OCCASIONAL PAPER No. 28 INSURANCE CORPORATION of BRITISH COLUMBIA

FIXING ICBC'S FINANCES A PRIORITY FOR NEW GOVERNMENT

.After May 9th the new government will have a number of priority matters pressing for attention. The worsening financial at ICBC will be high on the list. The previous government's approach to addressing the growing cost of claims by suppressing the increase in Basic rates has drained the policyholders' capital reserves.

The structural deficit in the Basic program must be eliminated before the reserves decline to the point where the taxpayer will be forced to bail-out the corporation. The government must also act to reduce the rate of premium increases, which ICBC expects to be approximately 4 to 4.5 times the annual increase in the consumer price index for the next three years.

I PROBLEM DEFINITION

The looming financial crisis at ICBC is primarily the result of two factors; the government's rate increase suppression policy, and the recent rapid increase in claims costs.[1]

The suppressed increases in Basic rates has resulted in operating deficits, which depleted the accumulated capital reserve. By the end of 2016/17, the Basic capital reserve would have been well below the government's regulatory 100% minimum ratio, but were restored to near the minimum level by the government-ordered transfer of $922 million from the highly profitable Optional program.[2]

An adequate capital reserve ensures that current and future claimants will receive payment, and protects policyholders from rate shock in the event of an unexpected financial deterioration. The current provincial regulatory minimums (Basic at 100% and Optional at 200%) have been in place for 10 years. In 2014, ICBC convinced the BC Utilities Commission to increase the operating ratio for Basic insurance program from 130% to 145%. The ICBC board of directors has had an operating target of 260% for the Optional program since 2011.[3]

ICBC's February 2017 Service Plan three-year financial forecast shows a continuing loss of capital for 2017/18 and 2018/19. ICBC did not disclose the combined minimum capital test (MCT) ratios for 2017/18 or 2018/19, nor did it show the financial forecasts split between the Basic and Optional programs. As the regulatory capital minimums are at the program level, the Service Plan masks the extent of the looming crisis.

[1] The low interest rate environment has also negatively affected ICBC's net income and equity, but this factor is not unique to ICBC.
[2] Through cabinet orders $450 million was transferred in 2015, and $472 million will add to the Basic capital for 2016/17.
[3] A summary of the capital reserve ratios can be found in Chapter 3 of http://www.bcuc.com/Documents/Arguments/2015/DOC_43293_03-12-2015_McCandless_Final-Argument.pdf

Using relative values for 2014 and 2015, I have constructed forecasts for the two programs which add to ICBC's Service Plan forecast.[4] Table 1 shows that by 2018/19 the Basic capital reserve will be some $1.2 billion below the regulatory minimum, while the Optional capital reserve will have about $470 million in capital surplus to the regulatory minimum requirement.

Table 1 YEAR-END CAPITAL RESERVE EQUITY ($=million)

		---------2016/17----------		----------2017/18----------		---------2018/19---------	
		BASIC	**OPTION**	**BASIC**	**OPTION**	**BASIC**	**OPTION**
	Equity -- Start	1,543	1,603	1,150	1,405	716	1,721
	Total Comp Income	(865)	273	(434)	316	(423)	287
	Optional Transfer	472	(472)	nil	nil	nil	nil
	Equity -- **End**	1,150	1,405	716	1,721	293	2,008
	MCT Ratio %	83	195	50	229	20	257
	Minimum Sur/(Def)	(236)	(35)	(720)	221	(1,192)	448

Source: Derived from ICBC Service Plan 2017/18 to 2019/20, February 21, 2017.

When disaggregated to the program level, the ICBC forecast shows the structural Basic deficit eroding the capital reserve. By 2018/19 the Basic program capital will have dropped to only 50% of the regulatory minimum.

The 2016/17 fiscal year spans 15 months as the government changed the fiscal year from January to December to April to March. This is the main reason for the large loss in the Basic comprehensive income this year.

