New Brunswick
Insurance Board

Commission des Assurances du
Nouveau-Brunswick

Decision

The New Brunswick Insurance Board (the "Board") began operations in October 2004. This Board was formed for the purpose of regulating automobile insurance rates charged by insurance companies doing business in New Brunswick.

The legislation mandates the Board to set rates that are "just and reasonable".

Some of the factors that the Board must take into consideration are:

1. What should be the appropriate return on equity for automobile insurance companies doing business in New Brunswick? What Premium to Surplus Ratio is appropriate for New Brunswick? What investments and related returns should be credited to the policyholders in setting rates?

2. Should the rates for the business managed by Facility Association include a recovery of the "Cost of Capital"? If so, what would be considered a proper rate of return to recover this Cost of Capital?

This Board decided to hold a public hearing in order to enable the members to understand what effect these factors had in setting automobile insurance rates in the Province.

A notice was sent to all automobile insurance companies doing business in the Province. A notice was also sent to the Attorney General of New Brunswick and the Consumer Advocate for Insurance for New Brunswick. Attached herewith are a copy of the notice and a list of the parties, intervenors, the names of the presenters, the Board actuaries and the sitting members of the Board.

In addition to these witnesses, the Board also called as its expert witness, Dr. Richard McGaw, Professor of Economics at the University of New Brunswick at Fredericton.

The evidence consisted of 12 written submissions from the various presenters shown on the attached list of presenters as well as the *viva voce* evidence of 23 witnesses. In all, 10 companies appeared at the hearing and four sent submissions but did not appear.

Most companies requested a return on equity (ROE) from a low of 12% to a high of 17%. Other companies requested that the Board not set any fixed rate or range. Others suggested a range from 8.5% to 10%.

Ms. Jane Voll of the Insurance Bureau of Canada introduced a graph, prepared by her organization, showing the Property and Casualty (P & C) Industry return from 1975 to 2004. The latest yield is 8.73% during the past seven years and the highest was from 1975 to 1983 with a return of 11.2%. Attached to this decision is a copy of the earnings report submitted by the Insurance Bureau of Canada.

Ms. Voll explained that "Insurers have to supply their profit provision's assumptions. The most common method of explaining these assumptions involves providing the target premium to surplus ratio and the target return on equity." (Transcript, New Brunswick Insurance Board Hearing June 27, 28, 29, 2005; page 176)

Premium-to-surplus ratio is the premium revenue of a company divided by the equity of its assets minus its liabilities.

The Office of the Superintendent of Financial Institutions (OSFI) Canada has guidelines regarding the minimum capital that federally-regulated insurance companies must have. In New Brunswick, there is only one company doing business that is not a federally-regulated insurance company and this company is under the supervision of the Office of the Superintendent of Insurance for the Province of New Brunswick.

OSFI says that "(it) expects each institution to establish a target capital level, and maintain ongoing capital, at no less than the supervisory target of 150% MCT." (Guideline, Minimum Capital Test, July 2003)

In order to ensure that every claim against an insurance company can be paid in full, this Board will be guided by the OSFI regulations that an appropriate premium to surplus ratio should be between 1.5 to 2.2. That is, the companies are required to have $1 in equity set aside for every $1.50 to $2.20 in written premiums. The companies require capital and in order to attract this capital, the companies must provide an adequate rate of return. Because of the requirements of the regulators, the equity of the insurance companies must be kept in secure instruments such as Government of Canada bonds. The present rate of return of Government of Canada 10-year bonds is somewhere around 4% per annum. Thus, the companies need to build into their premiums a profit margin, in order to supplement the return on their invested assets.

The return on equity component amounts to a very small percentage of the total premium. When one considers that the amount paid out in claims amounts to about $0.70 on the dollar. And when one considers that the commission of approximately 13%, the taxes, the health levy and the operating expenses, what is left over for return on equity amounts to only a small portion of the premium dollar.

