# Final Arguments: ICBC Rate Request 2014

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*Every great cause begins as a movement, becomes a business, and eventually degenerates into a racket.*

Eric Hoffer, "The Temper of Our Time"

## CHAPTER 1: CONCEPTS AND RECOMMENDATIONS

### 1.1 INTRODUCTION

The 2014 rate request marks the eleventh year of the Utilities Commission's regulation over the monopoly auto insurance operated by the Insurance Corporation of British Columbia (ICBC). It would seem an appropriate time to assess the performance of the Commission in meeting the objectives of its governing legislation and regulations, and of representing the interests of policyholders compelled to purchase Basic insurance from ICBC.

In 2003 the government adopted the recommendations of the Core Review of ICBC. The new Liberal government was intent on bringing about significant change to many key government programs, and providing more competition and choice for consumers of public services. The new administration believed, with some justification, that previous governments had manipulated auto insurance rates to achieve short-term political advantage. This suspicion was common to all new governments since 1975.[1] The 2003 changes formally separated the compulsory Basic insurance from the Optional insurance and transferred the regulatory authority over the Basic monopoly to the Commission. This was intended to depoliticize the rate setting process and allow more public disclosure. As the finance minister said at the time: "It will probably take politicians a while to get used to not telling ICBC what to do all the time."[2]

In the summer of 2004 the government provided some principles and objectives to guide the Commission through a regulation known as Special Direction IC2 (SD IC2). This was in addition to the general direction in the legislation that allowed the Commission to regulate Basic insurance in a manner that the Commission considered "adequate, efficient, just and reasonable."[3] SD IC2 required, among other things, that the Commission:

- Set rates according to actuarially accepted standards.
- That rate changes be phased-in so that rates remain relativity stable and predictable,

[1] See R. C. McCandless, Politics and Public Auto Insurance in British Columbia, 1970-2010, BC Studies, Summer, 2013; 2013 Rate Request, Exhibit A2-10.
[2] Hansard, November 20, 2003, p. 1145.
[3] BCUC Decision, January 19, 2005, p. 7.

- That capital levels would be based on the Office of the Superintendent of Financial Institutions' (OSFI) guidelines,
- The Basic capital would be maintained (after a 10 year phase-in) at a Minimum Capital Test (MCT) ratio of 100%, while the Optional was sent at 140% (soon changed to 200%),
- The Basic insurance program must not subsidize the Optional insurance, and
- The Commission was subject to cabinet direction.

In the last 10 years the SD IC2 has been amended on a number of occasions, which has constrained the independence of the Commission in its oversight of the Basic program and forced it to implement decisions made by cabinet.[4]

The requirements that rates be set in accordance with accepted actuarial practice to balance annual revenue with expenditure (annual change to cover costs), and that rates remain relatively stable and predictable, has sometimes led to conflicting outcomes. The Commission has tried to find a balance between the two objectives. In the years since the Commission was given the regulatory authority over the Basic program the government has become more interventionist in its management of the process, and of its direction to the Commission (and ICBC) respecting rate setting and ICBC finances. Cabinet over-rode the Commission's capital policy in 2010 and 2011, transferred Optional capital to Basic in 2012 and 2013, and limited the Commission's rate setting authority in March, 2013.

Clearly the government (which continues to appoint the ICBC board of directors) has not de-politicized the management of ICBC, nor the Basic monopoly. In 2010, during the recession that followed the financial crisis of 2008/09, the government changed ICBC's governing legislation to allow the transfer of "excess" Optional capital to the government's own accounts. ICBC's net income is treated as government revenue and its total capital ($ 3.2 billion in FY 2013) counts as government assets; however the government has no equity in the corporation.[5]

The Commission has persevered in attempting to provide a public interest perspective on the regulation of Basic insurance. Through the detailed rate reviews of 2006 to 2014 (excepting 2008, 2009 and 2011 when no rate change was requested) the Commission and interveners have attempted to hold ICBC to account, and provide interested parties, and private and commercial holders of some 3.0 million Basic policies, the assurance that the rates are reasonable and just (although no rate rebalancing has yet been requested by ICBC). The reviews also provide some insight into the attitude of the senior management at ICBC and how they have adapted to the oversight of a now semi-independent regulator.

The Commission has not been a success in managing the capital levels of the Basic program. For reasons that will be developed in more detail in this submission, the Commission erred in its interpretation of the capital target material presented by ICBC during the 2006 and 2007 rate and capital reviews. The

[4] See Rowland J. Harrison, "Independence and the British Columbia Utilities Commission" in Independent Review of the British Columbia Utilities Commission, October 1, 2014.

[5] The government also uses the Basic program to fund other public services, provide a 25% senior discount and to pay for the administration of driver licences while collecting a fee for the licence (approximately $ 50 million in FY2013).

Commission chose to set the Basic capital management MCT target at 130%, and the target rose to 145% with the 2013 decision (with a +160% level required before any rebate to policyholders).

Responsible Basic policyholders purchase Optional insurance because the Basic third party limit of $200,000 has not changed in over 25 years,[6] and the Basic program does not provide for property damage to the at fault party's vehicle. The government chose not to provide the Commission with the regulatory authority over the Optional program. The result has been a focus on the Basic program even though approximately 86% of Basic policyholders buy ICBC's Optional insurance.[7] The Commission's single focus on Basic insurance as an entity means that it cannot review the highly profitable Optional program, and incorporate the high Optional capital level into a broader review of ICBC's financial health. Basic policyholders (who are Optional policyholders) suffer as a result.

The Commission has not forced ICBC to provide multi-year financial and operational forecasts of its Basic program. Rate requests focus almost entirely on the forthcoming policy year (currently November 1 to October 31), and provide financial comparisons of the new policy year forecast with the forecast of the previous policy year request. Most historic data sets are by fiscal year (which is the accident year); therefore comparisons with policy year data are difficult. Basing forecasted revenue and expenditure comparisons on a previous forecast can soon lead to a drift from reality. Multi-year forecasts are critical in determining the longer-range implications of various funding and capital scenarios. The Commission has not required ICBC to publically report quarterly Basic financial data, which is an important adjunct to the annual rate review process. In recent years the review bodies in Saskatchewan and Manitoba have been reviewing the rate and capital requests of the public auto insurance monopolies in those provinces, and the Commission could benefit from a closer relationship with those agencies.

## 1.2 CONSIDERATIONS

### 1.2.1 ACCEPTED ACTUARIAL PRACTICE AND INFORMED JUDGEMENT

Basic rates must be calculated using accepted actuarial practice, which appears to require that a member of the Canadian Institute of Actuaries (CIA) use their practice guides and standards. ICBC's rate recommendation is developed using a prospective process that incorporates a variety of expenditure forecasting models run by its actuaries. The product of these models is then reviewed and adjusted by ICBC's external actuary (Mr. Weiland) who applies "informed judgement" to produce the final recommendation. The rate request is generally in two parts; that required to match revenue with expenditure for the period, and that necessary to achieve the desired capital reserve level. Actuarial judgement is used in every forecast, as Mr. Weiland stated in 2006 "…there's certainly judgement in

[6] On an inflation-adjusted basis the $ 200,000 limit is worth approximately $ 40,000 today. The wage replacement coverage limits have not changed since 1991.

[7] ICBC's Optional program is a near monopoly with approximately 90% of the market.

pretty much all of our work that needs to be applied."[8] This was also noted by the Commission in its 2006 rate decision;"…there is a range of assumptions that fall within accepted actuarial practice."[9]

Given the number of variables involved in developing a recommended rate for a period extending some 16 to 18 months in the future, it is clear that rate forecasting is more an art than a science. ICBC has acknowledged that a range of assumptions can be consistent with accepted actuarial practice, as long as those assumptions are reasonable and based on the information available at the time.[10] ICBC also notes that the forecasting of loss trends requires analysis and judgement based on statistical models, advice from claims staff and the actuary's knowledge of the business and relevant economic and social influences.[11] The most obvious use of "informed judgement' in the 2014 rate request is the bodily injury (BI) adjustment for favourable weather during 2013.

It is to be expected that there will be a degree of misestimating when the actual result for the forecasted period is known. The misestimating can result in a positive or negative impact on the net income (income statement) and on the capital reserve (balance sheet). At certain periods the impact of the misestimating of the average BI claim cost was compounded by a delay in seeking a rate increase (especially in 2005/06, 2011 and early 2013). These delays increased the volatility of the fiscal year change in Basic net income and capital. The move to a fixed annual rate review date, and the Commission's willingness to grant speedy interim rate approvals, should eliminate this source of volatility.

### 1.2.2 GROWING COMPLEXITY

The rate setting process has become more complex with changing approaches to forecasting costs, and terminology that is foreign to all but those well versed in the often intricate nature of insurance.[12] The new price control scheme adds yet another layer of complexity. Public understanding of why they are paying the rates they are for compulsory auto insurance has suffered.

The annual rates are an amalgam of the cost of annual insurance (including non-insurance expenditures), and costs that relate to the capital reserve. One simple way to reduce complexity is to require a clear separation between items relating to the income statement and those that relate to the balance sheet. Most policyholders would not appreciate the difference, but the Commission should find such a separation useful in its analysis and in monitoring actual performance. Also, under the new price control scheme, changes to the capital reserve assume a greater importance to the overall annual requirement.

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[8] 2006 RR Hearings, Vol. II, p. 189.
[9] 2006 RR Decision, July 13, 2006, p. 17.
[10] 2012 RR BCUC IR 159.2, response.
[11] 2014 RR CDI IR 5.2, response.
[12] For example, the calculation of the capital maintenance is very convoluted.

### 1.2.3 RELATIVE STABILITY OF RATES – THE CAPITAL RESERVE

The government's objective of relative rate change stability and predictability has been in place since the Commission assumed oversight over the Basic program. The objective implies a multi-year dimension to reduce the potential volatility of annual changes inherent in the cover costs pricing scheme. This longer-term definition of relative stability was confirmed by Ms. G. Prior, ICBC's senior financial officer, during the 2006 rate hearing.[13] More recently, ICBC has suggested that rate stability must be considered over a five to ten year period.[14]The government has often cited the relative stability objective as a reason for its interventions in the capital and operating components of the rate setting process.

A sufficient and well managed capital reserve is the balancing mechanism designed to moderate large and unexpected fluctuations in expenditures. Rather than respond with a large change to rates ("rate shock"), capital is drawn down in a weak financial period then rebuilt to the target level. In a strong financial period capital above the target can be released to moderate an indicated price increase. To function properly the reserve must have an adequate level of capital, and management or the regulator must allow more than one year for the moderation to occur. To recoup the capital reduction in the following year would defeat the purpose of the balancing mechanism.

In 2013 ICBC seemed to adopt the position that the 130% capital reserve target was not intended to provide a fund to moderate annual rate changes, rather the additional 30% margin was to protect the 100% regulatory target. More capital would be needed to smooth volatility.[15]

### 1.2.4 RELATIVE STABILITY OF RATES – PRICE CONTROLS

In March 2013 the government imposed a form of price control (rate smoothing) on the Commission, beginning in PY2013. In essence, the government preferred to use the Basic capital reserve to a greater extent than previously to attempt to limit the recent volatility in rates (volatility resulting in part from the irregular timing of rate requests). Under a controlled price scheme capital would be depleted where costs were increasing faster than revenue. The reverse would be true if the controlled price produced more revenue than required.

The price control approach to meeting the relative rate stability objective has the potential of adding more volatility to the balance sheet. It also will weaken the ability to base annual rate changes on accepted actuarial practice to produce a rate change to cover costs.

[13] 2006 RR, Hearings, Vol. III, p. 418.
[14] 2013 RR, BCUC, IR 2.1, response.
[15] 2013 RR, BCUC IR 181.1 response.

1.2.5 CAPITAL RESERVE – WHAT IS ADEQUATE?

Since 2004 the government has required that the Basic program maintain a capital reserve at the OSFI defined MCT level of 100%. In the first rate request (2006) there appeared to be a good deal of confusion as to whether this level was adequate as a working or management target. The Commission rejected ICBC's rationale for adopting the 100% level as the management target, and agreed to a 130% target the following year. Following the 2013 price control directive the Commission added a further 15% margin, and set the rebate target at +160%.

The Saskatchewan and Manitoba compulsory auto insurance monopolies also base their capital management targets on the OSFI MCT guidelines. However, their recent capital stress tests indicate that the 100% MCT level is adequate as a management target. The Saskatchewan Auto Fund (SAF) specifically rejected a larger capital margin: "As a monopoly, SAF's capital target should represent that level required to remain solvent in all plausible maximum loss events, without the establishment of any excess capital buffers."[16]

A major argument of this submission is that the Commission should reduce the management capital target to 100%. This does not preclude the Commission from setting specific year rates on the basis of a higher MCT, but the 100% level is adequate for ICBC's Basic management target.

At a MCT of 100% the Basic program FY2013 assets would have exceeded liabilities by some $ 1.15 billion. Reducing the management target to the 100% MCT level would increase the risk that after a series of poor financial years, the capital level may decline below the management target, which would necessitate a capital rebuild surcharge. This is in keeping with the shock absorber function of the capital reserve. Lowering the management target would also lessen the volatility in the balance sheet. For example, the $ 1.1 billion growth in unpaid claim liabilities between FY2010 and FY2013 required an additional $ 110 million in risk free capital to maintain the 100% MCT level, plus a further $ 33 million to maintain the 130% management target, and $ 17 million more at 145%. The additional 45 basis points added some $ 50 million to the cost of providing for the growth in the claim backlog (see Appendix VII).

A capital management plan similar to that in place from 2007 to 2010 would require that, where the actual MCT was below the target, 1/5$^{th}$ of the difference be recouped as a capital surcharge for five years. Such a plan meets the criteria included in the government's 2013 rate smoothing directive. From the policyholder's perspective, to recover, for example, $ 100 million over five years to restore a 100% MCT target is no different than recovering the same amount, over the same period, to restore a 130% MCT target.

The government's SD IC2 requires the Commission to set rates to allow the Basic program to maintain a MCT of 100%, but it does not say that the rate must ensure that the 100% level is achieved each year.

[16] Saskatchewan Rate Review Panel, SAF 2014 Rate Application, MFR 15.

This was ICBC's position in 2006.[17] In fact, the 2013 price control directive contemplates circumstances where the actual MCT will be below the 100% MCT level.

