INSURANCE CORPORATION OF BRITISH COLUMBIA -- OCCASSIONAL PAPER No. 1

ICBC FACING SEVERE FINANCIAL PRESSURE

In late May 2016 the government released ICBC's annual report for the 2015 fiscal year.[1] The report was made public without a media release shortly after the Legislature completed the spring 2016 sitting, and confirmed that ICBC suffered a $257 million loss of net income in the compulsory Basic program[2] compared to the prior year.[3] The highly profitable Optional insurance program actually recorded a $100 million increase in year over year net income but, after the government extracted $138 million in "excess" capital equity, ICBC's total capital reserve declined by approximately $506 million. The risk-weighted capital ratio fell from 193% in 2014 to 157% in 2015, some $255 million below the board of directors' target of 185%.

ICBC 2015 FINANCIAL RESULTS ($=millions)

	BASIC		OPTIONAL		CORPORATE		
	2014	2015	2014	2015	2014	2015	2016/17 SP
NET INCOME	87.1	(256.8)	285.4	387.3	372.5	130.5	(11.0)
ASSET VALUE[4]	(170.0)	(305.0)	(90.0)	(157.0)	(260.0)	(462.0)	63.0
EQUITY	1,632.7	1,046.8	1,983.0	2,062.7	3,615.7	3,109.5	2,987.0
CAPITAL RATIO[5]	136	85	298	300	193	157	143
TARGET RATIO	145	145	260	260	185	185	185

Source: ICBC Annual Report 2015 and Service Plan for 2016/17 to 2018/19.

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[1] The fiscal year was January 1st to December 31st. The government changed ICBC's fiscal year to April 1st to March 31st during the spring legislative session. The annual rate setting "policy year" remains as November to October. The Saskatchewan Government Insurance also changed to an April to March fiscal year during 2015. The Manitoba Public Insurance has a March to February fiscal year.

[2] The compulsory Basic program provides the insured third party liability coverage up to $200,000. Coverage beyond the Basic, and damage coverage to the at-fault policyholders' vehicle, is purchased through ICBC's Optional program, or through a private insurance company.

[3] There was no comment on the results in the print or television media.

[4] Includes changes in the fair value of assets and pension and post-employment benefits re-measurement.

[5] Basic and Optional ratios are derived as ICBC does not report this level of detail.

The reduction in the Basic net income was primarily the result of claims costs rising $320 million (14%) and an increase in the provision for prior years claims of $140 million. Rate increases of 5.2% in 2014 and 5.5% in 2015, and a small increase in policies sold, increased the Basic revenue by $206 million. The sale of certain equity assets increased investment income to approximately $606 million, but this is not expected to continue in 2016/17 as reflected in the service plan.

The Optional program, where ICBC has approximately 90% of the market, recorded a net income increase of approximately $102 million on the strength of a 9% increase in revenue. Claims costs increased by $97 million, but this was off-set by a reduction in the provision for prior years claims and increased investment income.

Continuing low interest rates are lowering the yield on ICBC's fixed income (bonds) assets, producing less dividend income per new dollar invested. As ICBC's bonds mature and new bonds purchased, ICBC loses the benefit of the higher market value of matured bonds (the average duration is about 2.5 years to match average claim durations). Low interest rates, while benefitting borrowers, are putting pressure on all pension and insurance funds which hold a majority of their assets in fixed income securities. In 2015, ICBC had approximately 68% of its $13 billion in assets in bonds.

DECLINING CAPITAL RESERVES

The capital reserve level (management target) is based on a risk-based formula, known as the Minimum Capital Test (MCT), used by the federal Office of the Superintendent of Financial Institutions (OSFI) to regulate the capital levels of federally incorporated pension and insurance corporations. The BC government adopted the OSFI MCT to set the minimum levels for Basic (currently 100%) and Optional insurance (currently 200%) programs in 2004. The BC Utilities Commission has set the Basic management target at 145%, while the ICBC board of directors has set the Optional target at 260%, resulting in a combined corporate target of 185%.[6] The capital management target for the compulsory Basic insurance publicly-owned auto insurers in Saskatchewan and Manitoba, operating under the no-fault model, is 100%.

The sharp decline in the 2015 Basic capital reserve is a serious concern as it shows an acceleration of the pressure on Basic capital. Without the transfer of $486 million of Optional capital in 2012 and 2013, the Basic capital reserve ratio would have fallen from 153% in 2010 to approximately 46% by December 31st. The Optional capital infusion allowed the Basic capital to begin the 2015 year at 135%.

In the summer of 2015, cabinet rejected ICBC's proposed 11.2% increase in Basic rates, and ordered the transfer of $450 million in Optional policyholders' capital to the Basic program, effective in 2016/17. Rather than accept the actuarially indicated rate increase, the government chose to temporarily re-inflate the capital reserve through the one-time transfer. The BC Utilities Commission was ordered to assume the transfer in approving the November 2015 rate increase of 5.5%.[7] The combined operating

[6] The management MCT target for Intact Financial, the largest private auto insurer in Canada, is 170%.
[7] See OIC 596/14 of 14 October 2015.

net income loss of some $256 million, combined with the $306 million net loss in the value of assets, dropped the Basic equity by some $560 million (34%) by year-end, or about $200 million below the government-mandated 100% minimum.

