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July 25, 2023

Ms. Laurie Balfour
Executive Director
Automobile Insurance Rate Board
2440 Canadian Western Bank Place
10303 Jasper Avenue
Edmonton, AB T5J 3N6

Re: AIRB Annual Review

Dear Laurie,

We welcome the opportunity to comment on Oliver Wyman's report on industry experience for the AIRB's annual review for private passenger vehicles. Our commentary focuses on the inflation challenges affecting auto property damage claims.

Inflation Challenges

In last year's annual review response, we noted the unprecedented macroeconomic uncertainty in Canada and globally:

- The pandemic has caused systemic supply chain challenges
- People are returning to normal activities but what the new normal will be is unknown
- The economy is facing inflation at levels not seen in decades
- A recession might be on the horizon
- Russia's invasion of Ukraine is compounding the supply chain challenges.

In the case of auto insurance, when these macroeconomic factors started converging in late 2021, the three main parts of auto property damage costs began increasing at an unusually high rate:

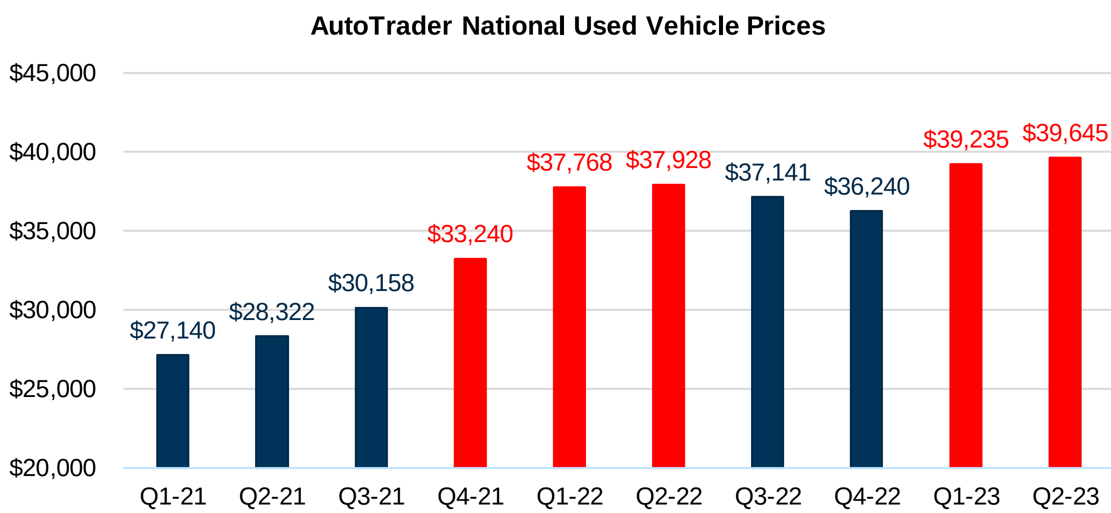
1. Cost of replacing unrepairable vehicles
2. Repair costs
3. Vehicle rental costs.

Two years after inflation's onset, auto property damage claim costs continue trending upwards. We believe that insurers must continue to factor inflation from this macroeconomic uncertainty into their auto rates for policies issued in 2024.

Cost of Replacing Vehicles

The main cost of replacing unrepairable vehicles is the price of used vehicles. That is a cost that insurers cannot control. A combination of increased demand, the global microchip shortage, and plant closures caused a shortage in new vehicles. Used vehicles filled the gap and, because of the demand for vehicles and the shortage of new ones, their prices increased significantly in the latter part of 2021 and into early 2022.