1.2.6 CAPITAL TARGET EQUIVQLENTS

The following summarizes the OSFI MCT ratios at various target levels for the Basic program compared to those of the two other monopoly insurers.

BASIC MCT -- TERMINOLOGY AND LEVELS

| | OSFI | ICBC | SAF | MPI (1) |
|---|---|---|---|---|
| SOLVENCY | 0 | 0 | 0 | o |
| MIN./INTERVENTION | 100 | 100 | 100 | 100 |
| SUPERVISORY (2) | 150 | 100 | 100 | 100 |
| MANAGEMENT | 150+ | 130 | 100 | 100 |
| RATE SMOOTHING | N/A | 145 | N/A | N/A |
| CAPITAL REBATE | N/A | 160+ | 100 | 100 |

(1) The MPI is awaiting approval of the Public Utilities Board.
(2) The ICBC regulatory level of 100% is equivalent to at least the OSFI supervisory level.

The following summarizes the OSFI MCT values at various target levels for the Optional program compared to those of Intact Financial and the Co-operators General Insurance.

OPTIONAL MCT --TERMINOLOGY AND LEVELS

| | OSFI | ICBC | INTACT FIN. | CO-OP GEN. |
|---|---|---|---|---|
| SOLVENCY | 0 | 0 | 0 | 0 |
| MIN./INTERVENTION | 100 | 200 | 100 | 100 |
| SUPERVISORY | 150 | 200 | 150 | 150 |
| MANAGEMENT | 150+ | 260 | 170 | 180 |

By regulating to the government's minimum MCT of 100% for the compulsory monopoly Basic program an observer might conclude that this level was equivalent to the OSFI supervisory target. Yet it is also the equivalent of the OSFI management level because the government set the target in 2004 to accord to the OSFI classification system. It is logical to conclude that if the government determined that the Optional level of 200%, which is clearly in excess of the OSFI supervisory level, is acceptable as a management target, then so too is the 100% for Basic acceptable as the management target.

[17] 2006 RR, BCUC IR 20.6 response.

By not clarifying in 2006 the compulsory/monopoly MCT equivalents to the OSFI targets for competitive market insurers ICBC gave the Commission the impression that the 100% level (often described as the regulatory or minimum target) was a financial third rail, and that anything less was risking the financial solvency of the program.[18] A modified form of the CIA Dynamic Capital Adequacy Test (DCAT) methodology, intended to test solvency and financial condition, was employed to recommend a management target higher than the competitive sector examples (if the compulsory/monopoly 100% equates to the OSFI competitive sector management target, then the BCUC 130% Basic management target is higher than that chosen by Intact Financial). The confusion respecting the relationship of the regulatory 100% and the OSFI target persists even today -- in 2013 ICBC asserted that the proposed 150% target represented the OSFI supervisory target.[19] In May 2014 the Commission stated that any MCT percentage below 100% "would reflect the risk of insolvency for Basic insurance."[20]

**1.3 RECOMMENDATIONS**

With over a decade of experience in regulating ICBC's Basic program it seems an appropriate time to review and reflect on what has been achieved, and what approach the Commission should adopt for the future. From this observer's perspective, the rate review process has been ensnared in the trap of detail. The insurance industry has developed its own lexicon of terms and complex methods to forecast expenditures and revenues. The Commission has too often succumbed to the temptation of exploring many of the myriad (and sometimes arcane) assumptions and forecasting methods that result in the rate request. Some assumptions have significant financial implications, while others have little impact or their impacts are offset by some other factor. Too often, it seems, in the absence of a longer-term focus or context, the rate review process has become a form of operational audit.

The Commission was provided the mandate to regulate the legal auto insurance monopoly to represent the public interest, and to de-politicize the rate setting process. If the Commission adopts the premise that it represents Basic policyholders and claimants it would begin the process of developing a more focussed approach.

Insurance costs are subject to short term volatility due mainly to factors that ICBC cannot control, such as crash frequency and severity, interest rates and changes in the financial markets affecting asset values. This sometimes results in significant trends, such as BI costs or the growth in claim backlogs, being partly masked by other factors. Rate setting has also been influenced (and more directly controlled since March 2013) by the government seeking to achieve the sometimes contradictory objectives of financial viability and relatively stable price changes.

[18] At that time ICBC's chief actuary said she was unfamiliar with the OSFI classification system, see 2006 RR Hearings, Vol. II, p. 519-20.
[19] See 2013 RR, BCUC IR 69.6 response.
[20] BCUC Decision, May 14, 2014, p. 28.

A modified approach to regulating the Basic program will require the Commission to revise its current relatively passive approach. Rather than judging the reasonableness of annual rate changes, the Commission should adopt a longer-term (3 to 5 years) planning horizon. This will require ICBC to develop multi-year financial and other performance objectives for the Basic program, and a reporting system that provides adequate and consistent information and analysis on progress toward targets. The objectives should include policy issues such as:

- Is the trend in BI cost increases sustainable?
- Are the inflation eroded coverage limits adequate?
- What are appropriate claim processing times?
- Are vehicle risk classifications fair?
- Is the paper based sales model still appropriate?
- Is ICBC efficient and effective?

Some of these issues have been raised during various rate reviews, but not in a structured way, or in the context of ICBC reporting on progress toward a Commission standard or target.

The longer-term focus will require ICBC to shift some resources from preparing and defending the annual rate proposals to more emphasis on planning and reporting on results.

The following recommendations are offered in the context of moving to a longer-term, objectives-orientated regulatory approach.

**1.0 CAPITAL**

**1.1 Separate the rate approvals between capital and operating.**

**1.2 Set the Basic capital management target at 100% MCT effective November 1, 2014.**

**1.3 Once the actual MCT approaches the management target set annual capital rate adjustment to achieve a 110% level to recognize the risk resulting from price controls.**

**1.4 Where the forecasted actual MCT falls below 100% set the rebuild rate to recover 1/3$^{rd}$ per year; and if the MCT exceeds 115%, release 20% of the difference as part of the following year rate adjustment.**

**1.5 Require ICBC submit a DCAT analysis using CIA guidelines (with FY2014 as the base year) for the 2015 rate submission.**

**2.0 OPERATING**

**2.1 Continue the current interim approval for the balance of PY2014, but set a combined increase of 3.7% as the PY2014 base for PY2015.**

**2.2 Set multi-year rate change targets similar to those shown in Table 1.0.**

**2.3 Require ICBC to submit plans to (a) reduce the unpaid claim liability to $ 6.0 billion by FY2017, and (b) to hold to $ 6.5 billion by FY2017.**

**3.0 PROCESS**

**3.1 Require that future rate requests (e.g. PY2015) and supporting data be filed in a fiscal year format, and in a policy year format where necessary for clarity.**

**3.2 Require that the financial implications be forecasted to FY2019 with FY2014 as the base year.**

**3.3 The multi-year format be the same as that on page 87 of the 2013 annual report (including the MCT), including the percentage change, and a commentary and analysis of the reasons for the assumptions used to develop the forecast.**

**3.4 Require that ICBC publically file quarterly financial reports on the Basic program, including an analysis component. These should be based on the page 87 format of the FY2013 annual report, and include the MCT.**

TABLE 1.0: CAPITAL REDUCTION AND RATE SMOOTHING SCENARIO

| | FY2014 | FY2015 | FY2016 | FY2017 | FY2018 | FY2019 |
|---|---|---|---|---|---|---|
| **Operating ($=mil)** | 130.0 | 112.5 | 112.5 | 112.5 | 112.5 | 112.5 |
| **%** | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 |
| **Capital Res.($=mil)** | (37.5) | (57.5) | (95.0) | (112.5) | (62.5) | (25.0) |
| **%** | (1.5) | (1.8) | (3.3) | (4.0) | (2.5) | (1.0) |
| **Total ($=mil)** | 92.5 | 55.0 | 17.5 | 0 | 50.0 | 87.5 |
| **%** | 3.7 | 2.2 | 0.7 | 0 | 2.0 | 3.5 |
| | | | | | | |
| **Capital Res.($=mil)** | 1,700 | 1,642 | 1,547 | 1,435 | 1,373 | 1,348 |
| **MCT Ratio** | 145 | 140 | 132 | 123 | 117 | 115 |

This scenario splits the rate change between operating (income statement) and capital (balance sheet), and assumes no change in policy volumes or the average premium revenue. It also assumes that unpaid claim liabilities remain constant through the period. Based on ICBC's 2015-2017 service plan (released

on February 18, 2015) one would conclude that a smaller annual growth rate for operating costs is warranted because the Basic claim cost rate change is more pronounced than the Optional change.

## CHAPTER 2: THE BURDEN OF CURRENT CAPITAL LEVELS

### 2.1 THE COST OF THE OPTIONAL CAPITAL TARGET

The Optional insurance management target is 260%. This number is not published by ICBC, but was included in the government's 2012 review of ICBC.[21] The management target is 110 basis points higher than the OSFI supervisory target for private insurers, 90 basis points higher than that of Intact Financial and 60 basis points higher than the government minimum.[22] Why the Optional target was set at such a high level has not been explained by the ICBC board.

Some 86% of Basic policyholders buy their Optional insurance from ICBC,[23] and the ratio has remained relatively unchanged since 2004 when the changes to the Optional product were implemented.[24] It would appear that the private insurers have been unable or unwilling to lower their prices to attain a larger market share. Some 3.1 million annualized Basic policies are expected for PY2014, therefore it is estimated that some 2.7 million Optional policies will be earned in this period. The 260% MCT target will require (using FY2013 data) approximately $ 1.65 billion in capital (or some $580/policy). A reduction to the regulatory minimum would save approximately $ 380 million (some $ 140/policy), and a reduction to the equivalent target of Intact Financial would save $ 570 million (some $ 210/policy). Reducing the capital management target will also require a reduction in the average price per policy otherwise the government will have an even greater windfall gain from Optional policyholders.

### 2.2 THE COST OF THE BASIC CAPITAL TARGET

Using the FY2013 data, the Basic capital management target of 145% would equate to some $ 1.67 billion. The target, following the Commission's decision to add 15% for the risk related to price controls (rate smoothing), is 45 basis points higher than the DCAT tested 100% targets adopted by the other two public auto monopolies. The additional capital required (using FY2013 actual) to maintain the extra 45%

[21] See Ministry of Finance, Internal Audit and Advisory Services, ICBC Review, 2012.
[22] See 2014 RR, Intervener Submissions, Exhibit C4-3.
[23] See ICBC customer survey in 2014 RR, p. 10-4.
[24] See 2006 RR, BCUC IR 39.2 response, Attachment A, p. 10.

margin is approximately $ 520 million (or about $ 170/policy). If one assumes that the government 100% minimum is equivalent to the OSFI competitive sector management target (as the two other public monopolies do) then the Commission's pre-control Basic management target of 130% is 30 basis points higher than the target of Intact Financial.

The high capital target has other consequences for the Commission and Basic policyholders beyond the extra carrying cost.[25] The OSFI MCT rules require that a risk premium of 10% be added to the unpaid claim liabilities. For FY2013 the Basic unpaid claim liabilities totalled $ 5.7 billion and ICBC anticipates this will grow by some $ 300 million in FY2014. The 10% risk factor on $ 6.0 billion requires $ 600 million in equity at the 100% MCT level, while at 145% the additional capital required is $ 270 million, or some $ 87/policy. The FY2014 growth in unpaid claims liability adds approximately $ 13.5 million to the total cost of Basic insurance (equivalent to a 0.5% rate increase) that would be avoided at the 100% level.[26]

The higher capital target also requires more revenue to fund the capital maintenance. ICBC says that the increase in the capital maintenance is being funded from equity generated investment income, implying that this is avoiding a further increase in rates.[27] In fact, if the management target was lowered more of this investment revenue could be used to offset future rate increases rather than being notionally used to offset the growing cost of maintaining the capital ratio. In a time of low interest rates every investment income dollar possible should stay on the annual income statement.

In summary, the higher capital management target comes at a significant cost to Basic policyholders. The extra 45% capital margin ($ 540 million using FY2013 results) is in essence a contingency fund on top of the $ 1.1 million contingency already incorporated into the OSFI calculations of the MCT, and one that grows by a compounded rate with the growing cost of claims and liabilities. Rather than providing insurance against volatility, the large capital reserve, especially if it is in the form of higher OSFI risk weighted assets, can have the effect of **increasing** the degree of volatility of the funding required, especially if ICBC allows the unpaid claim liability to grow at the rates experienced during the last four years.[28]

[25] Or opportunity cost.
[26] ICBC forecasts that unpaid claims liabilities will rise by approximately 5% per year to 2017 (approximately $ 900 million), requiring an additional $ 90 million for the 100% target and a further $ 40 million for the 145% management target; see 2014 RR, RM IR 3.a response Attachment A, p. 6.
[27] 2014 RR, RL IR 5.12 response, Attachment A.
[28] The 2015-2017 service plan suggests that the growth rate of total liabilities will exceed the growth rate in current year claims (see p. 13).

## CHAPTER 3: A REVIEW OF ICBC CAPITAL LEVELS -- THE QUEST FOR STABILITY

### 3.1 THE PURPOSE OF A CAPITAL RESERVE

A capital reserve is required to protect the corporation's policyholders and claimants from a sudden and unexpected deterioration in the corporation's finances. Federally regulated property and casualty (P&C) insurers in Canada must maintain a sufficient capital level calculated from risk based guidelines issued by OSFI, known as the Minimum Capital Test (MCT). As a provincial Crown corporation ICBC is exempt from the OSFI rules, but the government directed that it do so when it restructured the regulation of Basic and Optional programs. The OSFI guidelines require that insurers operate with a minimum risk-adjusted 100% MCT ratio but state that the ratio should be at least 150% (supervisory level), with an additional margin to reflect the company's specific or unique characteristics. For example, Intact Financial, the largest private auto insurer in Canada, operates with a MCT target ratio of 170%.