The $450 million Optional capital infusion raised the Basic capital ratio of approximately 120% to begin the 15-month bridge fiscal year.[8] This is 25 basis points below the Utilities Commission's (high) target of 145%, and 20 basis points above the 100% regulatory minimum. The transfer lowers the Optional ratio to some 230% to begin the 2016/17 fiscal year, which is 30 basis points below the ICBC board's capital reserve target, and 30 points above the regulatory minimum.[9]

THE 2016/17 OUTLOOK – THE GOVERNMENT'S DILEMMA

In February 2016, ICBC published its corporate level three-year financial forecast, which includes undisclosed assumptions for Basic and Optional rate increases for November 2016, and undisclosed assumptions concerning the growth in claims costs, policy growth, interest rates and inflation. ICBC must file the detailed 2016 Basic rate increase request with the Utilities Commission by late August 2016.

The 15 month 2016/17 fiscal year complicates comparisons to prior fiscal years when attempting to estimate Basic and Optional rates, net income and equity changes. Using two approaches, the indications are that the Basic program will end 2016/17 with loss of $400 to $480 million in net income, and a capital reserve ratio of 80 to 85%. The Optional program will record positive net income of between $400 to $360 million, and a capital reserve ratio (after the government extracts $150 million) of between 240 and 260%.

My forecasts assume Basic rates increase by the 7% maximum allowed by the cabinet-imposed regulated cap, while Optional rates increase by 4%. Claims costs are assumed to increase by approximately 8% for Basic and 6% for Optional. These claims costs assumptions may be too conservative in light of the 2015 results.

These forecasts would result in the Basic capital reserve being $200 to $300 million below the 100% regulatory minimum by 31 March 2017. If the government is contemplating another infusion of Optional capital to raise the Basic ratio to the 100% minimum it would need to lower the Optional management target from the current 260% to approximately 200%.[10]

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[8] In the spring 2016 legislative session the government amended the Insurance Corporation Act to change ICBC's fiscal year from a calendar year to the government's fiscal year.

[9] It is ironic that the government established the regulatory minimums in 2004 to ensure that the Basic program would not subsidize the price of Optional insurance. From 2010 to 2016/17 the Optional program has subsidized the government through $1.2 billion in capital transfers, and the Basic program by some $936 million. See also Richard C. McCandless, *Politics and Public Automobile Insurance in British Columbia, 1970 to 2010*, BC Studies, Summer, 2013; http://www.bcuc.com/Documents/Proceedings/2013/DOC_36019_A2-10_Politics-and-Public-Automobile-Insurance-in-BC-1970-2010-R-McCandless.pdf

[10] As the ICBC Optional program has 90% of the market, a reduction in the regulatory minimum to 150%, and a reduction in the management target to 200%, would be a reasonable expectation. The Insurance Corporation Act

Given the recent escalating growth in Basic expenditures, one would anticipate that the government is reviewing options to moderate or reduce the increase in claims costs, including a modification to the current full tort model for pain and suffering claims.[11] It cannot rely on the highly profitable (or over-priced) Optional insurance to continue to subsidize the Basic rates, and to continue to pay a form of dividend to the government.[12] Reducing the amount of property damage claims for the not-at-fault claimants, or reducing the already low Part 7 benefits, are not viable options,[13] given that the public will correctly perceive a loss of potential benefits to support a particular class of claimants.

If the recent trend in the growth in Basic BI claims costs persists in 2016/17, and this will be clarified in the August31st detailed submission to the BC Utilities Commission, the government will be faced with essentially two choices; either continue to suppress the Basic rate increase to about 7% and lower the capital reserve below the regulatory minimum, or raise the rates by approximately 18% to keep the capital reserve above 100%.[14] A bridge could be constructed by redirecting the planned $150 million transfer to government, and adding a further $150 million of optional capital, to keep the Basic capital above the minimum level. But in the absence of a significant moderation in Basic claims costs this would be a bridge to nowhere.

A rate shock of 18% would ensure that automobile insurance rates would be a major issue in the May 2017 election, particularly if the government continues to extract Optional policyholders' capital to reduce the government's direct borrowing requirements.

 July 30, 2016.

The writer is a retired senior BC government public servant who's paper on the 40-year financial history of ICBC was published by *BC Studies* in 2013. The same academic journal will be publishing his paper describing the BC government's manipulation of the finances of BC Hydro from 2008 to 2014 in the fall. He has been an intervener in the BC Utilities Commission's 2014 and 2015 reviews of ICBC's rate requests.

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was amended in the last legislative session to give the cabinet the authority to set the Optional capital management target.

[11] All other provinces either legislatively ban or cap the amounts for minor pain and suffering awards.

[12] The 2016/17 to 2018/19 service plan suggests that the government will take $450 million from the Optional capital over the three years. A dividend is a return on equity, and the government has no equity in ICBC.

[13] Of the $2.62 billion recorded in 2015 for Basic current year claims, approximately $2.0 billion were BI claims, and $415 million were property damage claims, and $190 million was for medical, rehabilitation, wage loss, home support and death benefit (Part 7) claims.

[14] The BCUC approved capital management policy allows for a capital rebuild rate surcharge.