The government has relied on operating and capital infusions from the Optional program to subsidize the Basic rates. However, Table 1 shows that for the coming year the Optional program capital surplus of some $218 million will be insufficient to keep the Basic capital at the 100% regulatory minimum. If the $218 million was transferred, the net Basic capital shortfall of $0.5 billion would require an additional Basic rate increase on April 1, 2017 of approximately 18%.

In my Occasional Paper No. 27, I suggested that the 200% regulatory minimum for the Optional capital reserve is too high.[5] Table 2 shows the effect of a reduction of the Optional regulatory minimum to 150%.

Table 2 CAPITAL RESERVE SURPLUS/DEFICIT ($=million)

	2016/17	**2017/18**	**2018/19**
Basic @ 100%	(236)	(720)	(1,192)
Optional @150%	325	596	838
Net Position	89	(124)	(354)

[4] My Total Comprehensive Income for the Basic program is slightly higher in the second and third years because ICBC reduced the Non-Insurance total for additional recoveries and I did not. The 2017/18 Optional current claims has been increased slightly.

[5] http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_27_24_march_2017/pdf

Reducing the Optional minimum ratio to 150% would liberate sufficient Optional capital to keep the Basic slightly above the 100% regulatory level for 2016/17, but would be insufficient to continue into 2017/18 or beyond. Table 2 shows the Basic shortfall to the minimum regulatory level at $354 million by 2018/19.

GROWTH IN THE CLAIMS BACKLOG

ICBC's recent service plan forecast showed total liabilities climbing from $13.55 billion in 2015 to $16.92 billion by 2018/19. Unpaid claims (the backlog) comprise approximately 65% of the total liabilities, therefore we can assume that by 2018/19 the unpaid claims liability will grow from $9.0 billion in 2015 to $11.3 billion in 2018/19.

This growth in the backlog is the result of ICBC not devoting sufficient resources to claims processing. The MCT formula requires that every $1 of unpaid claims liability be covered with $1.06 in risk-free assets (e.g. government bonds). Therefore, adding $2.3 billion in unpaid claims liability will require ICBC to add $138 million, or the capital ratio will fall.

Keeping the value of unpaid claims under control is a priority for private sector insurers. For example, Intact Financial, which is 65% larger than ICBC (based on premiums earned), reported a 9% ($740 million) increase in its unpaid claims liability from 2012 to 2015, while ICBC reported an increase of 29% ($2.0 billion) in the same period.[6]

II THE CRISIS PRESENTS AN OPPORTUNITY

"*You never let a serious crisis go to waste… it's an opportunity to do things you think you could not do before*."[7]

The financial crisis at ICBC presents an opportunity for the new provincial administration to reform the financial structure of the public auto insurer.

To immediately restore the Basic minimum capital to the 100% ratio by 2018/19 would require a rate increase of some 50% on November 1, 2017, followed by a 5% increase the following year. Such a significant increase would likely prove too disruptive to policyholders and the economy generally, as the new Social Credit government learned in early in 1976.[8]

A better approach would involve a variety of changes to the current funding model, as well as a commitment to a strategy to reduce total claims costs in future years. The current model has demonstrated an imbalance between the price and cost of the two insurance programs, which should be corrected. The crisis also provides an opportunity to correct errors whereby the taxpayer has benefited at the expense of the Basic policyholders in funding certain non-insurance programs.

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[6] Between 2012 and 2015 ICBC reduced the claims division by 103 positions as the claims backlog increased. In 2016 ICBC is adding about 80 claims positions, saying the action was to mitigate cost increases.
[7] Rohm Emanuel, chief of staff to President Obama during the 2008/09 financial crisis.
[8] The Bill Bennett government initially planned a major rate increase, but bailed-out ICBC with taxpayer funds, see http://www.bcpolicyperspectives.com/media/attachments/view/doc/article_bc_studies_icbc_2013/pdf

Table 3 is a summary of a variety of changes that the new administration could make to eliminate the Basic program's structural deficit, and position ICBC to reduce or reverse the value of claims costs in the medium term (3 to 5 years). The summary begins with the Basic capital shortfall, and the Optional surplus, from the regulatory minimums shown in Table 1 for 2017/18 and 2018/19, with marginal adjustments for each initiative subtracted from the status quo totals. Details on the initiatives are summarized in Appendix 1.