### 3.2 CALCULATION OF THE MCT

The OSFI guidelines require P&C insurers to adjust their actual assets and liabilities by applying risk factors to calculate the MCT. The primary risk factors for ICBC are:

- government bonds – zero risk
- high grade bonds—up to 8% risk
- common shares – 15% risk
- mortgages – 8% risk
- unpaid claims –10% risk
- unearned premiums –10% risk

For FY2014 ICBC calculated that the Basic program required approximately $ 1.2 billion in capital to achieve a 100% MCT, with the main components estimated at:[29]

- 10% of $ 5.7 billion unpaid claims $ 552 million
- 10% of $ 1.1 billion unearned income $ 100 million (includes deficiency)
- 15% of $ 3.0 billion common shares $ 450 million

The mix of assets is important, for example if all of the Basic assets were government bonds the 100% ratio could be achieved with some $ 500 million less capital, or a decline in the value of unpaid claims would also have a favourable impact on the 100% MCT calculation.

[29] 2014 RR, BCOAPO et.al. IR 15.2-4, response.

By FY2013 ICBC had total capital of $ 3.64 billion equating to a MCT of 204%. Basic capital totalled $ 1.71 billion (MCT of 149%) and Optional was $ 1.93 billion (MCT of 304%). The third quarter financial summary, released on December 12, 2014, shows the corporate MCT at 211% as of September 30th. The 2015-2017 service plan forecasted a MCT of 193% for FY2014 after transferring $ 130 million to the government. Is this amount of capital appropriate? Is the current Basic target appropriate?

### 3.3 WHAT CAPITAL LEVEL IS APPROPRIATE?

The amount of the capital reserve is of fundamental importance to the annual determination of the price of Basic and Optional policies. The government also has an interest in ICBC's capital levels because the equity is included in the government's financial statements as a government asset (although the government has no equity in the corporation).

When the government implemented the decisions of the 2003 core review Basic insurance continued as a public monopoly, while ICBC's Optional insurance would continue to compete with private insurers. To de-politicize the control of ICBC the Basic program oversight the rate setting authority, including the setting of the MCT target, was transferred to the BC Utilities Commission. Within seven years the government had mostly abandoned this de-political objective.

For some reason when the initial split of Basic and Optional accounts was made the government assigned most of the existing capital to Optional, leaving the Basic program seriously under-capitalized. This was partially corrected in 2005 with the transfer of $ 530 million in capital from Optional to Basic, but the Basic MCT was only 79% that year. The initial misallocation had consequences when the Commission began their review of the Basic finances.

The provincial cabinet, through regulation (Special Direction IC2), set the minimum MCT target for Basic at 100% and 200% for Optional insurance. The Basic MCT was to be achieved over a number of years and was based on the recommendations of a joint government/ICBC staff committee which used a 2003 report prepared by Mr. W. Weiland of Eckler Partners, the external actuary to ICBC. The Basic ratio was set less than the OSFI management level for competitive insurers to reflect the monopoly position of the Basic program, and the fact that most of the assets in 2003 were no-risk government bonds.

In January 2005 the Commission directed ICBC to submit a capital plan for Basic insurance. ICBC complied by including a capital plan and a stress test in their August submission to establish the Basic rates for 2006 (no change in rates from 2005 was initially requested). A stress test of the capital level, known as a Dynamic Capital Adequacy Test (DCAT), was prepared by ICBC's external actuary, Eckler Partners.

### 3.4 THE 2005 DCAT REPORT

The purpose of a DCAT is to model the impact on an entity's capital reserve of a sudden and unexpected deterioration in revenue, an increase in costs or a decline in assets. The DCAT modelling follows

guidelines developed by the Canadian Institute of Actuaries (CIA), and is a requirement for insurers supervised by OSFI. A short to mid-term base scenario (Eckler used five years) was developed from a base year with assumed changes to revenue, expenditures and capital. The impacts of selected adverse scenarios are then calculated to determine the change in the capital of the base scenario. The adverse scenarios tested are to be plausible, and occur with a certain probability range (once in 45 years or once in 99 years).

The 2005 Eckler analysis was in two parts and assumed that Basic was a stand-alone financial entity. The selected adverse scenarios were a jump in inflation, a drop in equity values, an under-estimation of unpaid claims and a sudden rise in the cost of claims. The second part of the report was a modified version of the CIA DCAT which assumed the 100% MCT was the base (rather than solvency). During the rate review a number of concerns were raised about the modified - DCAT report assumptions, which included the three year lag before a price increase, and the likelihood of an increase in inflation without an increase in the discount rate on unpaid claims. The inflation adverse scenario had the greatest impact on Basic capital, and the average of the four suggested a MCT target of 128% (rounded to 130%).

ICBC recommended a capital management target of 100% in the belief that if the Basic program encountered financial difficulty the Optional capital reserve was available as a temporary backstop until the Basic capital could be rebuilt. At the time ICBC took the view that the OSFI supervisory target level could apply to the corporation as a single entity. They also said that a 100% ratio would help to keep Basic rates at a reasonable level in achieving the low cost objective.[30]

During the last four months of the 2005 fiscal year Basic average claim costs rose rapidly, and in January 2006 ICBC was forced to refile seeking a 6.5% rate increase. Needless to say this change, following ICBC's assurance as late as October that the rates would not need to increase, did not instil much confidence in the Commission in ICBC's forecasting ability. "This proceeding has highlighted the dynamic nature of the business, the volatility of losses, the DCAT and MCT results, and the apparent difficulty of the Corporation to make reliable and stable predictions of its business results—even in a relatively short-term timeframe."[31] This was ICBC's first rate request to the Commission and the first where the appropriate level of working capital was under review.

In their July 2006 decision the Commission considered the 100% MCT ratio for Basic (and 200% for Optional) as the minimum, and directed ICBC to provide a new Basic target within the range indicated in the Eckler report. The direction to ICBC assumed that the suggested MCT target in the modified DCAT report conformed to accepted actuarial practice.[32] None of the interveners had suggested that the Basic 100% MCT target was inadequate.

The modified DCAT report had the form of a review of capital adequacy but it was fundamental y different in that it used modified adverse scenarios to suggest a MCT level above the 100% minimum as the management target for the Basic program. This difference will be more fully explored in Appendix I.

[30] See Appendix III.
[31] 2006 RR BCUC Decision, July 13, 2006, p.88.
[32] IBID., p.30.

### 3.5 THE 2007 FILING

ICBC submitted the 2007 Basic rate request (a 3.3% increase) in March 2007 and now recommended a capital MCT target of 130%. A revised modified DCAT report (February, 2007) was included and again inflation was the most adverse scenario, and again there was no increase in the discount rate and the response time remained at 36 months. The base scenario continued to show Basic capital below the 100% ratio[33] for the period under review, and ICBC said that the Optional capital was available in the event of a serious short term adverse event.

During the July hearings ICBC admitted that because of the overly long response time frame the adverse inflation scenario was not plausible, but there was no meaningful discussion of the lack of a related increase in the discount rate on unpaid claims. It was noted that OSFI was changing their MCT guidelines in January of 2007 to include the market value of assets (from book value), and this led to some confusion as to the true state of Basic capital under the new guidelines. ICBC filed revised DCAT tables in early September 2007 using the new guidelines and more recent financial results. No analysis was provided and the assumptions supporting the adverse scenarios did not change from the February report. However, the external actuary (Eckler) now concluded that the Basic program was in a satisfactory financial condition.

Despite the improved financial condition of the Basic program, and the favourable September report on the capital position, the Commission's decision of January of 2008 was still skeptical that the 130% target level was sufficient. The Commission approved the capital management plan (including rules on capital maintenance, build and rebates), but wanted more assurance that the 130% target was high enough and the probability level was appropriate. Perhaps the September DCAT partial resubmission was not fully understood.

### 3.6 THE 2008 CAPITAL REVIEW FILING

On June 30, 2008, ICBC filed a report concerning the adequacy of the 130% MCT target. The report summarized the previous DCAT filings and included updated financial information. The 2008 report now said that the misestimating of the unpaid claims liability was the most adverse scenario. The report said that the 130% target was sufficient at a probability level of about 1 in 15 years.

During 2008 and 2009 ICBC benefitted from a decline in claim frequency and other positive financial developments. The corporation did not file for a rate increase in 2008 or 2009, while Optional rates were reduced by 3.0% and 3.3% respectively during these years. By year-end FY2009 the Basic MCT had reached 162% ($ 1.6 billion), and the Optional MCT had jumped to 388% ($ 2.0 billion). However the effects of financial crisis of 2008/09 and the subsequent recession were beginning to be reflected on ICBC's books, as well as the books of their sole shareholder.

[33] The additional $ 100 million capital transferred from Optional in FY2007 was not included in the base scenario.

### 3.7 THE 2010 GOVERNMENT INTERVENTION

The financial crisis of 2008/09 led to a sharp down-turn in economic activity, and by the winter of 2009/10 the government was desperate for new revenue sources. ICBC was enjoying profits and had accumulated large capital reserves in both the Basic and Optional programs. The Commission was aware of the large amount of Basic capital, and in January ordered ICBC to submit a capital reduction plan by June. This action likely set off alarm bells in the ministry of finance. In May 2010 cabinet changed (OIC 287/10) the Commission approved capital management plan to prevent any release of Basic capital, and effectively raised the MCT target to 150%.

The government also changed the Insurance Corporation Act to allow excess Optional capital (the amount above the board determined Optional MCT management target) to be transferred to the government. Since the creation of ICBC in 1973 the government had been legislatively prohibited from taking ICBC funds.

In late May, ICBC submitted their request for a 1.9% Basic rate reduction effective November 1st, and announced a 3.0% reduction in Optional rates. No DCAT analysis was submitted as under the new cabinet directive there would be no release of Basic capital. In August the Commission ordered a 2.4% reduction in Basic rates, and stated that it was not in the public interest to question the merits of the government's intervention.[34]

Like most organizations ICBC changed to the IFRS accounting rules in FY2010. This had the effect of excluding certain pension assets and reducing the actual MCT ratio (although OSFI did not reduce its targets). Despite this change in accounting ICBC still recorded a FY2010 year-end Basic MCT of 153%; Optional recorded 312%, after the transfer of $ 575 million of "excess" capital to the government.

### 3.8 PRESSURE ON BASIC CAPITAL

With hindsight the 2.4% reduction in PY2010 Basic rates was a mistake.[35] By 2011 ICBC's equity assets (common stock) were beginning to regain some of their market value lost during the 2008/09 market crash, but the decline in interest rates forced by "quantitative easing" was reducing investment income. Coupled with a rise in average bodily injury claim costs in 2011, the combination resulted in a rapid decline in Basic capital. Optional capital was less severely affected as most claim expenditures were for property damage.[36]

Despite the worsening financial picture for the Basic program ICBC did not seek a rate increase for November, 2011. The government had been suffering intense public and media criticism for its management of public finances (e.g. the HST, BC Hydro and BC Ferries), and had chosen a new premier

[34] BCUC Reasons for Decision, May 24, 2010, p. 15.
[35] Perhaps this is an example of over-reliance on historical trends when forecasting costs.
[36] See Appendix VII.

in the spring. Perhaps a large increase in Basic auto rates, which normally would have been filed in late August, was not welcome in the late summer of 2011?

When ICBC did seek an increase in Basic rates on December 1, 2011 (effective February 1′ 2012) it was for a shocking 11.2% increase; an Optional rate decrease of 6% was also announced. ICBC cited lower investment income and rising bodily injury costs as the primary reasons for the increase in Basic rates. The request would have been even higher but for a November cabinet order (OIC 560/11) that directed ICBC to exclude any capital build provision from the submission. ICBC did not submit a DCAT analysis with the request, but again asserted that the 130% ratio was appropriate for the Basic financial risks.[37]

The increasing bodily injury claim cost and the changes in the financial markets were causing difficulties with ICBC's rate forecasting models. The initial request assumed that the MCT would equal 107% by year-end FY2012, however, by April ICBC was suggesting that a 14.5% rate increase might be more accurate, and that the MCT was likely to fall below 107%.[38]

In their August 17 2012 decision the Commission stated that the recent Basic MCT forecast was "uncomfortably low" and reiterated that the priority was to maintain the financial health and solvency of the Basic business. ICBC was directed to submit monthly MCT estimates and file for a rate increase if the MCT appeared to be falling below 100%.[39]

During the 2012 rate review process ICBC had hinted that annual approach to rate and capital setting was becoming less appropriate and that a longer term perspective was required.[40] Rate stability and predictability was becoming more difficult to achieve against the pressures of rising bodily injury costs and declining investment income. The growing cost of unpaid claims was also a factor, but this was not canvassed in any detail at the time.

Given these pressures one might have expected the 2013 rate request to be submitted in early December, 2012. Instead in February 2013 cabinet directed (OIC 82/13) ICBC to transfer $ 373 million in Optional capital to Basic for FY2012. The transfer raised the FY2012 year-end MCT ratio to 137% ($ 1.43 billion) from the 101% which would have been recorded without the Optional capital transfer. The loss of the $ 373 million in capital resulted in a year-end MCT of 313% ($ 1.82 billion) for the Optional program, which was little different from the 317% recorded for the previous year, despite the 6% rate decrease.

### 3.9 PRICE CONTROL OR RATE SMOOTHING

On March 19, 2013, cabinet (OICs 152/13 and 153/13) fundamentally changed the nature of Basic rate setting by imposing a form of price control (called rate smoothing) on the Commission by directing that

[37] 2012 RR, DUCK IR 15.c response.
[38] 2012 RR, BCUC IR 127.1 and 128.1 responses.
[39] 2012 RR, Decision, August 17, 2012, p. 46.
[40] 2012 RR, BCUC IR 2.1 response.

certain costs be excluded from the 2013 rate calculation. Effective for PY2014, Basic rates could only change within a 3% margin of the Commission approved rate increase for PY2013. The government justified this further reduction in the authority of the Commission by saying it would help achieve rate stability, and the FY2012 $ 373 million transfer of Optional capital provided the margin to allow this maneuver to occur. The government may have also desired that another major increase in auto rates not become a negative issue during the election that was called a few weeks later.

In late August 2013 ICBC filed a "smoothed" 4.9% rate increase request which would have been 11.5% without the new scheme. They also announced that Optional rates would decrease by 4%. Included in the request was a new capital management plan where ICBC now requested a further 20% MCT margin on the existing 130% Basic capital target to allow for a potential higher risk resulting from the price increase limitation. No revised DCAT analysis was filed to support the 130% ratio, nor the further 20% smoothing margin. During the review the Commission asked why the public auto insurance monopolies in Saskatchewan and Manitoba were operating with capital levels much lower than that of ICBC's Basic program. ICBC responded that the situation was different in BC and that a comparison with the other monopoly insurers was beyond the Commission's jurisdiction.[41] ICBC reaffirmed that the 130% ratio remained appropriate although they now referred to this reserve level as the "solvency target," which further complicated the capital target terminology as it implied that the basic program's financial health would be at risk if the capital fell below the 130% level.

