COMMENTARY **ICBC**

LOOMING INSOLVENCY: COVID—19 INDUCED FINANCIAL MARKET SLIDE THREATENS ICBC'S FINANCIAL HEALTH

Will the current Covid-19 induced decline in the world and Canadian financial markets result in ICBC becoming insolvent by fiscal year end? Because of the lack of any capital reserve to buffer against adverse financial events it is highly likely that ICBC's liabilities will exceed its assets by 31 March 2020.

Need for a Capital Reserve

In Canada the Office of the Superintendent of Financial Institutions (OSFI) regulates nationally chartered insurance companies. OSFI uses a risk-weighted formula (the minimum capital test or MCT) to ensure that these private insurance companies have adequate capital (equity) reserves to honour their financial obligations to claimants in the event of an unplanned adverse financial event. The Covid-19 induced drop in the financial markets is such an unplanned adverse event.

The public auto insurers in Saskatchewan and Manitoba are not regulated by OSFI but have adopted the federal regulator's formula to set an MCT ratio of 100% for their monopoly Basic insurance programs, and approximately 200% to 250% for the Optional programs.

In the mid-2000s, the B.C. government set the Basic MCT target at 100% and required a minimum of 200% for the Optional program. The B.C. Utilities Commission later set the Basic target at 130% (then 145% in 2013) as a further buffer against potential losses.[1]

Recent Operating Losses Have Depleted ICBC's Capital Reserve

Until the 2014 fiscal year ICBC had a healthy capital reserves in both the compulsory Basic program (MCT of 136%) and in the Optional (MCT of 298%) program. The total reserve was approximately $3.6 billion. However, the rapid increase in claims costs during the next few years was not matched by increases in premium revenue, nor legislated limits on the full tort injury claims. From 2015 to 2018/19 ICBC suffered combined operating losses of some $3.0 billion. When combined with other losses in the

[1] http://www.bcpolicyperspectives.com/media/attachments/view/doc/bcuc_icbc_2016_final_20_dec_2016/pdf/bcuc_icbc_2016_final_20_dec_2016.pdf p. 7.

value of its investments due to lower interest rates, the public auto insurer ended 2018/19 with only $119 million in equity.[2]

The NDP government has announced a series of changes designed to reduce the overall cost of injury claims. This will be accomplished by eliminating most claims for pain and suffering, and lowering the cost of legal representation and related costs by significantly increasing the care coverages available to all parties injured in a crash.

Beginning in 2021/22, most of the annual net savings are destined to be returned to policyholders through a 20% reduction in the average premium. Under the enhanced care (no-fault) ICBC forecasts that the 2019/20 combined Basic and Optional net loss of $91 million will become a $191 million net income for 2022/23.[3] Of interest is the forecast for total equity which rises to approximately $1.1 billion for year-end 2022/23.

ICBC Service Plan 2020/21 to 2022/23 ($=million)

	F 2019/20	B 2020/21	B 2021/22	B 2022/23
Net Income	(91)	86	148	191
Equity	57	302	691	1,088
MCT	n/a	n/a	n/a	n/a

Source: https://www.icbc.com/about-icbc/company-info/Documents/Service-plan-2018-2021.pdf p. 17.

ICBC did not provide its assumptions for the significant increase in the equity, but this deficiency mirrors the rest of its service plan, as our public insurer did not provide any detailed assumptions to justify its multiyear forecast and budgets. Also, ICBC is no longer providing the MCT ratio for these years.

It did concede that its capital levels are currently well below its management target, and the government had, through OIC 67/18, suspended the Basic MCT regulatory minimum of 100% from 2018 to 2021.[4] The service plan assumes that the suspension will continue, and that the minimum targets may actually be reduced in the future:

> This temporary suspension is expected to be in place until the full extent of the impact of product reforms and various other initiatives become known. This will allow ICBC, in consultation with government, more time to refresh the capital management plan, on which future targets will be based. With significant changes

[2] It is likely that without the cabinet-ordered limit of expert reports, announced in February and March 2019, ICBC would have been insolvent by 31 March 2019, see http://www.bcpolicyperspectives.com/media/attachments/view/doc/comment_icbc_14_february_2019/pdf/comment_icbc_14_february_2019.pdf and http://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary_icbc_400_million_27_october_2019/pdf/commentary_icbc_400_million_27_october_2019.pdf

[3] https://www.icbc.com/about-icbc/company-info/Documents/service-plan-2020-2023.pdf p. 17.