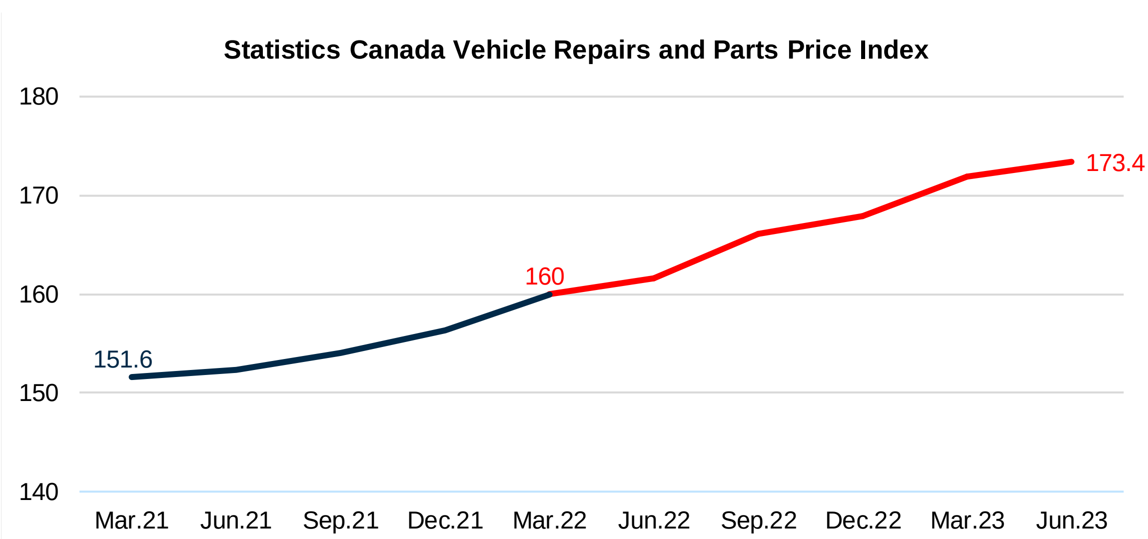
Specifically, according to AutoTrader, between Q3 2021 and Q2 2022, the national average price of a used vehicle increased by 25.8%, from $30,158 to $37,928. After declining slightly in the latter part of 2022, used vehicle prices started to increase again. AutoTrader reports that as of Q2 2023, the national average price of a used vehicle was $39,645, the highest price on record.



<u>Repair Costs</u>

Because of supply chain challenges that caused a shortage of parts and inflationary pressure on the cost of labour, repairing a vehicle became more expensive. Fortunately, insurers have some control over this cost. Insurers with agreements with preferred repair shops, such as Definity's Repair Partners, have been able to absorb some of the initial underlying cost pressures. However, the effectiveness of this mitigation measure is eroding over time as preferred shops renegotiate their agreements with insurers to reflect these economic realities.

Despite some insurers' best efforts with their preferred shops, Statistics Canada reports that as of June 2023, the cost index of passenger vehicle parts, maintenance, and repairs continued trending upwards.