During the hearing phase ICBC's chief actuary confirmed that the loss of asset value during the 2009/10 crisis was the worst decline in 40 years, and that this was included in the corporation's MCT analysis to support the 130% Basic ratio. She also suggested that a capital target below this level could put the taxpayer at risk.[42] Perhaps she was unaware of the $ 1.8 billion in Optional capital recorded for FY2012.

The new rate smoothing scheme added an additional level of complexity to the rate setting process. In its May 14,' 2014 decision the Commission accepted a further 15% MCT margin to the Basic MCT target to account for the rate smoothing risk, and decided that capital would be rebated only after a 160% ratio had been achieved (and then only reduced to 150%). In essence ICBC could now accumulate Basic capital up to 160% before any rebate to policyholders. Using the FY2013 actuals the various reserve amounts are shown below assuming 3.1 million annualized policies:

MCT @ 100% = $1.15 billion or $370/policy
MCT @ 130% = $1.50 billion or $485/policy
MCT @ 145% = $1.67 billion or $540/policy
MCT @ 160% = $1.84 billion or $595/policy

[41] 2013 RR BCUC IR 69.1, response. In its final submission of March 5, 2015 ICBC again advised the Commission to ignore the capital management plans of other public insurers, and in fact ban any further discussion (p. 11). It would appear that this is a sensitive issue.
[42] 2013 RR, Hearings, Vol. V, p. 682-3.

### 3.10 THE 2O14 REQUEST AND THE MODIFIED DCAT UPDATE

Having achieved most of their 2013 objectives of the 4.9% rate increase (adjusted to 5.2%) and an increase in the Basic MCT target to 145%, plus a 15% margin before any rebate, ICBC found that the bodily injury growth rates were moderating during 2013 and the first quarter of 2014. The market value of their investment assets was also improving. ICBC, unlike the public insurers in Saskatchewan and Manitoba, does not publically disclose Basic quarterly actual reports. The high level corporate financial summary for the third quarter (released on December 12, 2014) showed the cost of net claims incurred during the year up only $ 62 million (2.6%) over the same 2013 period. Corporate MCT had risen to 211% (up 3.4%) over the same 2013 period. In the absence of any analysis from the corporation it is presumed that the reported increase in prior year claims reflects the decline in the discount rate, and the (one-time) repayment resulting from the historic Optional coding error. The 2015-2017 service plan released on February 18, 2015 forecast a corporate MCT of 193% for 2014.

On February 17, 2014, cabinet again directed (OIC 55/14) that Optional capital (later determined as $ 113 million) be transferred to the Basic program for FY2013. This raised the FY2013 Basic MCT to 149% ($ 1.72 billion), while the Optional MCT was 304% ($ 1.93 billion) after the transfer to Basic and $ 237 million appropriated by the province. The order also fixed the policy year to commence November 1st and required annual rate filings, which should eliminate an important source of basic rate volatility.

On August 31, 2014 ICBC requested a 5.2% increase in rates for PY2014 with no change in Optional rates. ICBC discounted the lower than expected average BI claim cost for 2013 as a result of abnormal weather, and forecast that costs would move toward the pre-recession trend line. Unlike previous years, ICBC did not include a chapter in their submission devoted to the capital management plan or MCT levels, although it was a major topic during the 2013 rate review. Again no DCAT analysis was provided, and ICBC estimated that the Basic MCT would be approximately 145% by December 31, 2014.

In response to an information request ICBC provided a report entitled “Management Target Analysis for ICBC’s Basic Insurance” prepared in December, 2013.[43] The report is an update to the report filled with the Commission in June, 2008, and reviews the four adverse scenarios against a base scenario running from FY2014 to FY2017. The average of the four scenarios has declined to 123%, but the report says the Basic MCT target of 130%is still appropriate because it is close to the most severe of the four adverse scenarios, which was now a sharp decline in common share and mortgage investment asset values. Previous DCAT reports had concluded that unpaid claims (2008) and inflation (2006 and 2007) were the greatest threat to the Basic capital.

The document also asserted that a 20% additional margin was appropriate to account for the risk of price controls (rate smoothing), although no analysis was provided to support this assertion. Appendix I contains a more detailed review of the 2013 report and suggests that the adverse scenarios are either not plausible or have other serious deficiencies.

[43] 2014 RR, RM IR 3.a response.

### 3.11 WHY IS ICBC'S BASIC CAPITAL TARGET HIGHER THAN THE OTHER TWO PUBLIC MONOPOLY INSURERS' TARGETS?

Both the SAF and the MPI made rate applications to their oversight/regulatory bodies during 2014, and both included DCAT reports to support a management target MCT of 100%.[44] The obvious question is why does the Basic monopoly program in this province require a target of 130% (plus 15% for the price control risk)?

There is a fundamental difference in philosophy between ICBC and the other two monopoly insurers respecting the purpose of the DCAT stress test. ICBC's modified DCAT approach assumed that the 100% MCT mandated by regulation was the monopoly equivalent to the OSFI supervisory level, and that a higher management target was required to provide extra contingency margin for adverse events. The two other monopoly insurers use the CIA/ DCAT adverse scenarios to ensure that the assets remain greater than liabilities in the event of a sudden deterioration in the capital levels. This is why the SAF and the MPI are able to use the higher CIA occurrence probability levels (SAF used 1/99 years and MPI used 1/40 years) of an adverse occurrence and still recommend a management target of 100% MCT for Basic. ICBC, however, citing their modified DCAT report, continues to assert that a higher capital contingency is necessary.

With the passage of time, the fact that the 2005 and 2007 capital target recommendations were not based on the CIA guidelines for DCAT capital testing has been forgotten. In their 2013 rate review ICBC stated: "The MCT target was established based on an industry standard risk analysis which considered the impact of plausible adverse scenarios on the Basic capital."[45]

This difference in approach also explains why ICBC's corporate MCT target at 190/195% is higher than that of Intact Financial which operates in a competitive market with a target of 170%. ICBC stated that Intact Financial has a management target higher than 170%, but had they read Intact's 2013 annual report they would have found that the 170% level was indeed Intact's target, and their capital excess was highlighted as proof of their strong financial position.[46] ICBC's high Optional management target of 260% -- 90 basis points higher than the Intact Financial management target-- also contributes to the high capitalization levels, and cost, of auto insurance in this province.

When the Commission agreed to the 130% Basic MCT target it was based on the recommendations of a modified DCAT analysis that implied that a target above the 100% government minimum was necessary.[47] The changing financial forecasts during 2005/06 did not instil confidence in the Commission in ICBC's forecasting capabilities. ICBC recommended a 100% management target for Basic insurance even though their external actuary had suggested a higher capital reserve. ICBC's external actuary stated that the Basic capital was in an unfavourable condition, and the Commission believed that a MCT below the 100% level (even if the corporation as a whole was above the stipulated corporate target) was

[44] Saskatchewan Rate Review Panel, 2014 Rate Application of SAF, and Manitoba Public Utilities Board, 2014 Rate Application of the MPI.
[45] 2013 RR BCUC IR 181.1 response.
[46] 2014 RR RM IR2 2.11 response.
[47] See Appendix III and Appendix IV for more information.

unacceptable. The decision to adopt a Basic management target of 130% was made without the benefit of comparisons to the other monopoly Basic insurers as ICBC appears to have been the first public auto insurer to adopt this methodology to set the capital reserve level.

## CHAPTER 4: THE GOVERNMENT'S INTENTION

What was the government's intention when it selected the 100% MCT level as the requirement for Basic capital? A review of the documents available does not provide a definitive answer, but it is clear that the government expects that the Basic program will remain solvent (no taxpayer subsidy) and that the capital reserve will be used to moderate the annual volatility in rates resulting from the annual cost forecasting process.

In 2003 the MCT classification system was relatively new to OSFI and the insurance industry. It was certainly new to ICBC, which had operated with a crude premium based capital target prior to the 2003 splitting of Basic and Optional insurance reporting. To implement the separation of the monopoly and competitive programs the government formed a joint public servant/ICBC staff committee, which in turn sought the advice of ICBC's external actuary (William Weiland) and other consultants. In March 2004 the committee presented its' recommendations on the appropriate capital targets and the splitting of ICBC's capital reserve.[48] The government's primary focus was to ensure that the Optional business would operate "on a level financial playing field" with private insurers, therefore its capital management target was set at a MCT of 200% which was equivalent to the OSFI management target (its supervisory target plus an entity specific risk margin). The committee also recommended that almost all of ICBC's existing capital reserve be allocated to Optional, perhaps to guard against claims that the Basic rates would subsidize the Optional costs.[49]

One must assume that if the government chose the 200% MCT level for Optional to equate to the OSFI management target, then the 100% level chosen for Basic was selected for the same reason. In 2004 British Columbia was the first public auto insurance monopoly jurisdiction to adopt the OSFI capital classification system, therefore there were no existing monopoly insurers to emulate. The joint committee relied on the Weiland report (he was the only one who seemed to understand the OSFI classification system and the CIA capital stress testing methodology). He wrote that, assuming most of the Basic assets were government bonds, a 100% MCT for Basic insurance represented a "reasonable standard" for capital adequacy.[50]

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[48] See Appendix IV, section B.
[49] Or perhaps this was an indication that ICBC's finances were more complex than the public servants in Victoria assumed.
[50] Appendix IV, Section B.

The first Basic rate review before the Commission began badly and ended poorly. The rapid rise in Basic claims costs during FY2004, and especially during FY2005 where current and prior year claims costs rose 19.2%,[51](combined with the government's miscalculation of the capital reserve allocation) caused a great deal of confusion for ICBC during the 2006 rate review process. The Commission was confused and concerned as well. Rather than add clarity, the 2005 Eckler (Weiland) modified DCAT report muddied the waters even more. The appointed actuary said that the Basic capital was in an unsatisfactory condition and that the 100% MCT level was akin to the OSFI supervisory level, therefore more capital was required.

The Commission seemed to believe that the modified DCAT approach was in keeping with accepted actuarial standards (even if the probability levels seemed low), and rejected ICBC's 100% MCT management target recommendation in favour of a target more in line with that recommended by the external actuary. The following year ICBC recommended a 130% management target. This level, together with a capital build and release plan, was approved by the Commission.

In his January 24 2007 directive to transfer a further $ 100 million of capital to Basic the government minister responsible for ICBC said the 100% MCT was an appropriate capital level.[52] By 2010, however, facing worsening financial markets and declining interest rates, the government directed that no Basic capital should be released to policyholders. This change in the Commission approved capital plan was to "enhance" the effectiveness of the capital management plan and reduce future rate volatility.[53] It should be noted that the government was attempting to deal with its own growing budget deficit and was about to appropriate over $ 0.5 billion in "excess" Optional policyholders' capital. It was also important to the government that its assets (of which ICBC's capital formed an important part) be as large as possible if the government's credit rating was to remain stable (see Appendix VI, Table 8).

By 2011, the government's finances had stabilized and the November directive (OIC 560/11) allowed some relaxation of the 2010 restriction on capital. The directive suggested that capital above the 100% level "should be made available to help manage rates." ICBC had not requested a rate increase in 2011 despite facing mounting claim costs.[54] The November directive ordered ICBC not to seek a capital rebuild surcharge in their forthcoming 11.2% rate increase (effective February, 2012).

Due in part to the delay in seeking a rate increase in 2011, Basic capital levels had fallen to levels close to the 100% target during FY2012, and had the potential to fall below the regulatory target by year-end. In mid-December 2012 the government directed that all the Optional "excess" capital ($ 373 million) be transferred to Basic, which resulted in a year-end MCT of 137% (101% excluding the transfer). One suspects that the government did not want to be seen as taking over $ 370 million from policyholders' Optional capital reserve, while expecting them to pay a surcharge to rebuild some $300 million in Basic capital.

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[51] 2013 RR, BCPSO IR 37.3-4 response.
[52] OIC 38/07.
[53] OIC 287/10.
[54] FY2011 net claim expenditures rose 8.2% over FY2010.

The government had decided to become even more directive in setting Basic rates. In March 2013 the cabinet orders respecting the price controls (rate smoothing) were issued.[55] The new scheme placed rate change controls on the Commission and would potentially require the greater use of the capital reserve to fund shortfalls in net income. ICBC was directed to seek Commission approval for a new capital management plan "to protect the solvency[56] of Basic insurance" while using the capital to promote more stable and predictable rates."[57] For the first time the government acknowledged that the actual MCT might fall below the 100% MCT level. The central role of treasury board was also acknowledged.

The government also changed the policy year to commence on November 1st. This delayed the expected 2013 request, and built up the cost pressures.[58] According to ICBC, the forecasted PY2013 rate increase request would have been 11.5% without the rate smoothing.

In 2013 the government resumed the skimming of the Optional capital ($ 237 million) and in February 2014 (OIC 55/14) directed that some of the FY2013 Optional "excess" capital be moved to Basic. This transfer raised the Basic FY2013 MCT to 149%, close to the 150% management target requested by ICBC in its 2013 capital management plan.

In summary, this outline of the government's directives and initiates does not provide a clear indication of how the Basic 100% MCT relates to the OSFI management target. Since the 2010 changes the government has increased its cash position by appropriating the "excess" Optional capital. Government assets grow as ICBC's capital increases;[59] therefore the government has an incentive to encourage high Basic capital levels. It has also attempted to manage Basic rate volatility through manipulating the capital management plan, and in 2013 through controlling rate changes more directly through price change limits. The 2013 directives, however, clearly contemplate that the Basic MCT may fall below the 100% MCT level. ICBC's answer, at least since the 2006 rate request, to the question is simple --increase the Basic management target (and the Basic rebate level) and increase rates to reflect the growing cost of claims.

[55] OICs 152/13 and 153/13.
[56] Perhaps the drafter of the letter meant solvency according to ICBC's new and confusing definition of the 130% management target. One must assume solvency meant assets greater than liabilities as this would be accepted actuarial practice.
[57] OIC 153/13.
[58] It also avoided the potential problem of a Basic rate increase becoming an issue during the May 2013 election.
[59] Between FY2004/05 and FY2013/14 the government's "equity" in ICBC rose from $1.05 billion to $3.67 billion, or an increase of 350%, compared to 230% for BC Hydro; data from the Ministry of Finance, Public Accounts.

