Regulation and the Canadian auto insurance market

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Auto insurance can be imagined as a large pool into which drivers put their money as premiums. Funds from this pool are then used to provide compensation for the losses suffered during auto accidents through claims and for the expenses of running the auto insurance business. Automobile liability insurance is mandatory for all drivers throughout Canada. This insurance provides financial protection for drivers who are held responsible for injury or loss sustained by others as a result of the action of the driver's vehicle. This automobile insurance coverage and the range of benefits vary widely from one province or territory to another. In British Columbia, Saskatchewan, and Manitoba, government run insurers[1] provide the basic mandatory auto insurance

Severe regulation creates high costs for insurers

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policy, and compete for the sale of optional[2] insurance coverage with private companies. Quebec's public insurer runs a monopoly on personal bodily injury auto insurance that covers damages to a victim's own body, but does not compete with the private sector for the sale of property damage coverage, which covers a victim's vehicle and other assets. Private insurers provide all the automobile insurance supplied in six other Canadian provinces: Alberta, Ontario, New Brunswick, Nova Scotia, Prince Edward Island, and Newfoundland & Labrador. Each provincial government sets its own standards and its own minimum limits for the amount of liability coverage that drivers must buy (IBC, 2009).

Automobile insurance is compulsory in Canada, which raises concerns about its affordability. High auto insurance rates, mostly in Ontario and British Columbia, have long been a source of anger for drivers. To combat the perceived high cost of auto insurance, different provincial governments have passed a variety of premium rate setting regulations, with varying levels of severity, and these rate control regulations are often introduced in conjunction with changes to product design and coverage mentioned above. The provincial and federal regulators claim that the primary objective of these regulations is to keep premium prices within the means of Canadian drivers. Are these regulations justified if they can reduce the burden for consumers of high premiums while meeting regulatory objectives, or is the affordability of Canadian auto insurance greatly compromised by regulatory severity?

The regulatory landscape in Canada

Both private and government-owned auto insurers in Canada are extensively regulated in the form of rate setting restrictions, mandatory minimum liability and accident benefits laws, solvency laws, etc. Insurers are regulated by both federal and provincial governments. The federal Office of the Superintendent of Financial Institutions (OSFI) is concerned primarily with the solvency (financial health) of private insurance companies that are registered under federal statutes. This includes capital requirements that serve as a cushion against unexpected losses.

Provincial regulators (e.g., the British Columbia Utility Commission (BCUC) in BC) govern the rate regulation and mandatory minimum coverage laws. Depending on the province, regulators may oversee how insurance companies assess risk, determine prices, and handle claims. Provincial regulators actively determine which factors insurers can and cannot use when setting auto insurance rates. A driver's age and gender may be considered in certain provinces, for example, but not in others. Insurers must have their risk classification system approved by provincial regulators and must also receive government approval any time they want to change their rates.

There are also differences in mandatory minimum coverage across provinces. Each determines which types of insurance protection are mandatory or optional for all vehicles and also sets minimum liability limits. For example, in 2009, the compulsory minimum third-party liability coverage was $200,000 in every province except in Quebec and Nova Scotia where drivers were required to have minimum third-party liability coverage of $50,000 and $500,000 respectively (IBC, 2009). Insurers design their products according to these coverage regulations. Some provinces permit people to sue for pain and suffering and for economic loss above and beyond their insurance benefits, but set limits on these payments.

What are the objectives of these regulatory regimes? One primary objective is to combat high premium costs . According to the regulators, rate regulation is necessary to reduce premium price variation across drivers, and specifically to reduce premium price levels for high-risk drivers who are more prone to accidents (Derrig and Tennyson, 2008). It has also been claimed that rate regulations create "efficiency" by subsidizing insurance rates for some drivers who might otherwise drive without any insurance (Keeton and Kwerel, 1984).

Is the current regulatory environment working for Canadians?

Most of the regulatory objectives are highly controversial and do not stand up well under the scrutiny of empirical research and economic theories. According to the empirical studies, most regulations aimed at reducing premiums are unnecessary and overly burdensome, thus suggesting that greater and more intrusive regulation is counterproductive.