The Board was presented with competing approaches to determine an appropriate rate of return on equity. The Board accepts Dr. McGaw's statement that the Capital Asset Pricing Model (CAPM) is the predominant method used in industrial practice, looking at the cost of capital. Both the Board's expert witness, Dr. Richard McGaw, and the Attorney General of New Brunswick's expert witness, Dr. Basil Kalymon, argued that the proper test would be the CAPM. Other suggestions were made to the Board but the Board is of the opinion that these methods are untested in Canadian jurisdictions and that the CAPM method is fit and proper to be used in deciding the rate of return on equity.

Even when deciding that a certain rate of return on equity is required, the companies are not always able to obtain that rate. Evidence from Co-operators General Insurance Company and The Dominion of Canada Insurance Company indicated that because of the pressure of competition in the marketplace at certain periods, they have had to reduce their target return on equity. And previously stated, the results of the attached sheet from the Insurance Bureau of

Canada shows the actual rates of return on equity obtained by the companies. These rates were much lower than the sought after return on equity.

In his submission, Dr. McGaw found that the automobile insurance industry in New Brunswick was competitive. He stated:

> …it is reasonable to conclude that the P & C insurance industry is reasonably competitive. I understand about 50 companies are operating in New Brunswick and that similarly no firm has a significantly large share of the New Brunswick market. The market is clearly much less concentrated than most manufacturing industries and the banking industry.
>
> Exhibit 7 of the FA submission shows that the volume of business is returning to levels experienced prior to the recent insurance rate shocks. This is a sign of a healthy and competitive insurance market in the Province when nearly all can be provided with insurance in the usual manner. (Dr. Richard McGaw, The Return on Equity for Automobile Insurers, June 2005, pages 7-8)

He added that:

> The information available confirms broadly that automobile insurance in New Brunswick is a competitive industry. Price regulation has generally been seen in economics as one way of correcting for the presence of monopoly and the tendency to excess profits. While automobile insurance rates are regulated in many jurisdictions, the justification from the point of view of economics is not clear. Since insurance is compulsory, there may be some point to regulating at a broad level to ensure public confidence but strict ROE regulation makes more sense in areas like cable television, telephones, or gas pipelines where there is often a single provider and competition is limited or non-existent. (Dr. Richard McGaw, The Return on Equity for Automobile Insurers, June 2005, page 8)

Dr. McGaw continued:

The Board should allow rates that meet the standards set out at the beginning. It is in the interest of all parties that the insurance industry offers a return to shareholders that is available to investments in unregulated industries that offer similar risk. A rate that is too high provides an excess reward to shareholders at the expense of consumers and a rate that is too low provides short-term benefits to consumers at the expense of shareholders. However, this benefit will be short-lived as insurers withdraw from the industry. (Dr. Richard McGaw, The Return on Equity for Automobile Insurers, June 2005, pages 9-10)

He concluded that:

I would recommend that the Board not define a specific ROE for all insurers. No matter what rate is set, since the ROE allowance is forward-looking, actual outcomes will still vary. Companies should be free to innovate and seek ways to improve profits. Companies can choose different approaches, service levels, or risk profiles. Since companies will differ in their business practices and risks taken, different rates of return are warranted. (Dr. Richard McGaw, The Return on Equity for Automobile Insurers, June 2005, page 10)

In dealing with the setting of an appropriate ROE, Dr. McGaw had this to say:

Further the underlying conditions that determine what an ROE – - an appropriate ROE might be in a regulatory setting change. So another issue that hasn't been addressed by anyone, and I don't have an answer for you, but it's a problem, is what is the time frame of an ROE setting? You know, is it one year? Is it five years? That's I think a difficulty of setting one.

So for all of these reasons, if I were asked the question which I posed to myself, why are we doing -- why should we set an ROE? My answer would be that we shouldn't. The performance of the last 30 years has given a rate of return that I think could not in any way be characterized as excessive. (Transcript, New Brunswick Insurance Board Hearing June 27, 28, 29, 2005; page 426)

At the termination of his evidence, the Chairman asked Dr. McGaw if it would be a better way to look at the return on equity at the time of each particular rate application. Dr. McGaw gave the following reply:

> Yes, that's what I would say. And that you send a signal that you have some range in mind that might be, you know, 9 to 12, 13, something in that zone as what people – what are they targeting for. And require for people who are the outliers to justify.
>
> I think it would be a waste of resources to have everyone coming forward to justify well, we are doing 11 percent and here is why, and we are doing 11.5, and here is why and so on.
>
> But I think what the Board should be concerned with is the outliers. And, you know, that's a good use of your time and also a better use of the times of the people submitting for rate claims. (Transcript, New Brunswick Insurance Board Hearing June 27, 28, 29, 2005; page 445)

The Board agrees with the recommendations of Dr. McGaw. The Board will not abdicate its responsibilities by creating a fixed rate or range of return on equity. The Board will review the requested rate of return of equity on each application and decide what the rate should be based on the criteria of setting "just and reasonable rates" for the policy holders of New Brunswick.

The Facility Association and Cost of Capital

The following statement, taken from the presentation of the Facility Association in its Exhibit 1, page 1, succinctly describes the nature and purposes of the Facility Association:

> The Facility Association (the "Association") is an unincorporated non-profit association created on June 28, 1977. The Association manages and accounts for

the operations of certain insurance pools on behalf of member insurance companies.

The results of the operations of these insurance pools, including administration costs incurred by the Association and investment income earned on assets invested by the Association, are all allocated to members, who account for their shares of insurance pool operations in their own financial statements. The insurance pool operations do not encompass all costs and revenues related to underwriting the underlying insurance business. Various related costs and revenues are not accounted for within the insurance pools but rather, are incurred by members directly and recorded only in each member's own financial statements. The Association administers the sharing between members of the results of operations ("experience") of the insurance pools and periodically assesses members to fund operating deficits or pays excess funds to members, all in accordance with the Association's Plan of Operation. (Facility Association Submission to the New Brunswick Insurance Board, Public Hearing, Issue # 2 "Cost of Capital", June 27, 2005, Exhibit 1, page 1)

Various costs, related to business underwritten in the insurance pools, are incurred by individual members directly and accordingly, are not reflected in these financial statements.

All the premiums, claims and expenses of the insurance pools are allocated to member companies who are required by regulation to record these amounts in their books. Member companies of the Residual Market Segment pay premium taxes and health levies directly to the provinces based on their share of the Residual Market premiums. They also pay certain other costs such as association dues, directly. Accordingly, these costs are not recorded in these financial statements.

Investment income earned by members on amounts due to the Association and certain premium levies charged by members in respect of uninsured automobile exposures are also not reflected in these financial statements.

> No provision for income taxes has been recorded in these financial statements. The results of operations of the insurance pools, including administrative expenses incurred by the Association and investment income earned on insurance pool assets invested by the Association, are included in the members' income for tax assessment purposes. (Facility Association Submission to the New Brunswick Insurance Board, Public Hearing, Issue # 2 "Cost of Capital", June 27, 2005, Exhibit 1, page 2)

The voluntary market companies say that they do not inflate their internal target return on equity assumptions to implicitly or explicitly allow for there being no cost of capital provision in Facility Association rates.

The Facility Association was created in order to enable the Province to provide automobile insurance for all residents who were in possession of a valid driver's license in this Province.

That also enabled the companies who did not want to insure these high risks to provide coverage to those drivers.

The companies were thus able to write only the risks that they considered to be acceptable and would enable them to make a profit. The fact that they were able to off-load the so-called "bad risks" to this insurer of last resort enabled the companies to write only the risks that they wanted and thus they were able to maximize their profit margins.

In the submission of the Facility Association, Exhibit 8, a portion of the decision by the Board of Public Utilities of Newfoundland and Labrador is presented which states:

> The Superintendent, in his intervenor's submission and in direct evidence, stated that in his opinion Facility was required to operate as a non-profit association and could not, under legislation, distribute profits to its members. He also stated that regardless of the provisions of the Plan of Operation the legislation takes precedence.
>
> From the evidence of witnesses and argument of Counsel, the Board concludes that Facility is a non-profit association that operates as nothing more than the