## CHAPTER 5: THE REVIEW PROCESS AND REPORTING

### 5.1 FISCAL YEAR

The current review process can be enhanced by requiring ICBC to submit their expenditure and revenue forecasts in a fiscal year format. The current policy year process is of limited use. The policy year has changed through a regulatory change, while the fiscal year has more permanency. Rate changes affect net income for more than one fiscal year, which will require ICBC to make explicit their revenue and expenditure assumptions for at least two fiscal years.

The addition of a fiscal year comparison facilitates the comparison of the revenue and expenditure assumptions incorporated into the rate request with the actuals of one or more prior years. It would also be helpful in linking the anticipated capital levels and the MCT to the target for each fiscal year.

The policy year forecast is useful for comparing changes from the prior year forecast, but has limited utility in determining the appropriate rate change for the upcoming year.

### 5.2 MULTI-YEAR FORECASTS

The lack of a multi-year forecast of the impacts of the rate change is a major weakness in the current process. A robust budgeting system requires a longer-term planning horizon to identify future year impacts of the major variables that drive the cost of Basic insurance. The recent imposition of the price control framework requires a multi-year view of expenditures, revenue and capital levels.

A multi-year planning and budgeting approach may be seen by some as incompatible with the requirement to set the annual rate on the basis of accepted actuarial practice, where the objective is to balance revenue with expenditure each year. However, ICBC maintains that relative rate stability and predictability in rates must be viewed in a longer term perspective. The current annual approach is an impediment to longer term planning, both for operational expenditures and capital requirements.

### 5.3 THE EXPLICIT SEPARATION OF OPERATIONAL AND CAPITAL RATES

Under the current system operating and capital requirement calculated separately and summed to total the annual rate change request. The net income positon of the operational (income statement) portion is a key variable in forecasting the capital level, while the change in the fair market value of assets is another key factor in the capital forecast. In the 2014 request of a 5.2% increase 0.2% is for capital (maintenance) and the balance is for the net change in operational assumptions.

ICBC has been reluctant in the past to forecast changes in the market value of assets, which is understandable given the nature of the financial markets. However, if the Commission is to properly

assess the rate change proposal on the future condition of the Basic program it must have ICBC's best estimate of the forecasted position of the balance sheet. The explicit separation will also facilitate the greater use of capital to moderate annual changes in the rate set for operational cost pressures.

More focus on changes to the capital position will highlight important trends in the cost of key variables, such as the cost of unpaid claim liabilities. Tables 3 through 6 in Appendix VI show the growth in the unpaid claim liabilities and the compounding effect of the OSFT-MCT rules on the requirement for capital.

### 5.4 ENHANCED ACCOUNTABILITY REQUIRES ENHANCED TRANSPARENCY

ICBC publishes a three year plan, an annual report and a quarterly one-page financial summary. These are consolidated at the corporate level, except for a high level summary of Basic and Optional finances included in the annual report. It does not produce public reports specifically on the monopoly Basic program.

The Commission must rely on the rate review process to receive detailed information and analysis on the cost and performance of the Basic program. ICBC supplies a great deal of information to support its rate request, but is reluctant to provide more public information on a regular basis specifically focussed on the Basic program.[60] This desire to limit public information may be understandable as the financing of the insurance business can be complex. However, as a Crown monopoly ICBC has an obligation to the public, and its 3.1 million (annualized) policyholders, to be more open and transparent with respect to its management of the $ 2.4 billion in annual Basic revenue. To assert that the consolidated corporate information meets the legal requirements is not good enough.

The Commission and ICBC should review the public reporting frameworks currently in use by the SAF and the MPI with a view to implementing best practices.[61]

[60] ICBC does not believe that posting Basic quarterly financial results would enhance accountability (see 2014 RR, RM IR 12.d response). In 2006 they also resisted filing quarterly MCT reports with the Commission (2006 RR, Hearings Vol. IV, p. 777-78), and stated that pro forma statements of operation would have little value because of the requirement to use accepted actuarial practice in rate-setting (2006 RR, ICBC Final Arguments, p.52).

[61] The SAF third quarter report for 2014 can be found at:
https://www.sgi.sk.ca/pdf/quarterlyreports/SAF_2014_Sept_quarterly.pdf

## APPENDIX I: AN ANALYSIS OF ICBC'S 2013 MODIFIED DCAT REORT

### 1.1 GENERAL

Over the nine years since the first modified DCAT submission ICBC has brought the detailed preparation of the DCAT reports in-house and had added some refinements to the data. From 2005 to 2007 the most adverse scenario was a jump in inflation. In the June 2008 filing the misestimation of unpaid claims had the largest impact on capital reserves. No new reports were filed with the Commission from 2008 to 2014, but ICBC did produce the December 2013 report (hereafter referred to as 2013 report) in November 2014 in response to an information request. While the average of the adverse scenarios in the 2013 report has declined to 123% ICBC says that the management target should be based on the worst case adverse scenario (a steep decline in non-bond asset values).

Two criteria are important when reviewing the DCAT adverse scenarios: is the selected event sudden and unexpected, and is the degree of the event and the management/regulator response plausible? The first criterion requires that the event, such as an increase in the average cost of claims, be beyond the normal range of change. The second requires that the degree of change has some basis in reality. There is also a time dimension as some events may be one-time and others may have a longer term impact on the capital reserve. The timing and the degree of management response (e.g. a price increase) are also important assumptions.

### 1.2 THE 2013 REPORT

The 2013 Report compares the 2013 forecast with the scenarios filed in the June 2008 comparison, but neither report includes detailed calculation tables, which were included in September 2007 DCAT update. The report was written prior to the imposition of rate smoothing, and the base scenario does not include the $ 113 million transferred to Basic for FY2013. A 10% probability level (one event in every 10 years) was selected, although the 2008 report assumed a probability level of about 7.5%. The average of the four adverse scenarios is 123%; the 2006 and 2007 reports were 128% (averaged up to 130%). Perhaps the change to an 18 month response time (from 36 months) accounts for the lower average of the four events modelled.

The 18 month response assumption is too conservative in the light of the Commission's recent record of granting interim rate approvals; the 2014 interim approval was granted within four working days.

The asset decline scenario depicts the impact of a loss of about 22% (loss of the normal return of 8% plus a 14% decline in market value in one year), plus a further loss in the second year. This is a more severe reduction than was described in the June 2008 filing, and it is a more severe decline in equity

returns than that modelled by the MPI in their 1/40 year adverse scenario.[62] Also, the reduction amount chosen is in addition to the 15% risk margin already included in the 100% MCT level as required by the OSFI guidelines. Under this scenario claim liabilities are not at risk because they are mostly covered by government bonds, therefore, what is primarily at risk is the amount of capital beyond the 100% MCT level. If the corporation covered all of its liabilities with assets in the form of bonds there would be no risk to capital by a sudden drop in equity values.

This scenario is, in essence, seeking a contingency on a contingency. ICBC did not include any rebound in market value in their scenario (as occurred within two years following the 2008/09 market crash) and said to do so would require a more severe initial market value drop in the assets "to maintain a 10%-likelihood for the adverse scenario."[63] This implies that the scenario was constructed to achieve a specific result, rather than allowing the plausible scenario to dictate the result.

The second adverse scenario is a sharp one-time rise in the average cost of claims. This scenario was modelled using eight years of claim cost, yet a review of the Basic fiscal year financial reports does not support such a jump in average costs. The scenario did not capture the moderation in the average BI cost recorded in FY2013. This scenario does not seem plausible given the history.

The third scenario provided models a single year jump in the cost of unpaid claims. ICBC has stated in a number of filings, and in responses to information requests, that a key benefit of the new business model and the new claims process is a better estimation of the ultimate cost of a claim. This scenario seems at odds with these assertions. The recent financial statements also show only minor annual adjustments for losses occurring in a prior year, although the FY2014 forecast includes an increase. The discount rate on unpaid claims is already at a very low level, therefore one must doubt if a further decline in the discount rate was a reason for selecting such a scenario. ICBC says that since the filing of the 2007 modified DCAT report their annual prior year adjustments for unpaid claims have been significantly smaller. "This has had the effect that the recent years of experience have moderated the overall volatility being observed and as a result, uncertainty in the estimated ultimate claims costs has reduced."[64]Given the rationale provided, this scenario does not seem plausible.

A major jump in inflation is the subject of the last scenario. Here ICBC has assumed inflation rises from 1.8% to 4.0% (or an increase of 120%). The 2008 report only assumed a 75% increase (2% to 3.5%) with a one in 20 year chance of occurrence. Again, ICBC did not assume an offsetting rise in the discount rate or in bond yields.[65] A rise in the discount rate should offset most of the negative effects on inflation on unpaid claims. The CIA educational note for November 2013 states that an inflation risk is normally linked to an increase in market interest rates (which strongly suggest a higher discount rate and higher investment income).[66] A rise in the interest rate is generally considered positive for insurance companies, while a decline in interest rates increases the cost of unpaid claims (lower discount rate) and

[62] MPI 2015 Rate Application, Vol. II, RSR p. 7.
[63] 2014 RR RM IR2 2.4 response.
[64] 2014 RR RM IR2 2.9 response.
[65] 2014 RR RM IR2 2.6 response.
[66] Canadian Institute of Actuaries, Dynamic Capital Adequacy Testing, November 2013, p.38.

lowers investment income. This is confirmed by ICBC in their 2013 annual report (page 64) where a 1% increase in the discount rate has a favourable impact on net income and equity. ICBC's response to a question on this adverse scenario again suggests a force fit of the rate of inflation was made to produce the intended result.[67] The exclusion of an increase in interest rates calls into question the plausibility of this scenario.

### 1.3 MANITOBA'S DCAT REPORT OF JUNE 2014

The Manitoba Pubic Insurance (MPI) submitted their 2015 Basic rate application to the Manitoba Public Utilities Board (MPUB) on June 16, 2014.[68] Included in the submission was their June 2014 DCAT report which recommended a maximum MCT capital target of 100%. The report modelled adverse scenarios that included a decline in interest rates and a combined asset loss/ low interest rate scenario, all with a probability level of 2.5% (1/40 years).

The DCAT report, conforming to the Canadian Institute of Actuaries' guidelines, defines a satisfactory financial condition as occurring throughout the forecast period (to FY2018/19) if:

- Under the base scenario the MPI meets the regulator's minimum capital target, and
- Under the base scenario, and all plausible adverse scenarios, *the statement value of the insurer's assets is greater than the statement value of its liabilities.* (emphasis added)

The MPI states that the purpose of the capital reserve is to "protect motorists from rate increases made necessary by unexpected events and losses arising from non-recurring events or factors." [69] The MPI believes that, as a monopoly, a MCT target of 100% is adequate to protect against reasonable volatility in the Basic program, and that this level of capital provides an acceptable level of rate stability.[70]

In early December 2014 the MPUB decided "in principle" that the DCAT methodology could be used to estimate the MCT target range, but that further discussion was required to finalize the adverse scenarios. In approving a 3.4% rate increase for 2015/16 they noted that the MPI was transferring some capital from its equivalent of Optional program to bolster the Basic capital reserve.[71] The Manitoba government does not appropriate excess capital from their public auto insurer and, in fact, pays the MPI for administering the provincial driver licencing program.

[67] 2014 RR RM IR2 2.7 response.
[68] Manitoba Public Utilities Board (MPUB), MPI 2015 Rate Application, June 16, 2014.
[69] MPUB, MPI 2015 Rate Application, Exhibit MPI-11, p. 2.
[70] Ibid., p. 5.
[71] MPUB, Order 135/14, December 5, 2014.

1.4 SASKATCHEWAN AUTO FUND (SAF)

The SAF 2014 rate request was submitted to the Saskatchewan Rate Review Panel (SRRP) in February, 2014. The SRRF can only make recommendations to the government and does not control the capital target. The SAF changed their target from a MCT range of 75 to 150% to a fixed target of 100% and instituted a 1/5 per year rebuild policy, similar to that approved by the Commission in 2007. The MCT target was based on a DCAT analysis where the adverse scenarios were modelled at a 99$^{th}$ percentile level (1/100 years).

In their June 2014 report the SRRP stated that in choosing the 1/100 year occurrence percentile level the SAF might be too conservative. They noted that the results of the adverse scenarios suggested a MCT target of between 88% and 91.5%, which the SAF rounded up to 100%.[72] The SRRP contracted with three external actuaries to review the rate request and the capital assumptions. The consultants noted that the worst adverse scenario caused an 88% decline in the MCT level over three years.

Clearly, in basing their MCT target on the results of their DCAT analysis the SAF is not assuming that the adverse scenario margin is in addition to the minimum/supervisory level; it is to ensure that in an adverse event the corporation can still pay its long term commitments. This implies that the MCT may fall below the 100% target after an adverse event, and in the following years the capital rebuild policy will be utilized to restore the margin.

To complete the story, the Saskatchewan government accepted the panel recommendation and moderated the capital rebuild rate increase. The SAF now operates with a target MCT of 100%.

**APPENDIX II: SUMMARY OF CAPITAL TARGETS 2004 TO 2014**

FISCAL YEAR ACTIVITY

**2003/04**

- Government sets Basic minimum MCT at 100% and Optional at 140% then 200% based on joint committee recommendations; orders ICBC to adopt OSFI guidelines for DCAT.
- Government allocates practically all of the existing capital to Optional (OIC 678/04)

December 31-- Basic MCT @ 42%

[72] Saskatchewan Rate Review Panel Report on SAF, June 11, 2014.

