

RATE SUPPRESSION AND CAPITAL DESTRUCTION: ICBC RATE SHOCK LURKING

Rate Suppression as Government Policy

In 2012 the provincial government was becoming alarmed at the future rate implications of the rising electricity costs at BC Hydro, and growing claims costs of the compulsory automobile insurance provided by ICBC. When the BC Utilities Commission (BCUC) appeared to be ready to raise electricity rates higher than the government desired, cabinet ordered it to approve rate increases for 2012 and 2013 at levels well below the growth in costs. The 1.44% increase of April occurred a few weeks before the May 2013 provincial election.

In November 2013, after BC Hydro requested a significant two-year increase in rates, the government announced a 10-year financing plan, with rate increases determined for 2014 and 2015, and capped at lower than required levels for the next three years. The centerpiece of the plan was a new “rate smoothing” deferral account which allowed BC Hydro to record unapproved future revenue, ensuring the appearance of robust profits. In March 2014 cabinet ordered the BCUC to approve a detailed list of financial measures, including the new deferral account.

The price control scheme had already been in place for ICBC’s Basic program. Through a March 2013 cabinet directive, the cost of service model--which ensured that revenues and expenditures remained in balance--was modified by an annual cap on the allowed rate increase. The healthy capital reserve would be used to moderate annual volatility in costs on net income, thereby smoothing the annual change in rates. The planners in the Ministry of Finance knew that a large capital pool existed in the profitable Optional insurance program to back-stop the Basic capital.¹

The Best Laid Schemes o’ Mice an’ Men....

Price controls can be effective in moderating the effect of a one-time spike in costs on insurance rates. The difficulty comes when the cost base continues to grow faster than revenues. If price suppression continues in this environment the annual deficits will deplete the accumulated capital reserve equity. In effect, the family assets are being consumed to support an unaffordable lifestyle.

The planners had not anticipated the steep rise in injury claims costs (2014) and in vehicle damage claims costs (2015) which, combined with the effects of decreasing interest rates, rapidly drained the Basic capital reserve. In 2015 the government was forced to transfer another \$450 million of Optional policyholders’ capital to re-inflate the Basic reserve.

Table 1 shows the difference between ICBC’s forecasted (indicated) rate increase requirement, the actual increase requested and the change in the Basic capital reserve ratio from 2011 to 2015. The 2016 forecast

¹ In fact, in late 2012 the government ordered \$373 million of Optional capital transferred to the Basic reserve, followed by \$113 million the following year, to keep the capital reserve funding ratio at a healthy level.

capital ratio was provided by ICBC in October 2016, and includes a further \$472 million of Optional funds transferred to the Basic program.

TABLE 1 -- RATE CHANGES AND CAPITAL RATIO (percent)

	PY2012	PY2013	PY2014	PY2015	PY2016
Indicated Rate	11.2	11.8	5.2	11.2	15.5
To Capital	nil	6.6	nil	5.7	10.7
Requested Rate	11.2	5.2	5.2	5.5	4.9
Approved Rate	11.2	5.2	5.2	5.5	tbd
Capital (in. Optional)	137	149	137	118	100

Source: ICBC rate requirement applications; capital ratio is fiscal year-end from annual reports, adjusted to incorporate capital transfers of \$486 million for 2012 and 2013, \$450 million for 2015 and \$373 million for 2016. The capital ratios for 2016 are for 12 months to December 31, 2016.

The 2016 Rate Increase

In 2016, the government changed ICBC's fiscal year to match the government's April to March pattern, thereby adding three months to the 2016/17 transition year. The longer year would (all else being equal) have required a higher rate increase in 2016 to ensure the regulatory minimum capital target was achieved. Instead, the 4.9% increase was lower than the 5.5% increase for the prior year. And ICBC did not offer the hope that claims costs would decline, which may have justified the lower increase.

Instead of abandoning price controls, the government ordered another raid on the Optional 'bank' totaling \$472 million which re-inflated the year-end Basic capital to the regulatory 100% minimum. By March 2017 it is estimated that the Optional capital reserve ratio will have fallen to about 200%, which is the regulatory minimum.²

It should also be noted that the notional separation between the Basic and Optional programs creates the false impression that there are two distinct groups of policyholders. Over 90% of Basic policyholders purchase additional liability coverage, in part because the Basic limit has not increased in over 20 years. Some 80% of Basic policyholders purchase ICBC's Optional coverage; therefore, all Optional policyholders are Basic policyholders. The government and ICBC acknowledge the 'single wallet' when they defend the higher Basic rates in terms of the combined impact of the two programs.

The Effect of a Lower Capital Reserve

All insurance companies operate with a capital (equity) reserve to ensure that sufficient assets exist to pay current and anticipated claims in the event of an adverse event. The federal regulator,

² Estimates developed by the writer as ICBC does not publicly report details on the Optional program.

the Office of the Superintendent of Financial Institutions (OSFI) developed a risk-weighted formula to produce a capital ratio, and set 150% as the “supervisory” minimum for private insurers operating in a competitive market. The government adopted the formula and determined that 100% would be the minimum for the monopoly Basic insurance, and 200% for the near monopoly Optional program.

Until the August amendment to Special Directive IC2 the BCUC set the Basic capital target.³ At the urging of ICBC, the BCUC set the annual capital ratio at 145% to ensure that sufficient assets would be available to pay claims in the event of an unexpected one-time financial shock. The ICBC board of directors had established a (high) 260% ratio for the Optional program.