Table 3 IMPACT OF INITIATIVES ON YEAR-END CAPITAL POSITION ($=million)

		-------2017/18--------		-------2018/19---------	
		BASIC	**OPTION**	**BASIC**	**OPTION**
1	Status Quo Forecast Surplus/(Deficit)	(720)	218	(1,190)	445
2	Optional Min MCT Ratio to 150%	(720)	596	(1,190)	838
3	Reduce Optional Rates 15% X 2 Years	(720)	376	(1,190)	462
4	Increase Basic Rates 7% X 2 Years	(520)	376	(790)	462
5	Government Pays for Services	(425)	376	(695)	462
6	Adjust Basic/Optional Costs	(395)	346	(665)	432
7	Province Pays Seniors' Discount	(295)	346	(565)	432
8	Enhance Photo Radar Fine Revenue	(280)	346	(545)	432
9	Basic Capital Rebuild 3% Surcharge	(195)	346	(375)	432
	LONGER-TERM COST REDUCTIONS				
10	New Basic Option (SAF Model)	(195)	346	(350)	432
11	Cap on Minor P&S (Alberta Model)	(195)	346	(320)	432
12	Review Claims Adjudication Process	(195)	346	(320)	432
13	Review Subrogation Options	(195)	346	(320)	432

The first group of initiatives helps rebalance the capital reserve between the Basic and Optional programs. The second group requires a longer implementation period, or more review. The government must also commit to lowering the number and cost of claims by investing more resources in traffic enforcement and public education.

A NEW OVERSIGHT MODEL?

During the review and implementation of these initiatives the government must also reconsider the role of the BC Utilities Commission. Is the current split governance model, with the BCUC focused on the Basic program and the government directing the it and the Optional program still a viable approach? Should the Utilities Commission, with its emphasis on process, and single year rate requests, be replaced an insurance regulator with a longer-term horizon, operating in a timelier manner?

This is another opportunity to remodel the governance/oversight structure for public auto insurance in this province.

SUMMARY

The new government must act quickly to stop the looming financial crisis at ICBC. The corporation's three-year forecast indicates that the Basic capital is declining at an alarming rate. The cross-subsidy from the highly profitable Optional program is no longer enough to maintain the Basic and Optional capital reserves at the regulatory minimums.

Reducing the Optional minimum ratio to 150% would help, but the downward trend would continue. More fundamental changes are required to rebalance ICBC's capital reserves, and begin to restore a healthy financial condition.

The previous government's suppression of the increase in Basic rates ignored the underlying problem of injury claims costs increasing at unsustainable levels. Now ICBC is at the point where a much more concerted effort is required.

The writer is a retired senior BC government public servant whose paper describing the BC government's manipulation of the finances of BC Hydro from 2008 to 2014 was published by *BC Studies* in November 2016. *BC Studies* published his paper on the 40-year financial history of ICBC in 2013. He has been an intervener in the BC Utilities Commission's recent reviews of ICBC's rate requests, and is currently an intervener in the Commission's current reviews of ICBC and BC Hydro rate requests.

APPENDIX 1

EXPLAINATION OF TABLE 3 INITIATIVES

Item 1 Status Quo Forecast:

- The Basic and Optional surplus of deficit from the regulatory minimum capital requirements.
- Includes a 5% to 6% annual rate increase for Basic, and 3% for Optional.

Item 2 Change Optional minimum MCT to 150%

- Given ICBC's near monopoly in the Optional market, and assuming the Basic capital is stabilized, reducing the MCT ratio to 150% is reasonable.
- Increases the Optional program "surplus" by $380 million in 2017/18, and an additional $240 million in 2018/19.

Item 3 Reduce Optional price by 15% each year

- This reduces the capital surplus to better reflect the true cost of providing Optional insurance.
- Insurers selling Optional auto insurance will complain (see Item 4).