**2005**

- January; BCUC requests capital management plan and expresses concern about the capital reserve allocation between Basic and Optional
- August ; ICBC submits DCAT(Eckler Partners) with 2006 rate request (no increase)
- Most severe adverse scenario is **inflation** with average of 128% for all scenarios
- ICBC says 100% MCT is reasonable for Basic as Optional capital can provide support if needed.
- October; Government (OIC 734/05) transfers $530 million Optional capital to Basic and requires Commission to recognize government directives to ICBC (OIC 735/05)

December 31-- Basic MCT @ 79% ($453 million); Optional MCT @ about 190% ($ 706 million)

**2006**

- January; ICBC refiles with 6.5% rate increase and revised DCAT (Eckler)
- Eckler says 130% is required for Basic (as stand -alone entity). with **inflation** the main threat
- Basic management target recommended at 100% MCT, with new corporate target of 150% (meaning Optional at ±240%)
- Optional to back stop Basic which is considered a benefit of an integrated entity
- July; BCUC decision on 2006 request; says MCT of 100% for Basic and 200%MCT for Optional are minimums and wants a Basic target within the indicated DCAT range
- February 2007; Government orders (OIC 39/07) a further transfer of $100 million Optional capital to Basic and says a 100% MCT is appropriate for Basic

December 31 – Basic MCT @ 107% ($ 690 million); Optional MCT @ ±190% ($ 817 million)

**2007**

- March; ICBC files 2007 request seeking 3.3% increase effective May 1st
- ICBC now says the Basic MCT target should be 130% based on Eckler modified DCAT report, where average adverse is 128% and **inflation** remains the main threat
- Eckler report (pre $ 100 million transfer) says base scenario results in unsatisfactory financial condition for Basic
- July; during hearings ICBC admits that inflation scenario probably not plausible and undertakes to submit a revised modified DCAT with FY2006 data and new OSFI guidelines respecting full market value of assets
- September; ICBC submits new modified DCAT data tables; Eckler now says the Basic financial condition is satisfactory; no significant change to assumptions in the March filing
- January 2008; BCUC decision on 2007 request; not satisfied with the probability factors in the modified DCAT analysis and reliance on Optional capital in major loss years
- BCUC says financial stability more important than stable and predictable rates and directs ICBC to provide assurance that 130% for Basic is adequate
- BCUC approves capital plan including maintenance, build and rebate

December 31 – Basic MCT @ 136% ($ 1.17 billion); Optional MCT @ 292% ($ 1.26 billion)

**2008**

- June; ICBC submits report on adequacy of 130% MCT for Basic with latest estimates and reconciling 2005 and 2007 modified DCAT reports.
- **Unpaid claim reserve misestimation** is now the greatest threat, and the existing 130% MCT target was assumed to be sufficient for a probability of about 7.5% (one occurrence about every 15 years)
- ICBC says that even at a 1% probability (1/99 years) the Basic program has a satisfactory condition
- No rate increase was requested following the 6.5% and 3.3% increases in the prior two years
- Optional rates decreased by 3% following the decline of 3.8% in 2007

December 31 – Basic MCT @ 141% ($ 1.26 billion); Optional MCT @ 341% ($ 1.5 billion)

**2009**

- No rate request for Basic**;** Optional rates reduced 3.3%

December 31 – Basic MCT @ 162% ($ 1.6 billion); Optional MCT @ 388% ($ 2.0 billion)

**2010**

- Government changes Insurance Corporation Act to transfer "excess" optional capital to the province
- April; BCUC directs ICBC to file plan to reduce Basic capital
- May; Government (OIC 287/10) changes BCUC approved capital release plan with 150% MCT now the effective target
- May; ICBC submits request for a 1.9% reduction in Basic rates and new capital management plan; Optional rates reduced 3.0%; no modified DCAT filed
- August; BCUC approves a 2.4% reduction in rates but still considers **inflation** to be greatest threat to Basic capital
- Government takes $ 576 million of optional capital

December 31 – Basic MCT @ 153% ($ 1.70 billion); Optional MCT @ 312% ($ 1.79 billion) using the new IFRS accounting rules

**2011**

- No rate increase requested for November despite declining interest rates ; no change in Optional rates; no DCAT update
- Government modifies (OIC 560/11) restrictions on capital and requires BCUC to accept its directions
- Government takes $ 100 million of Optional capital
- December; ICBC submits request for 11.2% increase effective February 1, 2012; Optional rates reduced 6%
- No updated DCAT provided

December 31 – Basic MCT @ 115% ($ 1.13 billion); Optional @ MCT @ 317% ($ 1.82 billion)

**2012**

- New OSFI guidelines for MCT in effect
- ICBC estimates FY2012 MCT at 108%
- August; BCUC approves the rate increase; says the MCT forecast is uncomfortably low and the primary concern to policyholders should be the financial health of the Basic program; requests ICBC to file monthly MCT estimates
- February 2013; Government (OIC 83/12) directs transfer of $ 373 million Optional capital to Basic for FY2012

December 31 – Basic MCT @ 137% ($ 1.43 billion); Optional MCT @ 313% ($ 1.82 billion)

**2013**

- March; Government imposes "rate smoothing" price controls on Basic and directs BCUC to exclude certain costs from the 2013 rate request (OICs 152/13 and 153/13)
- August; ICBC submits 2013 request "smoothed" to 4.9% with new capital management plan (rebates) and proposed additional 20% MCT margin above the existing "solvency" target; no DCAT update; Optional rates reduced by 4%
- Government takes $ 237 million of Optional capital
- February, 2014; Government directs (OIC 55/14) that $ 133 million in Optional capital be transferred to Basic for FY2013
- May, 2014—BCUC 2013 decision to rise the Basic MCT target to 145% and no rebate until the MCT reaches or exceeds 160% (then only down to 150%)

December 31—Basic MCT @ 149% ($ 1.72 billion); Optional MCT @ 304% ($ 1.93 billion)

**2014**

- August; ICBC submits 2014 request for a 5.2% increase (November 1); no change in Optional rates; Basic MCT forecast 145%; no updated DCAT provided
- November; ICBC submits "2013 Management Target Analysis" for Basic which updates 2007 and 2008 DCAT reports; **Asset Decline** is now the greatest threat and the average of the four adverse scenarios is 123%
- November; Government forecasts record ($ 434 million) transfer from Optional for FY2014/15
- December; ICBC forecasts Basic FY2014 capital of $ 1.71 billion

**APPENDIX III: THE EARLY CAPITAL REVIEWS**

1.0 THE 2004 REVIEW

The BC Utilities Commission assumed jurisdiction for the regulation of the Basic insurance program with the proclamation of the amendments to the Insurance Corporation Act in mid-2003. In July 2004 ICBC submitted a proposal to allocate revenue, expenditure and capital between the Basic and optional programs. This was an important foundation stage to prepare for future rate and capital reviews.

In June 2004 cabinet passed Special Direction IC2 (OIC 307/04) which, among other things, set the OSFI defined MCT targets at 100% for Basic and 140% for Optional, which were to be achieved by FY2014. This was quickly followed in July by a modification (OIC 678/04) that increased the Optional target to 200%, and ordered that for the beginning of FY2004 ICBC's capital is divided such that Optional achieve a MCT of 170%.

The result was that some 95% of ICBC's capital reserve of some $ 530 million was allocated to Optional. ICBC had estimated that some 58.5% of their operation was related to basic (including non-insurance) while 41.5% related to Optional.[73]

During the 2004 review of the cost allocation it was clear that ICBC senior financial staff were surprised by the capital split ordered by the government. They had always managed ICBC as a single corporate entity, and the splitting of the chart of accounts, and other reporting changes necessitated by the transfer of the oversight function to the Commission, was a major undertaking. Geri Prior, the chief financial officer, believed that ICBC's capital reserve was sufficient to avoid a rate increase.[74] William Weiland, ICBC's external actuary, disagreed. He stated that "by conventional measures in private industry" he believed that ICBC was under-capitalized.[75] He agreed that the Basic monopoly status reduced the corporation's risk level, but said that many risks similar to the private insurers remained.

It was apparent during the hearings that Mr. Weiland had a better understanding of the details of the OSFI guidelines, and of the detail of ICBC's finances, than Ms. Prior did. His 2003 report had been a key resource to the 2003 government/ICBC committee that recommended the original 100% Basic and 140% Optional MCT targets. Mr. Weiland did not clarify that the government 100% Basic minimum target was equivalent to the OSFI management level for private insurers, and seemed to favour a higher target.

It would appear that Commission staff was also unfamiliar with the dynamics of the OSFI capitalization rules. At one point in the hearings it was suggested that the less risky assets (bonds) be assigned to the Optional account to lower the funding required to achieve the supervisory target, and lower ICBC's total

[73] BCUC Decision, January 19, 2005, p. 15.
[74] 2004 ICBC Financial Allocation, Hearings Vol. V, p. 887.
[75] Ibid.

risk profile.[76] Such an allocation would have made the Basic gap between available capital and required capital that much larger, requiring a much larger increase in Basic rates to achieve the target level.

During the review proceedings it was not made clear that the Basic program contained a much higher proportion of BI expenditures compared to the Optional program. Changes in frequency and severity for BI claims have a larger impact on total claim expenditures than do property damage claims.

Mr. Weiland outlined the features of the DCAT approach to stress testing the size of the capital reserve against financial solvency. He also stated that a modified DCAT approach could be used to determine an adequate MCT management target, however he did not clarify that his modified DCAT was not part of the Canadian Institute of Actuaries' DCAT guidelines.[77]

The assignment of most of the capital reserve to the Optional program provoked some speculation as to the government's purpose for such a split. Ms. Prior noted that government officials were of the view that the Optional program entailed higher risk since it had to compete with private insurers for policies. She assumed that this was why the capital target was set at 200%; at this level Optional prices would not benefit from a low capital reserve level.[78] Mr. Weiland noted that most private insurers were in the 150% to 200% range.

One commissioner speculated that the assignment of virtually all the capital reserve to Optional was intended to make that program more attractive for possible privatization. It was also noted that that the departure from ICBC's estimated 58.5%/41.5% financial division amounted to a subsidy of the Optional program by Basic policyholders. The Commission was expressly tasked to prevent such a subsidy.[79]

In their final argument ICBC said that the 100% MCT target for Basic was acceptable for the monopoly component of the business. "The facts in evidence demonstrate that the 100% MCT level of capital for Basic insurance is not unwarranted for insurers, it is well below the supervisory targets and internal targets used by OSFI."[80] It went on to note that the management of Basic capital has "important and long-term implications for policyholders and for ICBC as capital is necessary to protect policyholders and ensure smooth and stable rates."[81]

In their January 19, 2005 decision the Commission noted that ICBC's latest forecast for the FY2004 Basic MCT was now 26% (the actual was 42% while the Optional MCT was over 240%). The Commission directed ICBC to submit a capital plan with their 2005 rate application.

[76] Hearings Vol. VI, p. 1030/31.
[77] Ibid., p. 1036.
[78] Ibid., p. 1049.
[79] Ibid., p. 1053.
[80] 2004 Financial Allocation, ICBC Final Argument, p. 31-32.
[81] Ibid., p. 34.

## 2.0 THE 2006 RATE REVIEW

The 2006 rate review was the first full of the Basic program conducted by the Commission. As noted in the BCOAPO et al. final argument: "It has proven an extraordinary complex proceeding, and all the more so because of the novelty of the process for each of the participants."[82]

It was not an auspicious beginning for the corporation's financial staff as they were forced to change their original August 2005 request for no increase. By October they admitted that rising BI average costs would indicate an increase of 4.2% might be in order, but the restoration of $530 million in capital (about 113% MCT) led them to believe that there an increase was not necessary. By January they were forced to re-file and request a 6.5% rate increase as the 2005 forecast MCT had declined to 79%. They advised that 2.3% of the total was for capital maintenance and rebuild, and 2.8% was for a 2005 operating deficiency.

During the hearings it became clear that ICBC's forecasting methods involved a good deal of actuarial judgement, and that Mr. Weiland had the board's authority to make the final rate recommendation. It was also clear that ICBC had not adequately anticipated the rising BI costs.

ICBC recommended that the Basic MCT management target be set at 100%. Included in their filing was the 2005 DCAT report prepared by Mr. Weiland. The base scenario used 2005 financial data and used CIA methodology to test the capital solvency. The Basic program, prior to the capital restoration, was judged to be in an unsatisfactory financial condition and would be insolvent under two of the adverse scenarios. The second part of the report used a modified form of the CIA/DCAT to recommend that the Basic MCT management target be set at 130%.

It was apparent that senior ICBC financial staff did not have a detailed knowledge of the CIA/DCAT methodology or of the OSFI MCT guidelines. They relied heavily on Mr. Weiland's knowledge and experience. It was also clear that neither the Commission staff nor the interveners were familiar with the OSFI- MCT guidelines, or of the risk profiles of the Basic and Optional programs.

During the hearings there was no detailed questioning of the 2005 modified DCAT report and whether or not the government's 100% MCT minimum target was in fact equivalent to the OSFI management target. No questions were posed as to how the government chose the 100% level. The Commission and the interveners focussed most of their questions on other aspects of the new and often complex submission.

ICBC requested that the Basic management capital target be set at the 100% MCT level. The large Optional capital reserve (they did not quantify the amount) would back-stop the Basic in relation to the OSFI targets in the event that the Basic capital fell below the target until the basic capital could be

[82] 2006 ICBC RR BCOAPO et.al. Final Arguments, April 28, 2006, p. 1.

rebuilt. The relative wealth of the Optional program was "a benefit that the Basic insurance receives from being part of the integrated corporation."[83]

Neither the Commission nor the interveners noted that all of ICBC's Optional capital reserve came from the Basic policyholders who also purchased ICBC's Optional product.

In its July 13 2006 decision the Commission assumed that the modified DCAT report was in accordance with the CIA guidelines, and that the OSFI targets applied to Basic as a stand-alone entity. The modified DCAT methodology was equated to accepted actuarial practice. Mr. Weiland stated in the 2005 report (p. 6) that he believed that the Basic management MCT target should be above the 100% target. The Commission, influenced perhaps by the rapid change in MCT projections during the review process, ordered ICBC to develop a Basic capital management target "within the DCAT indicated range" as the ICBC recommendation would entail an "unacceptable risk of failing to attain, and then maintain, at least the required statutory minimum."[84] The Commission was not persuaded by ICBC's argument that the 100% level provided a proper balance between an acceptable financial condition and relative rate stability, and that the SD IC2 MCT wording allowed year over year flexibility in maintaining the 100% MCT target.[85]

## 3.0 THE 2007 RATE REVIEW

In its January 9 2008 decision respecting the 2007 rate increase the Commission confirmed the Basic capital management target at 130%, which was the amount recommended by ICBC based on the February 2007 modified DCAT report. It also decided that the capital build (and release) would be achieved in five years. The Commission apparently discounted the admission by ICBC that the most adverse scenario in the February modified DCAT report was overstated, and the August 2007 modification of the base scenario, which now confirmed that the financial condition of Basic insurance was satisfactory. The Commission believed that a large capital margin was of higher priority than relatively low and stable rates: "the financial strength and stability of the Basic insurance business should be given relatively more weight than maintaining stable and predictable rates."[86]

The Commission had not altered its position from that described in the July 2006 decision. It recognized that the DCAT tool was intended to test solvency under various adverse scenarios, but it also assumed that the same methodology was used to assist in selecting an appropriate management MCT target.

