not transferred
209 to the Grid RSP. This Pool is designed to help companies cope with the “take-all-comers”
210 environment in the province.

211

212 In a competitive market, most insurers tend not to target the entire universe of private
213 passenger automobile risks. Insurers generally each have their areas of expertise and a
214 healthy competitive marketplace tends to allow a proper mix of generalist and
215 specialist/niche private passenger automobile writers. Moreover, because it is a practical
216 impossibility to have a perfect price for every risk, most insurers choose to have risk
217 eligibility rules to complement and protect their respective pricing structures. An
218 underwriter faced with a requirement to accept a greater degree of risk than that
219 contemplated by the company’s classification system and rates can transfer that risk to the
220 Non-Grid RSP. The Non-Grid RSP has a relatively low limit to ensure that it does not
221 become used as a marketing tool. That is, without such a limit, companies could deliberately
222 adopt a strategy of under-pricing certain risks to attract new customers. Because these risks
223 could then be transferred to the Non-Grid RSP, and because of the way all insurers share in
224 the results of the Pool, this would amount to companies growing their businesses at the
225 expense of their competitors.

226

227 The key point here is that RSPs are designed as mechanisms to promote stability in the
228 marketplace by making it possible for companies to accept risks they believe are not
229 adequately priced. Therefore, the general expectation is that RSPs by their very nature will
230 operate at a financial loss. It is also important to note that because the RSPs also act as a
231 cross-subsidization mechanism across the industry, at any given point in time, companies
232 will have their own, unique, financial results vis-à-vis the Pools.

Information Disclosure Statement

The Automobile Insurance Rate Board (the Board) is mandated to annually determine and set premiums for basic coverage. Basic coverage for private passenger vehicles means the insurance coverage statutorily mandated or provided for under sections 627 (third party liability coverage) and 629 (e.g. Section B benefits) of the *Insurance Act*. To enable the Board to do this, it needs to collect or receive information under the authority of section 656 of the *Insurance Act* and sections 4 and 11 of the *Automobile Insurance Premiums Regulation*. The Board is committed to making its rate setting process as open and transparent to the public as possible.

Therefore, this is to notify you that any information (including personal or business information) that is submitted to the Board for consideration in the rate setting process, will be considered made in the context of a public hearing, whether made as a written submission or an oral presentation. This information, including the transcript of discussions held at public hearings will be published on the board's web site as authorized by the Minister of Finance under section 816(7)(c) of the *Insurance Act*.

I acknowledge that I am submitting the attached information to the Board in the context of an open public hearing in the rate setting process and that, subject to section 11 of the *Automobile Insurance Premiums Regulation*, A.R. 124/2004, I am not required by law or by the Board to provide this information, that I do so on my own account at my own instance. For these reasons, I understand that the attached information will be made public and I am submitting the information to the Board on that basis.

If you have any questions concerning the management or disclosure of Board information, you may contact the Executive Director of the Board at (780)415-1126.



Signature

May 29, 2008

Date

David J. Simpson, M.B.A., FCIP
President & CEO
Facility Association

Print Name