Several studies done on US states and Canadian provinces argue against the regulatory severity in the Canadian auto insurance market. Skinner and Rovere (2010) found that compared to US states, Canadian provinces have severe regulations in the auto insurance sector. The study measured regulatory severity in 60 jurisdictions in the US and Canada and concluded that Ontario, Manitoba, British Columbia, and Saskatchewan have the most severe auto insurance industry regulatory regimes. Interestingly, drivers in these four provinces pay some of the highest premiums in Canada (Skinner, 2008).

Regulations that reduce premium price levels for high-risk drivers discriminate against better drivers by transferring cross-subsidies from low-risk drivers to high-risk drivers (Derrig and Tennyson, 2008). This cross-subsidization can conceivably reduce premiums for high-risk drivers while low-risk drivers pay higher premiums than they would otherwise if premiums were based on risk. As a result, high-risk drivers who receive subsidies are more likely to purchase insurance while low-risk

Consumers should be able to choose the insurance they need

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drivers who are charged higher prices may be less likely to participate in insured activities. This can potentially create an adverse selection problem in the insurance market by having more high-risk drivers and less low-risk drivers.

A moral hazard problem can also arise if cross-subsidization reduces the links between insurance risk and insurance prices, thus creating lower rates for high-risk drivers. When rates for high-risk drivers are lower than necessary to cover losses, the result is the encouragement of riskier driving behavior. Clearly, rate regulation is not meeting the regulatory objective of reducing the burden for drivers of high premiums.

What about solvency and minimum mandatory coverage regulations? Some sort of solvency regulation is desirable to protect consumers. However, overly stringent solvency requirements can reduce profitability and adversely affect the policyholders, as it can force auto insurers to withdraw money from high performing assets and instead invest in low performing assets (SRCL, 2011). This can reduce the investment return of insurers, which they use as a cushion against rising claim costs.

Kelly and Li (n.d.) found that if stringent rate control is introduced in conjunction with changes to product coverage—which has been a case for varying mandatory coverage systems in Canada across provinces—it forces insurers to redesign their products, which can also lead to increased costs.

Conclusion

The findings clearly show that tougher regulations in Canada are actually making auto insurance more unaffordable. Rate regulations create high costs for insurers via moral hazard and adverse selection. If solvency regulations become onerous, they can cause investment returns to go down. At the same time, mandatory minimum coverage regulations raise the product redesign costs and hinder insurer innovation. These will all lead to higher costs for insurers, and consumers will pay for these costs through elevated premiums.

Premium prices can be determined either by competitive pricing, where market forces set the price through effective competition among a large number of players, or by regulatory pricing where regulators set the prices through different levels of rate setting and product design regulations. The latter clearly doesn't work. Then what policy will benefit consumers? Leadbetter et al. (2004) suggested using competitive pricing in auto insurance settings. Their empirical study found that premium volatility in Ontario began increasing following the introduction of rate regulation in 1989. Prior to this, unexplained volatility in Ontario's automobile insurance premiums was less than for Alberta and the Atlantic provinces, which operated with rate regulatory regimes while Ontario allowed prices to be determined by market forces. Therefore, scaling back regulatory severity and allowing prices to be determined by market forces will benefit consumers. Empirical evidence and economic principles suggest that as long as prices are determined by competition rather than by rate regulation, solvency is appropriately regulated (see Harrington, 1991) and consumers have the freedom to choose the kind of auto insurance they need, and we should expect to observe lower premiums in Canada.

Notes

1 The government-run monopolies are the Insurance Corporation of BC (ICBC), Saskatchewan Government Insurance (SGI), and Manitoba Public Insurance (MPI). In Quebec, the government-run insurance body is Société de l'assurance automobile du Québec (SAAQ).

2 These are collision insurance that covers damages to a driver's own vehicle as a result of an impact with another vehicle, object, or person, and comprehensive insurance that covers damages caused by fire, theft, vandalism, etc. This coverage is not mandatory.

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