However, the Commission still seemed to equate the government 100% minimum with a form of insolvency. In expressing concern that ICBC had not tested the 130% target level against the more

[83] 2006 ICBC RR p. 25.
[84] 2006 RR BCUC Decision July 13, 2006, p. 25-27.
[85] 2006 RR BCUC IR 20.6 response.
[86] 2007 RR BCUC Decision January 9, 2008, p. 17.

severe CIA-DCAT 1% to 5% probability levels the Commission was confusing the modified DCAT report (which tested to the 100% MCT) with the CIA-DCAT methodology (which tests solvency). The Commission directed ICBC to provide evidence that the 130% MCT management target was adequate. This was done in June 2008, although ICBC did not alter the adverse scenarios and implied that the probability level was between 10 and 15 years.

The modified DCAT methodology (which used the 100% MCT as the floor) presented during the 2007 rate review came to be seen as part of the accepted actuarial practice in future rate reviews. This was reinforced by the lack of questioning, as no applications for a rate review were presented for 2008 and 2009, and the 2010 submission asked for a slight rate decrease

**APPENDIX IV: CAPITAL TARGETS –KEY DOCUMENTS**

A. INSURANCE CORPORATION ACT (capital solvency)

Section 8.0

Subject to the regulations…and any orders of the commission…the corporation must maintain for the purposes of the *Insurance (Vehicle) Act* reserves in amounts the corporation considers advisable in the interest of owners of vehicles and drivers of vehicles, and in the interest of good management of the business of vehicle insurance, so that the corporation has at all times sufficient funds to meet the payments under the *Insurance (Vehicle) Act* as they become payable.

B. 2003 JOINT COMMITTEE ON ICBC CAPITAL

The following are exerts from the final 2003 report of the joint government/ICBC on ICBC capital, and are attached to the chair's March 17 2004 report to the minister of finance (Gary Collins) and the minister responsible for ICBC (Rich Coleman).

Capital targets were needed:

- To protect the government's guarantee of ICBC solvency, by ensuring that ICBC maintains "an adequate overall level of capital…"
- Optional insurance competes with private insurers; "it is important that ICBC be subject to the capital requirements placed on private insurers to put them on a level financial playing field."

The committee relied on a report from Mr. William Weiland of Eckler Partners Ltd., which was reviewed by a separate actuary to ensure independence. Presumably the report was commissioned by ICBC.

The committee recommended that:

- the OSFI capital scheme be adopted;
- all of ICBC's existing capital be allocated to Optional in order to meet the 150% supervisory target required of any insurance provider;
- a corporate MCT target of 110% and an Optional MCT target of 170%; and
- a transition period of 10 years.

While there was no specific recommendation on the Basic target, it was assumed that the 100% target in the Eckler report was adequate because of Basic's legal monopoly. There was no apparent questioning as to whether to 100% was too high as it matched the OSFI minimum, and the committee's focus was on the level of Optional capital and the capital level of the total corporation.

The committee badly under-estimated the increase in Basic premiums required as a result of the shift of practically all of the available capital to Optional. They stated that an increase of $ 15 per policy, or 3% was needed, which was not in accordance with the Eckler report's warning that some $ 185 per policy would be required.

C. Summary of Eckler Partners Ltd., "Analysis of Capital Requirements for the Basic and Optional Components of Insurance Corporation of British Columbia Business," May 28, 2003.

- Used DCAT method to assess risks to capital
- Assumed a corporate MCT target of 150%
- Used a 100% target for Basic because government grade bonds have no risk and the policy liability risk is lower because of the monopoly
- Optional to function similar to private insurers therefore a minimum of 150% MCT is required
- Corporate target is roughly the sum of Basic and Optional, or 115%

"In order to meet the 150% MCT minimum for Optional Business by the end of 2003, the Basic scenario … was modified by transferring assets as of 31 December 2002 from Basic to Optional Business" ($ 234 million)(p. 14).

To meet the CIA standards for a satisfactory financial condition for the period FY2003 to FY2005 ICBC faces a $ 509 million capital deficiency, with Basic deficient by $ 570 million and optional having a $ 61 million surplus. (p.30)

Only the inflation scenario resulted in corporate negative capital, and the analysis excluded any rise in the yield curve. At the time ICBC was not discounting unpaid claims.

In conclusion, the report stated that the 100% MCT target for Basic and the 150% target for Optional "represent a reasonable standard" for capital adequacy. (p. 31)

## D. CANADIAN INSTITUTE OF ACTUARIES DCAT

### D.1 Canadian Institute of Actuaries 2007 Guidelines on DCAT

http://www.cia-ica.ca/docs/default-source/2007/207108e.pdf?sfvrsn=2

### D.2 Canadian Institute of Actuaries 2013 Guidelines on DCAT

http://www.cia-ica.ca/docs/default-source/2013/213077e.pdf?sfvrsn=2

### D.3 Committee on Solvency Standards for Financial Institutions "Dynamic Capital Adequacy Testing—Life Insurance, July, 1997." excerpts

Section 1 Background and Introduction

Introduction to the Concepts of Capital Adequacy Assessment

In the most general sense, solvency is the ability of an entity to honour its financial obligations. From the accounting point of view, solvency requires that assets equal or exceeds liabilities, and, therefore, that total equity is non-negative. This is attained as of a specific date by the preparation of a balance sheet.

…the appointed actuary's concept of solvency…extends beyond the balance sheet at a specific date to the continued vitality of the organization.

Objectives

Dynamic capital adequacy testing is the process of analyzing and projecting the trends of a company's capital position in its current circumstances, its recent past, and its intended business plans, under a variety of future scenarios….

The principle goal of this process is to help prevent insolvency….

D.4 CIA-Committee on Risk Management and Capital Requirements, "Dynamic Capital Adequacy Testing" November, 2013.

The insurer's financial condition would be satisfactory if throughout the forecast period,

- Under all plausible adverse scenarios the statement value of assets exceed liabilities, and
- Under the base scenario the supervisory target capital level is met. (p.17)

Adverse scenarios must be in the 95$^{th}$ to 99$^{th}$ percentile range. (p. 37)

Inflation risk is usually linked to a rapid and sustained increase in market interest rates. (p. 380

The DCAT process should be generally similar from one insurer to another, "with some degree of uniformity in the standard of plausibility of scenarios and approaches taken to testing." (p. 6)

E. William Weiland (Eckler Partners Ltd.), "ANALYSIS OF CAPITAL REQUIREMENTS FOR BASIC INSURANCE," August 11, 2005.

1.0 Purpose of Dynamic Capital Adequacy Testing (pg. 5-6)

To identify the following through the examination of plausible adverse scenarios:

- Plausible threats to an entity's satisfactory financial condition,
- Actions which lessen the likelihood of those threats, and
- Actions that would mitigate a threat if it materialized.

The financial condition of an entity is its prospective ability to meet its future obligations, especially obligations to policy holders and those to whom it owes benefits.

Under CIA standards a company's financial condition is considered satisfactory if during the forecast period:

- It is able to meet its future obligations under the base scenario and plausible adverse scenarios, and
- It meets the minimum regulatory capital requirement under the base scenario.

Mr. Weiland links the 100% MCT to solvency (p. 6)

For the fiscal period ending 31 December 2014, and all subsequent fiscal periods, the minimum regulatory solvency requirement for ICBC's Basic insurance is a Minimum Capital Test Ratio (the ratio of Capital Available over Capital Required) of at least 100%.

Mr. Weiland believes that the 100% MCT is not adequate (pp. 6-7)

Even if the Basic program has met the CIA test it may still fall below the target during a subsequent year. Eckler Partners advise that:

In such circumstance, the regulator may choose to intervene. Because of this, it is desirable that ICBC operate its Basic insurance with a capital level that would generate MCT levels above 100%, so that ICBC management would have the opportunity to respond to adverse circumstance in advance of possible intervention by the regulator.

Mr. Weiland acknowledges that the 130% MCT recommendation is not based on CIA/DCAT standards:

In this report, we have determined such capital management targets by constructing adverse scenarios that are less severe in their magnitude than the DCAT adverse scenarios and then observing the reduction that occurs in capital available. The amount of the reduction when added to the capital requirement under that particular scenario provides an estimate of the MCT target. (p. 7)

## F. SASKATCHEWAN RATE REVIEW PANEL REPORT OF JUNE 11, 2014.

The SRRP report is contains a useful review of the MCT and the DCAT. Its actuarial consultants' report is attached to the panel's report.

http://www.saskratereview.ca/images/docs/sgi-2014/20140528-saf-final-report.pdf

Excerpts from Eckler Ltd., Forkast Consulting and Kostelnyk Holdings Corp., report of May 28, 2014:

MCT management target of 100%: "… it appears there is some inherent conservatism in the selection of the MCT target ratio of 100%." (p. 33)

Choice of a one in 100 year event level for adverse scenarios: "Modeling a lower percentile level … would produce a lower MCT target ratio." (p. 33)

The use of DCAT to set the MCT management target is reasonable and appropriate to the circumstances. (p. 32)

**APPENDIX V: GOVERNMENT DIRECTIVES**

**2005**

- OIC 734/05 Letter of October 5, 2005 to ICBC directing the transfer of $ 530 million to Basic capital to achieve 100% MCT by FY2005 to enable maintenance of low and stable rates.
- OIC 735/05 October 5, 2005 Commission must accept government directives to ICBC

**2007**

- OIC 39/07 Letter of January 31, 2007 to ICBC regarding proposed rate design.
- OIC 38/07 Letter of January 24, 2007 to ICBC directing transfer of $ 100 million to Basic capital for FY2006 to complete the balancing of ICBC's capital and achieve 100% MCT.

**2010**

- OIC 222/10 Letter of April 19, 2010 to ICBC; fund the Transformation Program ($ 400 million) from Optional capital.
- OIC 287/10 Letter of May 18, 2010 to ICBC; suspends any rebate under the capital management plan to avoid possible rate volatility due to uncertain investment markets and thereby enhance the effectiveness of the capital management plan.

**2011**

- OIC 560/11 Letter of November 25, 2011 to ICBC; moderates direction of May, 2010, as ICBC should use more Basic capital in the short term: "The government believes that the capital available above the Basic insurance regulatory minimum should be made available to help manage rates."(p. 2) Capital build excluded from the rate request for the next three policy years.

**2012**

- OIC 82/13 Letter of December 13, 2012 to ICBC; transfer all of Optional excess capital to Basic for FY2012 to allow MCT to be equal to or above the 100% MCT level.

**2013**

- OIC 152/13 March 2013; amendments to SD IC2; incorporating rate smoothing, a customer renewal credit and annual rate changes; annual rate increases are limited and rates cannot decrease; the Commission to set rates to **allow** Basic to maintain at least 100% MCT level.
- OIC 153/13 Letter to ICBC; ICBC should seek Commission approval for a revised capital management plan "to protect the solvency of Basic insurance while also improving ICBC's ability to use Basic capital to promote more stable and predictable Basic rates." The plan will incorporate a customer renewal credit. If the MCT is projected to fall below 100% ICBC must report to Treasury Board and develop a plan to address capital levels.

**2014**

- OIC 55/14 February 17, 2014 Letter to ICBC; transfer to balance of excess Optional capital to Basic for FY2013 ($ 113.1 million), and says Treasury Board directs a change in the policy year to November.
- OIC 56/14 February, 2014; changes policy year to November to October.

**APPENDIX VI: DATA SETS**

The economic decline following the stock market crash of 2008-2009 had a short-term effect on the value of ICBC's equity assets (common shares), which reduced capital levels in FY2011. The rates for both Basic and Optional insurance were reduced in FY2010, and Optional rates were again reduced in FY 2011 while Basic rates remained unchanged, which contributed to the decline in net income in FY2011. Optional net income bounced back in FY2012 despite a 6% reduction in rates, while Basic net income did not recover as rapidly even though rates had increased by 11.2% in February.

TABLE 1 CHANGE IN KEY INDICATORS FY2009 TO FY2013 ($=millions)

| | FY2009(1) | FY2010 | FY2011 | FY2012 | FY2013 |
|---|---|---|---|---|---|
| **Rate Change % BASIC** | Nil | (2.4) | Nil | 11.2 (Feb) | 5.2 (Nov) |
| **Rate Change % OPT.** | (3.3) | (3.0) | Nil | (6.0) | (4.0) |
| | | | | | |
| **Net Income BASIC $** | 175.4 | 55.8 | (188.2) | (120.5) | 3.3 |
| **Net Income OPT. $** | 387.5 | 312.3 | 55.8 | 362.3 | 364.8 |
| | | | | | |
| **Equity Change BASIC $** | 373.0 | 106.0 | (384.8) | 297.8 | 288.8 |
| **Equity Change OPT. $(2)** | 493.0 | (335.3) | 112.2 | 23.0 | 14.5 |
| | | | | | |
| **MCT BASIC %** | 162 | 153 | 115 | 137 | 149 |
| **MCT OPTIONAL %(3)** | 306 | 312 | 317 | 313 | 304 |

Source: ICBC Financial Statements.

(1) GAAP accounting rules.
(2) The government began to take "excess" capital in FY2010.
(3) Since FY2010 the actual MCT reflects the management target is 260% plus a provision for the Transformation Program.

The data for Basic net income confirm that cost increases are concentrated in BI claims under $200,000 as the Optional program's finances (which has a large component of property damage claims) was not impacted to the same degree.

TABLE 2: EQUITY EXCLUDING TRANSFERS ($=millions)

| | FY2009(1) | FY2010 | FY2011 | FY2012 | FY2013 |
|---|---|---|---|---|---|
| **BASIC Equity** | 1,596.7 | 1,514.5 | 1,129.7 | 1,054.7 | 1,230.3 |
| **BASIC MCT** | 162 | 153 | 115 | 101 | 107 |
| | | | | | |
| **OPTIONAL Equity** | 2,020.0 | 2,366.0 | 2,442.5 | 2,869.5 | 3,326.5 |
| **OPTIONAL MCT** | 306 | 438 | 434 | 493 | 525 |

Source: Derived from ICBC Financial Statements.