[4] https://www.icbc.com/about-icbc/company-info/Documents/service-plan-2020-2023.pdf p. 21.

being brought in by Enhanced Care coverage, the minimum capital requirements may change, as the claims liability risk and the investments portfolio evolve.[5]

The Lack of a Capital Reserve Suggests ICBC will be Insolvent by Year-End

In mid-February, when ICBC released its forecast for the current fiscal year it anticipated a minor combined Basic and Optional operating loss of $91 million, and year-end equity of only $57 million. Using the previous minimum targets for the Basic (100% MCT) and the Optional programs (200% MCT), the combined capital reserve should be in the order of $3.5 billion to $4.0 billion.

The Covus-19 infection has seriously disrupted the financial markets causing a flight to safety in the form of US treasuries and the purchase of government of Canada bonds.[6] This raises the value of the fixed income assets and lowers the dividend yield. The new 50-basis point drop in the US and Canadian interest rates is rippling through the system. The Bank of Canada's 1 to 3-year bond yield fell from 1.48% on February 20st to 0.81% on March 6th, a drop of 45%.[7] Since February 20th the average value of equities traded on the TSX has declined by about 10%, while the DOW average declined by about 12%.[8]

In its service plan ICBC states that a 1% decline in the claim discount rate (based on the interest rate) represents approximately $390-$415 million increase in claims costs, because the lower the discount rate the higher is the present value of the future unpaid claims obligation. If we assume that the discount rate has declined by 0.3% since the service plan was published the additional cost for 2019/20 would be approximately $120 million. The lower interest rates for the balance of the year will have a negligible effect on the annual interest earned, but will increase the fair value of ICBC's government bonds (which are valuated at 31 March). Generally, the higher claims cost resulting from a decrease in the discount rate is mostly offset by the increase in the fair value of the fixed income investments.

ICBC also has significant equity investment assets.[9] It estimates that a 10% decline in equity prices would translate to an estimated drop of some $434 million in ICBC's equity.[10] If we assume a conservative decline of 7% from the date of the service plan forecast (from 18 February) to the 31 March year-end, the loss would be approximately $300 million.

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5 Ibid.

6 https://www.bloomberg.com/news/articles/2020-03-06/-a-complete-bog-of-uncertainty-canadian-traders-on-crazy-week?srnd=premium-canada

7 https://www.bankofcanada.ca/rates/interest-rates/canadian-bonds/

8 https://www.nasdaq.com/articles/stock-market-news-for-feb-20-2020-2020-02-20

9 Approximately $4.7 billion as of 31 March 2019, see https://www.icbc.com/about-icbc/company-info/Documents/ar-19.pdf p. 62.

10 ICBC Service Plan 2020/21 to 2022/23, p. 19.

Using this simple analysis, ICBC's service plan forecast year-end equity of $57 million could slip to a negative equity of about $200 to $250 million by 31 March.

Government Announcement of the Benefits of the Enhanced Care Model Neglected to Discuss How to Restore ICBC's Financial Health

The government's announcement of the shift to the enhanced care (no-fault) liability model focussed on the higher financial limits for care and support for those injured in a crash, and the planned savings of 20% in the average policyholder's premium starting in 2021/22. The government did not commit to redirecting some of the claims cost savings to rebuilding ICBC's capital reserves.

Operating with an inadequate capital reserve increases the risk of a taxpayer bailout. Insulating the taxpayer from covering claim losses is not an attractive selling feature of the shift to the enhanced care model. But rebuilding an adequate capital buffer at ICBC is vital to lowering the risk that taxpayer funding may be required to cover the cost of claims and other liabilities.

 http://www.bcpolicyperspectives.com/

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 both ICBC's and BC Hydro's rate requests.