

INSURANCE CORPORATION OF BRITISH COLUMBIA – OCCUSIONAL PAPER 12A.

QUANTIFYING THE IMPACT OF THE 2016 RATE INCREASES ON ICBC'S CAPITAL RESERVES

In my Occasional Paper No. 12,¹ I attempted to provide an initial analysis on the impact of the Basic and Optional rate increases on the capital reserve levels. A sufficient risk-weighted capital reserve is necessary for insurers to ensure that they have a margin of assets in excess of the estimated unpaid claims and other liabilities to withstand temporary periods of financial adversity. A capital reserve ratio is established based on the Office of the Superintendent of Financial Institutions' (OSFI) marginal capital test (MCT) guidelines.

The current BC Utilities Commission approved Basic operating (or management) target capital reserve ratio is 145%, while the ICBC board of directors has established the Optional programs' target at 260%. The provincial government requires a minimum of 100% for Basic insurance and 200% for the Optional insurance.

In establishing the 2016 policy year (PY) Basic rates the government was limited by the 2013 'rate smoothing' limit of 1.5% greater or less than the 5.5% increase approved for 2015. It was also constrained by the minimum 100% capital ratio, which is calculated on ICBC's fiscal year.² The different accident and policy years adds a level of complexity for ICBC to translate the calendar year to the policy year, and creating a third period as the fiscal year complicates comparisons all the more.

The BC Utilities Commission has allowed ICBC to present its justification for the Basic rate changes without a detailed fiscal year comparison, not does ICBC forecast multi-year impacts of the annual changes, as ICBC does in its annual service plan at the corporate level. Given the level of information provided in the 2016 rate request, where some of the costs are projected at the fiscal year level while others (such as claims) are not, it is not possible to construct a "bottom up" estimate of the fiscal year impact. But a "top down" estimate is possible given the limited fiscal year information provided. Under this approach the +/- 5% rate increase was a "fixed" variable, and the amount of the Optional dollars transferred varies depending on the claims costs forecast.

This approach allows one to separate most of the major revenue and cost drivers to construct an estimate of the year-end 2016/17 capital reserves for the Basic and Optional programs. In its submission

¹ See Occasional Paper No. 12 at http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_12_26_august_2016/pdf

² The long-standing January to December fiscal year was changed in the spring 2016 session to April to March, therefore the 15-month 2016/17 transition year makes comparisons with the prior years' data more difficult; all of ICBC forecasting models are based on a January to December "accident year."

ICBC states that without certain claims costs and other savings (\$75 million), and the transfer of a total of \$472 million from the Optional program, the rate increase would have been 15.5%.

Of more importance is the fiscal year-end impact of the government's manipulation of the Optional funds on the capital reserve targets of the two programs. The following summary attempts to trace the decline in the capital reserves from the 2015 fiscal year to the end of the 15 month 2016/17 fiscal year, with \$=millions.

| | BASIC | | OPTIONAL | | |
|----------------------|---------------|------------|---------------|------------|--------------------|
| | <u>\$=MIL</u> | <u>MCT</u> | <u>\$=MIL</u> | <u>MCT</u> | |
| 2015 Year-end | 1,071 | 83 | 2,075 | 300 | ICBC Annual Report |
| Adjustment Oct. 2015 | 450 | 35 | (450) | (65) | |
| January 1, 2016 | 1,521 | 118 | 1,625 | 235 | |

The following components are approximations as some are policy year and others are fiscal year.

| | | | | |
|---------------------------|-------|----|-------|-----|
| Increase in policies | 85 | | 50 | |
| 2015 and 2016 rate change | 145 | | 45 | |
| Optional transfer | 472 | | (472) | |
| Other costs | (50) | | (30) | |
| Claims related costs | (652) | | (80) | |
| Reduction in capital | (177) | | -- | |
| Estimate 2016/17 | 1,344 | 95 | 1,138 | 160 |

ICBC says that a year-end estimate of \$1.344 billion equates to a MCT ratio of 102%, but this is for rate setting purposes. The other data supplied suggests that \$14.1 million equals 1% MCT for 2016/17, therefore the 95% is used. The numbers include \$99 million in Optional net income that will not be transferred until 2017/18, but the BC Utilities Commission is required to assume the addition for setting the 2016 rates. This maneuver kept the rate increase below 5%.

CONCLUSION

Unlike BC Hydro, which can defer cost variances, apparently create revenue, and increase the debt burden on future ratepayers through such accounting measures, ICBC must adhere to stricter accounting rules. It must maintain a minimum level of GAAP equity to ensure that current and future claims can be paid.

The decline of the Optional reserves to approximately 150% is not, in itself, a cause for concern as the 260% target served only to inflate the government's assets. The cost volatility of the Optional program is much less than that of the Basic program, as the recent growth in BI claims and claims costs is mostly confined to claims under \$200,000. A capital ratio of 150% is probably realistic.

The cabinet-ordered transfer of some \$300 million of Optional net income to the Basic program may foreshadow a rebalancing of the Optional and Basic rates to better reflect the costs.

If the 2016 funding patch holds for the balance of the fiscal year, what does the government elected in May 2017 face? If ICBC's projections for 2017/18 are within the ballpark, the Basic program will face another shortfall of \$600 to \$700 million. A rate increase of between 20% and 25% will be required to maintain the 100% capital reserve minimum. A rebalancing of the Optional and Basic rates could lower the indicated rate increase to between 10% and 15%, but the lower price of Optional insurance would likely drive the private insurers out of the market.

Other options include a switch to online policy renewals, which would save some of the current \$400 million in brokers fees,³ and a major public education and enforcement campaign to reduce the number of crashes.⁴ The Trial Lawyers suggest that a less adversarial approach to damage settlement negotiations may also reduce the total claims costs. Whether this is true or not, it would reduce the large and growing claim liability backlog and the resulting need for such a large value of assets.

In discussing the growing claims costs ICBC noted that because of the full tort model it "faces significant cost pressures which are not present in other jurisdictions..." where, if such claims are permitted, they are restricted or have caps.⁵ It is likely that this topic will be at the top of the ICBC briefing book of the next minister after May 2017.

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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.

³ In 2015 approximately \$395 million was paid; most of the fees are for Optional insurance.

⁴ The 2016 request actually budgets 30% less for public education programs, see Chapter 8, p. 8-2.

⁵ ICBC 2016 rate request, Chapter 7, p. 7-1.