(1) GAAP accounting rules.

Table 2 shows what the year-end equity positions would have been without the Optional capital transfers to the government and the Basic program since FY2010. Rather than reduce the price of the highly profitable Optional insurance the government has used the policyholders' retained earnings, which become balance sheet capital, to subsidize its own budget and to bolster the Basic capital. Without the transfers, by FY2013 the amount of the capital in the Optional program would have been enough to fund **all** of Basic and Optional insurance for 10 months that year.

TABLE 3: MARGINAL CHANGE IN KEY BASIC COMPONENTS ($=millions)

| | FY2008 | FY2009 | FY2010 | FY2011 | FY2012 | FY2013 |
|---|---|---|---|---|---|---|
| **Earned Rev.** | 92.3 | 7.9 | 3.0 | (14.7) | 127.6 | 147.8 |
| **Current Claims** | (21.5) | 31.4 | 69.7 | 155.7 | 131.0 | 103.3 |
| **Total Cost** | (42.3) | 164.5 | 109.7 | 172.3 | 42.7 | 186.6 |
| **Invest. Income** | (225.6) | 156.8 | (7.1) | (54.4) | 2.5 | 156.5 |
| **O.C.E.** | (121.3) | 197.4 | 71.7 | (153.4) | 51.7 | 172.3 |
| **Equity (1)** | 54.2 | 372.9 | 106.1 | (384.8) | 297.8 | 288.8 |
| **MCT** | 141 | 162 | 153 | 115 | 137 | 149 |

Source: ICBC Annual Financial Statements

(1) GAAP accounting until FY2009, then IFRS thereafter.
(2) MCT excluding Optional transfers; FY2012=101%, FY2013=107%

Table 3 provides more detail about the annual change in key financial components of the Basic program. The rate reduction in 2010 and the absence of an increase during 2011, combined with lowering interest rates and an 8.7% rise in claim costs, were the major reasons for the loss in net income in FY 2011. The 11.2% rate increase in February mostly offset the increase in claims cost for FY2012, and improved investment income reduced the net loss on operations to $ 120.5 million. The Basic capital position reached a MCT ratio of 137% because of the $ 372.6 million capital transfer from Optional.

TABLE 4: PER CENT CHANGE IN KEY BASIC COMPONENTS

| | FY2008 | FY2009 | FY2010 | FY2011 | FY2012 | FY2013 |
|---|---|---|---|---|---|---|
| **Earned Rev.** | 4.6 | 0.4 | 0.1 | (0.7) | 6.1 | 6.7 |
| **Current Claims** | (1.3) | 1.8 | 4.1 | 8.7 | 6.7 | 4.5 |
| **Total Cost** | (2.1) | 8.3 | 5.1 | 7.6 | 1.8 | 7.5 |
| **Invest. Income** | (55.2) | 85.6 | (2.1) | (16.3) | 0.9 | 55.7 |
| **O.C.E.** | (65.1) | 303.2 | 27.3 | (45.9) | 28.6 | 210.7 |
| **Equity (1)** | 4.6 | 130.5 | 2.4 | (26.9) | 26.4 | 20.3 |

Source: ICBC Annual Financial Statements

(1) GAAP accounting until FY2009, then IFRS thereafter.

TABLE 5: MARGINAL CHANGE IN BASIC UNPAID CLAIMS ($=millions)

| FY2008 | FY2009 | FY2010 | FY2011 | FY2012 | FY2013 | FY2014(1) |
|---|---|---|---|---|---|---|
| **$ = millions** | 152.4 | 108.6 | 244.5 | 467.6 | 431.0 | 330.0 |
| **Per Cent** | 3.5 | 2.4 | 5.3 | 9.7 | 8.1 | 5.7 |
| | | | | | | |
| **$ @100 MCT** | 15.2 | 10.9 | 24.5 | 46.8 | 43.1 | 33.0 |
| **$ @130 MCT** | 4.6 | 3.3 | 7.3 | 14.0 | 12.9 | 9.9 |
| **$ @145 MCT** | nil | nil | nil | nil | 6.5 | 5.0 |

Source: ICBC Annual Financial Statements

(1) ICBC forecast see 2014 RR IR2 RM xxx response

(2)

The OSFI MCT guidelines require unpaid claim liabilities be matched by assets including a 10% risk margin, while the BCUC target of 130%, plus a further 15% adds an additional asset requirement. For every $ 100 million increase in claim liabilities $10 million in additional equity is required to maintain the 100% OSFI target, while $ 3 million more is required at 130% and a further $ 1.5 million to achieve a 145% MCT. The total risk margin is $ 14.5 million; or almost 15% more than the original liability incurred. This is a great deal of insurance on top of the approximately 9% provision for estimating error (PFAD) already included in the balance sheet. The FY2013 unpaid claim liability increase of $ 431 million over FY2012 required approximately $ 19.5 million in additional capital; the equivalent of a 0.8% increase in Basic rates.

TABLE 6: BASIC INSURANCE RISK MARGINS FY2013 ($=millions)

| | FY2013 | OSFI@100% | BCUC@30% | BCUC@15% | TOTAL | Per Cent |
|---|---|---|---|---|---|---|
| **Common Shares(1)** | 2,100 | 315.0 | 94.5 | 47.3 | 456.8 | 21.8 |
| **Unearned Prem.** | 1,120 | 112.0 | 33.6 | 16.8 | 162.4 | 14.5 |
| **Unpaid Claims (2)** | 5,720 | 572.0 | 171.6 | 85.8 | 829.4 | 14,5 |
| **TOTAL(2)** | 8,940 | 1,000.0 | 300.0 | 150.0 | 1,450.0 | 16.2 |

Source: ICBC FY2013 Financial Statement.

(1) Estimated; OSFI uses a 15% margin

(2) The $ 5.7 billion includes a PFAD margin of approximately $ 760 million.

TABLE 7: OPTIONAL NET INCOME

| | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|
| **ICBC Opt. ($=mil)** | 365 | 362 | 328 | 316 |
| **% of Revenue(1)** | 19.6 | 19.8 | 18.2 | 17.3 |
| **% of Expenditure** | 24.4 | 25.0 | 22.2 | 21.0 |
| | | | | |
| **Intact Fin. ($=mil)** | 500 | 675 | 460 | 402 |
| **% of Revenue(1)** | 6.7 | 9.7 | 8.8 | 8.9 |
| **% of Expenditure** | 7.3 | 13.2 | 10.0 | 10.0 |

Source: Annual Reports.

(1) Includes investment income and excludes change in value of assets. Intact Financial completed an acquisition in 2012 which explains the increase in net income.

ICBC's Optional insurance produces significant and steady profits, with a rate of return that far exceeds that of Intact Financial, the largest auto insurer in Canada.

TABLE 8: ICBC EQUITY AND DIVIDEND ($=billion)

| FISCAL YEAR | EQUITY | DIVIDEND | TOTAL | NET CHANGE | % CHANGE |
|---|---|---|---|---|---|
| **14/15 SPlan** | N/V | .13 | N/A | N/A | N/A |
| **13/14** | 3.67 | .24 | 3.91 | .44 | 12.7 |
| **12/13** | 3.47 | -- | 3.47 | .26 | 8.1 |
| **11/12** | 3.11 | .10 | 3.21 | (.65) | (16.8) |
| **10/11** | 3.28 | .58 | 3.86 | .10 | 2.7 |
| **09/10** | 3.76 | -- | 3.76 | 1.02 | 37.2 |
| **08/09** | 2.74 | -- | 2.74 | .18 | 7.0 |

| | | | | | |
|---|---|---|---|---|---|
| **07/08** | 2.56 | -- | 2.56 | .49 | 23.7 |
| **06/07** | 2.07 | -- | 2.07 | .83 | 66.9 |
| **05/06** | 1.24 | -- | 1.24 | .19 | 18.1 |
| **04/05** | 1.05 | -- | 1.05 | .43 | 69.4 |

Source: Ministry of Finance Public Accounts and ICBC 2015-2017 Service Plan.

Since FY 2004/05 the government has recorded approximately $ 3.7 billion in ICBC equity growth and dividends as revenue, including the $ 1.2 billion in the growth of Basic equity from FY2005 to FY2013. ICBC's total equity is recorded as a government asset, and the annual net income is treated as government revenue.

From 2005 to 2014 the CPI has risen by approximately 21%.

## APPENDIX VII THE COST OF CLAIM BACKLOGS

The timely processing of claims is important to the claimants and to all policyholders. The OSFI MCT guidelines assign a 10% risk factor to unpaid claim liabilities, thus an increase of $ 100 million in claim liabilities requires an equal amount of assets plus $ 10 million in equity to maintain the 100% ratio. The BCUC Basic target of 145% requires a further $4.5 million in equity. The ICBC Optional management target of 260% requires $ 36 million in additional equity for every $ 100 million in additional unpaid claim liability ($ 10 million for 100%, plus $ 26 million for the 260% target).

One would expect that the change in amount required for the unpaid claim liability should be similar to the change in the cost of claims. (2006 RR January 27, 2006, p. 6-4.) However, between FY2010 and FY2013 the Basic unpaid claim liability rose by $ 1.14 billion, or about 25%. This was partly the result of the value of claims processed not keeping pace with the value of net new claims recorded, especially in FY2012 and FY2013.

TABLE 1 NET CHANGE IN UNPAID CLAIM LIABILITY ($=million)

| | Basic $ | Basic % | Optional $ | Optional % |
|---|---|---|---|---|
| **FY2010** | 108.6 | 2.4 | 110.1 | 7.4 |
| **Fy2011** | 244.5 | 5.3 | 65.2 | 4.1 |
| **FY2012** | 467.6 | 9.7 | 41.7 | 2.5 |
| **FY2013** | 431.0 | 8.1 | 79.7 | 4.7 |
| **FY2014(1)** | 330.0 | 5.8 | N/A | N/A |

Source: ICBC annual financial statements

(1) ICBC estimate; see 2014 RR BCOAPO IR 95.1-5 response.

It is clear that FY2012 and FY2013 were poor years for Basic claim processing as the total value of claims processed fell in relation to the value of net new claims, and declined in absolute value in FY2013.

TABLE 2 MARGINAL CHANGE IN BASIC CLAIMS ($=millions)

| | FY2010 | FY2011 | FY2012 | FY2013 |
|---|---|---|---|---|
| **Net New Claims** | 66.7 | 146.7 | 117.1 | 115.7 |
| **Paid/Disposed** | 100.5 | 10.8 | (105.4) | 152.3 |
| **Year End** | 108.6 | 244.5 | 467.6 | 431.0 |

Source: ICBC annual financial statements

ICBC believes that a disproportionate processing of less expensive claims in 2013 was partly responsible for the growth in the value of the backlog.

Two other reasons for the growth in the Basic claim backlog during FY2012 and FY2013 were the 2012 labour disruption, and the major reorganization of the claims processing department resulting from the business process transformation program.

TABLE 3 BASIC BODILY INJURY CLAIMS FY2009 TO FY2013

| | NEW CLAIMS | CLAIMS CLOSED | PENDING |
|---|---|---|---|
| **FY2009** | 41,074 | 40,551 | 51,633 |
| **FY2010** | 42,240 | 42,362 | 51,499 |
| **FY2011** | 43,126 | 40,044 | 54,561 |
| **FY2012** | 43,603 | 39,006 | 59,146 |
| **FY2013** | 42,708 | 41,145 | 60,775 |

Source: 2014 RR RM IR 2.1A response.

The decline in the number of BI claims processed in FY2011 and FY2012 confirms the financial data shown in Table 2. ICBC has acknowledged that the change to the new claims processing organization, and the introduction of new information processes, caused a slowing of normal claim processing. Claim processing positions were eliminated or not replaced in a timely manner which contributed to a decline in employee morale.

The development cost of the Transformation Program was funded from Optional capital; however the disruption to Basic BI claim processing has had an impact on Basic policyholder rates because of the rise in pending claim liabilities. Had the BI backlog remained at the FY2010 level through FY2013 approximately 9,300 fewer claims would be included in the Basic FY2013 liabilities. At a conservative $ 33,000 per claim, this additional backlog added some $ 307 million to the FY2013 unpaid claim liability estimate of $ 5.72 billion. The avoidable cost is the OSFI 10% equity margin and the BCUC 30% plus 15% additions. The "carrying charge" of the 9,300 claims is approximately $ 41.7 million in additional required equity to meet the 145% MCT target.

ICBC has recognized that the growing BI backlog is a problem. In the 2013 rate review they advised the Commission that the reorganization, and the slow filling of claims division staff vacancies, were partly responsible; although "transitional impacts" of the changes in claims handling could last until the end of 2016.[87] This year they advised the Commission that they intend to settle a larger proportion of the more complex (expensive) represented claims.[88] ICBC notes that this may increase the average BI cost per claim (paid severity) which may result in an increase in the rate indication of PY2015.[89] They did not discuss the possible reduction in the total unpaid claim liability. They say that they have now adopted a "deliberate strategy" to address the BI claim backlog, but they gave no assurance that the actual value of the pending claim liability will be reduced, or when this is likely to occur.

ICBC's projected FTE reductions for 2014 and 2015 of approximately 230 positions may exacerbate the growth in the cost of the unpaid claim liability.[90]

ICBC's 2015-2017 service plan forecasts an increase in total corporate liabilities of $ 1.57 billion from FY2014 to FY2017 (an increase of 12.8%), while net claims incurred are forecast to rise by $ 114 million (an increase of 3.2%).[91] Assuming about 70% of the liabilities relate to Basic ($ 1.10 billion), some $ 110 million in additional assets will be required to maintain the OSFI 100% ratio. An additional $ 50 million will be required to maintain the 145% Commission approved management target.

[87] 2013 RR BCUC IR 109.1-3 response.
[88] 2014 RR, p. 6-19.
[89] If the absolute cost of the unpaid claim liability were to decline the increase in the indicated rate resulting from the higher paid claim cost should be offset by a decline in the assets required to cover the remaining unpaid claim liability. The average cost of the remaining pending unpaid claims should also decline.
[90] 2014 RR, BCUC IR 69.1-2 response.
[91] ICBC Service Plan 2015-2017, February 18, 2015, p. 13.