> administrator of a risk sharing automobile insurance pool. The servicing carrier companies of Facility underwrite the business risks and, on behalf of the member companies Facility carries out an administration function including, *inter alia*, investment of funds, administration of the bank accounts, issuing of reports on the status of funds and accounts, distribution of members profits and issuing assessment notices for losses incurred. Facility's expenses are paid by the member companies and that is all Facility is paid. As their revenues can never exceed their expenditures, Facility can never earn a profit.
>
> While there may be profits generated by Facility's operations on behalf of its members, and regardless of to whom these profits belong, the Board agrees with the expert actuarial evidence of Mr. Suchar and Mr. Pelly that these profits should not be used in setting rates for the future. (Facility Association Submission to the New Brunswick Insurance Board, Public Hearing, Issue # 2 "Cost of Capital", June 27, 2005, Exhibit 8, page 2)

Since the inception of the Facility Association some 30 years ago, there has never been a cost of capital component in its rate making process. Prince Edward Island is the only province that allows a cost of capital to the Facility Association.

In a decision dated March 14, 2005, the Nova Scotia Review Board refused to allow the Facility Association to include a cost of capital in its application.

The Nova Scotia Review Board found that:

> ... there was insufficient evidence provided to demonstrate that the members of Facility have not previously received cost of capital benefits in part or in full. Past surpluses allocated to members contributed to their cost of capital. Additional revenue earned attributable to Facility but retained by the members of Facility, was not considered as to how it would affect the need for a cost of capital component. (Nova Scotia Review Board, In the Matter of a review of an application by Facility Association, Public Hearing, November 9 and 10, 2004, page 44)

In his testimony, Mr. David Simpson, president of the Facility Association, stated that up to this time a cost of capital has been denied in Ontario.

At the present time in New Brunswick, little over 2% of New Brunswickers are in the FA. In his testimony, the Consumer Advocate said, "...there are brokers in smaller areas that basically have one or two companies and FA. And unless you come in totally squeaky clean, a hundred percent pure, you are thrown in FA. And if you -- if the person in question doesn't do anything about it, he will remain in FA." (Transcript, New Brunswick Insurance Board Hearing June 27, 28, 29, 2005, page 363)

In the northern part of New Brunswick, because of the lack of agents for various companies who refuse to do business up North, a person may be in the FA because of where he/she lives and not because of the fact that he/she should be in there because of any infractions or accidents or any other reason but the location of his/her residence.

There is an inequity in New Brunswick and it rests with the companies to correct the situation.

Any surplus given to the companies by the Facility Association would not be considered by them in their rate setting process and any loss would also not be considered in the process. The Facility Association is not an insurance company; it does not have so-called "equity capital". It is supposed to be a non-profit organization and exists only for the purposes set out in the legislation. If the Facility Association is allowed to add a cost of capital to its rates, it would in effect make the Association a for-profit organization and would allow it to create profits which it would then return to the companies.

No matter if there was a surplus returned by the Facility Association to the voluntary market, these rates would not be appreciably reduced. These surpluses would, in effect, be returned to the shareholders of the companies.

The Board is of the opinion that the Facility Association was created on June 28, 1977 as a non-profit organization for the benefit of insurance companies who did not want to have high risk drivers in their books of business. Their part in the Facility Association was the price they had to pay for doing business in a regulated environment.

Insufficient evidence was presented to the Board to conclude that the Facility Association should receive any cost on its "so-called capital". The Facility Association's application is therefore refused.

Dated at the City of Saint John, New Brunswick this 25th day of July 2005.

By Order of the Board

Lewis C. Ayles
Chairman of the Board

Paul D'Astous
Vice-Chairman of the Board

Joanne Cowan McGuigan
Member

C. Kevin Duff
Member

Donald Lusby
Member

Richard Tingley
Member

New Brunswick Insurance Board

NOTICE OF HEARING

The New Brunswick Insurance Board (the "Board") will hold a public hearing to consider two issues.

Issue # 1:

What should be the appropriate return on equity for automobile insurance companies doing business in New Brunswick? What Premium to Surplus Ratio is appropriate for New Brunswick? What investments and related returns should be credited to the policyholders in setting rates?

All Intervenors are required to file written submissions with the Board no later than May 13th, 2005.

Issue # 2:

Should the rates for the business managed by Facility Association include a recovery of the "Cost of Capital"? If so, what would be considered a proper rate of return to recover this Cost of Capital?

Written submissions by the Facility Association and intervenors must be filed with the Board by May 13th, 2005.