Table 2 shows the year-end actual capital ratios from 2011 to 2017/18, including the Optional programs’ funding transfers to the Basic program in 2012, 2015 and 2016.

TABLE 2 -- YEAR-END CAPITAL RATIOS

	2012	2013	2014	2015	2016/17	2017/18
BASIC	137	149	136	118	102	64
OPTIONAL	313	304	298	236	202	216
CORPORATE	200	204	193	157	130	108
EQUITY (\$=Bil.)	3.25	3.64	3.62	3.15	2.84	2.55

Source: ICBC annual reports; ICBC 2016/17 Basic forecast; Optional 2016/17 and all 2017/18 are writer’s forecast.

This year the government amended the Insurance Corporation Act to give cabinet the authority to set the annual management targets.⁴ This will allow cabinet to lower the Optional capital management target to reflect the new reality, without the advice of ICBC’s actuaries.

Financial Nihilism as Government Policy

The lowering of both the Basic and Optional capital reserves to their regulatory minimums greatly increases the risk that ICBC will not have enough equity to pay claims, especially if the rate suppression policy continues.

The government’s financial planners have suppressed BC Hydro rates (while still declaring high profits) by increasing the deferral accounts and the debt. To make the scheme work at ICBC the

³ Through OIC 615/16 (August) cabinet assumed this responsibility.

⁴ Bill 10, spring legislative session.

capital equity reserve has been severely reduced, exposing claimants to higher risk. The avoidance of addressing the structural deficit in the Basic rates cannot continue to rely on the destruction of policyholders' assets.

The BCUC annual rate review process focusses on comparing the forecast policy year (November to October) rate change to the previous policy year forecast, adjusted for the latest forecast. Until this year ICBC has resisted my requests for a multi-year fiscal forecast to monitor the forecasted decline in capital, but this year ICBC did respond confidentially to the BCUC's request for such a view.⁵

My own simplified forecast for the Basic programs shows the structural deficit continuing. Even with a 5% rate increase for 2017 (and no Optional transfer), the capital reserve ratio will fall to about 64%, or \$500 million short of the 100% regulatory minimum by 31 March 2018. If the capital reserve were to grow to a less risky 110% ratio an additional \$140 million must be added to the requirement.

To recover the \$500 million by 31 March 2018 would require as massive rate increase for 1 November 2017. As the November policy year provides only five months of "new" revenue, an increase of approximately \$400 per policy would be necessary,⁶ or a total rate increase of about 46%.

If the government directs another Optional transfer for 2017/18, only some \$120 million would be available before the capital ratio drops to the regulatory minimum. Further increasing the risk by lowering the regulatory minimum to 150% might add a second tranche \$380 million to continue the Basic rate subsidy through 2017/18, but by then the Optional bank would be empty, with the capital near 150%.

By 2018 the music will have stopped. The government's destructive policy of spending policyholders' assets to suppress Basic rates would end, leaving policyholders with the prospect of a massive rate increase, and claimants with a higher risk of having their claims paid.

The Utilities Commission, the nominal regulator of Basic rates, has had its discretion restricted to the point where it can only warn policyholders of the rate shock rapidly approaching.⁷ It could offer cost mitigation or revenue increase suggestions; none of which would be palatable to a government hoping to keep insurance rates from becoming a source of public concern months before an election.⁸

⁵ ICBC requested that the BCUC keep the forecast confidential, as it may cause "prejudice" Basic policyholders! The BCUC denied ICBC's request, ordering ICBC to publicly file the forecast. ICBC has yet to comply.

⁶ If the \$500 million shortfall was covered over a full 12 months, instead of five, the increase cost per policy would be approximately \$150, or \$115 including the Optional transfer at 200%, see Appendix.

⁷ See "Is the BC Utilities Commission Independent?" in the government section of <http://www.bcpolicyperspectives.com/blog/posts/government-bc-utilities-commission-independence>

⁸ Examples could include elimination or capping minor pain and suffering awards, asking the government to pay ICBC for administering programs where the government collects the financial benefit, elimination of the senior discount, institute new online business processes, and stiffer sanctions for risky driving behavior (including enhanced photo radar).

Appendix Calculation of Required 2017 Basic Rate Change

My 2017/18 year-end forecast produced a Basic capital ratio of 64%, which would require approximately \$500 million to raise the ratio to the 100% regulatory minimum level. The forecast assumed a 5% rate increase on 1 November 2017.

Assuming a 1% increase in Basic rates generates \$29 million in revenue (using 3.25 million annual policies), a rate increase of 17% on 1 April 2017 would generate the \$500 million by 31 March 2018, including the 5% rate increase in November.

If the rate increase is delayed to 1 November 2017 there are only five months remaining in the fiscal year to generate the \$500 million, or 40% of the year. Instead of a 17% (plus 5%), a rate increase of 2.4 times greater, or $17\% \times 2.4 = 41\%$ would be necessary, plus the 5%.

To summarize the options:

	<u>1 April 2017</u>	<u>1 November 2017</u>
A) 100% requires \$500 million	17%+5%	41%+5%
B) 110% requires \$640 million	22%+5%	53%+5%
C) 100% with \$120 million from Optional	13%+5%	31%+5%
D) 100% with \$500 million from Optional	nil+5%	nil+5%

Per Policy (assuming 3.3 million annualized). Add \$45/policy for the 5% rate increase.

Option A	\$150	\$370
Option B	\$195	\$470
Option C	\$115	\$280

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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 published his paper, describing the BC government's manipulation of the finances of BC Hydro from 2008 to 2014, in November. 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.