Item 4 Increase Basic rates by 7% each year

- This captures the savings from the Optional rate reduction.
- Some 90% of ICBC's Basic private vehicle policyholders purchase Optional coverage from ICBC, therefore some 2.2 million of the 2.7 million annualized private policyholders will see no net change in their costs.

The combined effect of items 4 and 5 legitimates what the government has been doing since 2012, when Optional profits are transferred to bolster the Basic capital reserve. The private insurers, with approximately 220,000 Optional policies, will complain that the Optional price reduction will allow ICBC to gain a larger market share. They would prefer that the Optional program profits continue to support the Basic capital, rather than reduce the high Optional rates.

Item 5 Government Pays for Services

Currently, Basic policyholders pay for programs where the government receives the benefit. The Non-Insurance program includes about $60 million for the issuing of drivers' licenses but the fee is paid to the government (contrary to the 1998 Supreme Court of Canada ruling on fees vs taxes). The Road Safety program includes funding for highway improvements, and for enhanced policing. These costs should be paid by the government. ICBC should also expect payment for its provincial fine collection activity through the refuse to issue policy (the federal government pays ICBC for this service).

Item 6 Adjust Basic/Optional Costs

- The balance of the Non-Insurance and the Road Safety costs should be shared on a 60/40 basis.

Item 7 Province Pays Basic Senior Discount

- Most policyholders aged 65 and older receive a 25% discount on Basic rates. At a time when the Basic program is facing a financial crisis, this program should be eliminated (as the BC Ferries Corporation did in 2014). If the government believes that the 25% discount is beneficial, it should reimburse ICBC for the estimated $100 million annual foregone revenue.
- The discount applies only to Basic coverage, and is becoming costlier to other Basic policyholders as the number and proportion of policyholders 65 and older increases.

Item 8 Enhanced Photo Radar Fine Revenue

- Photo radar is an effective tool to enhance traffic enforcement.
- Current intersection cameras operate on limited hours; this should be doubled.
- Photo radar cameras should be re-instituted to enhance traffic safety.
- The additional revenue should be granted by the government to ICBC to reduce the cost of Basic policies, and to avoid public concern that the additional revenue is a "cash grab."

Item 9 Basic 3% Capital Rebuild Surcharge

- A surcharge on Basic rates until the capital reserve is at the 100% regulatory minimum.

Item 10 New Basic Insurance Alternative Coverage

- In addition to the current tort coverage, ICBC would offer a cheaper No Fault program with higher maximum medical, rehabilitation, wage loss and living assistance benefits.
- The new option would be modelled on the program introduced in Saskatchewan in 2003.[9] It is preferred by approximately 90% of the Saskatchewan Auto Fund (Basic) policyholders.
- With a large take-up, the No Fault option could substantially reduce the future cost of injury claims as the not at fault party could not sue for pain and suffering.
- Increasing the current limits Part 7 benefits, which have not been raised since 1991, is a core component of this option.
- No claims from those eligible for Workers' Compensation benefits (same as Saskatchewan).

Item 11 Cap on Minor Pain and Suffering Claims

- The BC legislation would have the benefit of current legislation in other provinces, particularly the Alberta model.[10]

Item 12 Review Claims Adjudication Process

- ICBC has been criticized by the Trial Lawyers Association of BC and by other knowledgeable parties for its litigious approach to claims adjudication.[11]
- ICBC's claims settlement philosophy and claims settlement authority levels should be reviewed to determine if significant savings are possible.

Item 13 Review Current Claim Subrogation

- Alberta and Ontario have legislatively prohibited subrogation relating to motor vehicle claims.
- The government should review the possible savings to policyholders by following these models.

[9] https://www.sgi.sk.ca/individuals/registration/personalautoinjury/index.html
[10] For an overview of minor injury caps see http://www.courthouselibrary.ca/training/stream/the-stream-tracy-mclean/2010/09/04/Minor_Injury_Caps.aspx

[11] http://vancouversun.com/storyline/ian-mulgrew-icbcs-claims-costs-balloon-fuelled-by-antagonistic-litigious-strategy