Persons intending to participate in either issue must notify the Board, in writing, at the address below, no later than April 29th, 2005. The Board will rule on whether they should be granted intervenor status and notify them by May 4th.

The hearings will commence on June 27th, 2005 at 9:30 am in the Delta Hotel Ballroom A, in the City of Saint John, New Brunswick.

The matter of industry return on equity will be dealt with firstly, followed by the Facility Association matter. If necessary the hearing will continue on June 28th & June 29th, until such time as all matters have been addressed.

Submissions should be sent to the email address listed below and an original copy should be mailed to the Board's civic address.

DATED at the City of Saint John, New Brunswick this 15th day of April 2005.

BY THE BOARD

Lewis C. Ayles

Lewis Ayles
Chairman

New Brunswick Insurance Board
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New Brunswick Insurance Board

Parties

IN THE MATTER OF a **Public Hearing** to consider:

Issue 1: What should be the **appropriate return on equity** for automobile insurance companies doing business in New Brunswick? What **Premium to Surplus Ratio** is appropriate for New Brunswick? What **investments and related returns** should be credited to the policyholders in setting rates?

Issue 2: Should the rates for the business managed by Facility Association include a **recovery of the "Cost of Capital"?** If so, what would be considered **a proper rate of return** to recover this Cost of Capital?

PRESENTERS:	REPRESENTED BY:
Allstate Insurance Company of Canada -------------------------------	Mr. Jeffrey R. Ill, ACAS, MAAA Vice President and Chief Risk Officer Allstate Insurance Company of Canada
Co-operators General Insurance Company ----------------------------	Ms. Katie Suljak Vice President, Actuarial Services Ms. Sherry Folkerson Underwriting Manager, Atlantic Personal Lines Mr. Terry McRorie Vice President, Atlantic Region (tentative)
The Dominion of Canada General Insurance Company ---------------	Mr. George L. Cooke President & Chief Executive Officer The Dominion of Canada General Insurance Company Mr. R. Douglas Hogan Senior Vice President and Chief Financial Officer The Dominion of Canada General Insurance Company
Facility Association ---	Mr. David J. Simpson President & CEO Facility Association Mr. Norman I. Seeney Chief Financial Officer Facility Association Mr. Brian Pelly Consulting Actuary

	Eckler Partners Ltd.
Insurance Bureau of Canada ---	Ms. Jane Voll V.P. Policy Development and Chief Economist Insurance Bureau of Canada
	Mr. Gilles Bernier Professor Finance and Insurance Université Laval
ING Insurance Company of Canada ------------------------------------	M. Jacques Valotaire Executive Vice President, Atlantic Region ING Insurance Company of Canada
	Mr. Claude Desilets Senior Vice president and Chief Actuary ING Insurance Company of Canada
	Dr. Abdul Rahman, Ph. D. Associate Professor of Finance and Economics School of Management University of Ottawa
	Mr. Don Fox Managing Director & Head of Financial Institutions CIBC World Markets Inc.
	Mr. Dennis R. Furlong Chief Operating Officer, Atlantic Region ING Insurance Company of Canada
McGaw, Rick	Mr. Richard McGaw Professor of Economics University of New Brunswick
Office of the Consumer Advocate for Insurance for New Brunswick--	Mr. Ronald Godin Consumer Advocate for Insurance
Province of New Brunswick ---	Mr. Bill Anderson Legal Counsel Province of New Brunswick
	Dr. Basil A. Kalymon Professor of Finance Richard Ivey School of Business University of Western Ontario
TD Meloche Monnex	Mr. Rick Evans Senior Vice President Claims Operations

Meloche Monnex Inc.

Mr. Brian Sypher
Senior Manager Client Services Center
Meloche Monnex Inc.