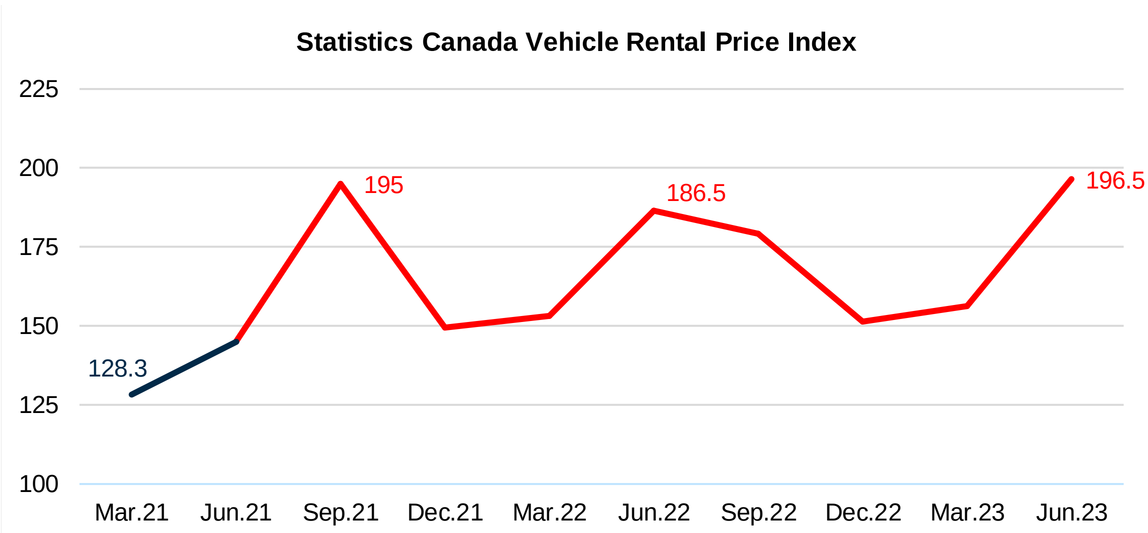


Vehicle Rentals

Although a smaller part of auto property damage claims than used vehicle prices and repair costs, vehicle rental costs remain high and volatile for two reasons:

1. There are still fewer vehicles available for rent as rental companies reduced their fleets at the start of the pandemic
2. Challenges in the supply chain for sourcing parts for repairs mean that customers need to rent vehicles for lengthy periods.

Over the past couple of years, the rental companies have replenished their fleets. However, the supply chain challenges remain, so customers continue to need to rent vehicles for lengthy periods. Statistics Canada reports that as of June 2023, the cost index for passenger vehicle rentals was 53.2% higher than before inflation's onset.



Overview & Outlook

Overall, since early 2021, the average used vehicle price increased by 46.1%, repair costs increased by 14.4%, and, subject to much volatility, vehicle rental costs increased by 53.2%. During this period, the CPI (Consumer Price Index) increased by 12.5%. Part of the reason that the inflationary impact has been greater on underlying auto insurance costs than on the typical good or service in the CPI is because of the extent to which both consumer demand and supply chain challenges have affected the cost of repairing and replacing damaged vehicles. While the Bank of Canada's actions to curb inflation through higher interest rates affect consumer demand, they do not unblock supply chains.

Canadian Black Book states that although the vehicle market has shown signs that it might be stabilizing, the "[lack] of both new and used car supply continues to be a challenge that we face with the situation slowly improving".

As for repair costs, even when supply chain challenges eventually ease, the rising cost of labour could continue driving up the cost of repairing a vehicle. RBC states that "accelerating wage growth and historic worker shortages characterized the labour market for much of 2022" and that "[as] of November, average hourly earnings rose ~10% compared to pre-pandemic levels – the fastest pace over a time period of that length since the 1990s". RBC concludes that "[with] a dearth of available workers, prospective employees will have more muscle at the bargaining table, which will in turn fuel more rapid wage growth".

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Recommendation

We agree with Oliver Wyman's approach to apply a one-time severity increase in the latter part of 2021 to account for inflation. However, given the uncertainty in the market and the evidence of continued inflationary pressure from supply chain challenges, we advise the AIRB to allow insurers to continue accounting for inflation in their severity estimates, on top of regular cost trends, for policies issued in 2024.

Conclusion

While advising the AIRB to allow insurers to continue factoring inflation in their rates, we note that actioning this recommendation requires the Ministerial Order that prohibits auto rate increases to expire at the end of 2023, as planned. We understand that the annual review is not the forum to debate the merits of this pause on auto rates. Nevertheless, the quickly developing cost trends noted in this commentary demonstrate the order's limited life span. If insurers continue to accumulate losses and do not have a path to cover their costs, moving capital away from the Alberta market becomes a legitimate option for some companies. Unfortunately, that would leave Alberta consumers with fewer product options and price points and might have broader economic implications.

We understand that the government is considering short- and long-term recommendations to improve the affordability of auto insurance. As Alberta is one of Canada's most significant economic engines and an important market for Definity, we are eager to work with the government and the AIRB on sustainable industry-wide solutions so that rate pauses are not needed in the future.

We hope the AIRB finds these comments helpful as it finishes its benchmarks for forthcoming rate approvals. We would be pleased to discuss our comments further.

Sincerely,

Ryan Stein

Ryan Stein
AVP, Regulatory and Industry Affairs

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