Mr. Craig Alexander
Deputy Chief Economist
TD Economics
TD Bank Financial Group

NEW BRUNSWICK INSURANCE BOARD ------------------------------

Mr. Jim Christie
Board Actuary
Ernst & Young

Mr Ryan Ho
Board Actuary
PriceWaterhouseCoopers

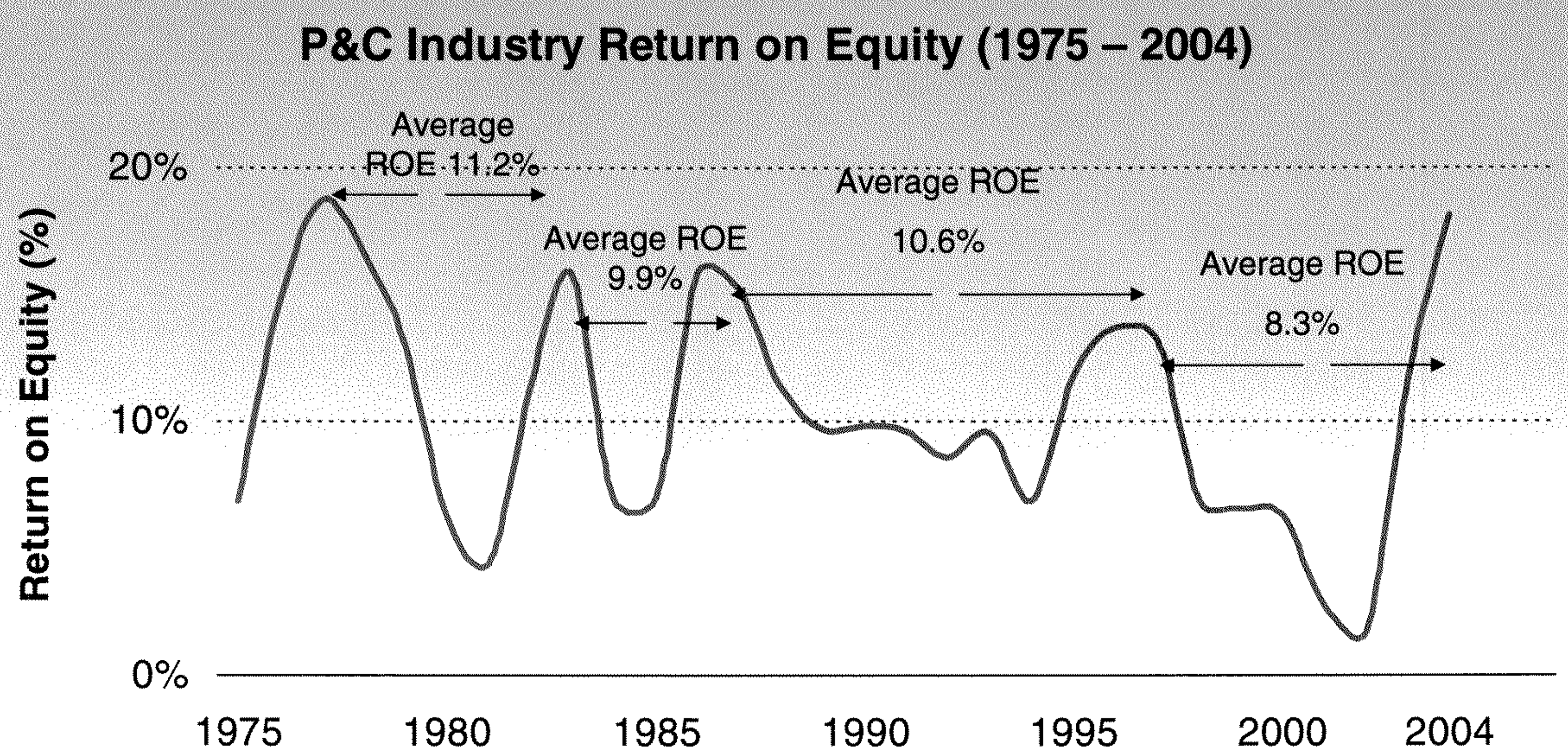
Panel:
Chairman: Mr. Lewis C. Ayles
Vice-Chairman: Mr. Paul D'Astous
Commissioners: Ms. Joanne Cowan-McGuigan
Mr. Kevin Duff
Mr. Donald Lusby
Mr. Richard Tingley

Secretary to the Board: Mr. Craig Astle

Insurance Bureau of Canada

Bureau d'assurance du Canada

Earnings



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