OCCASIONAL PAPER No. 27 ICBC

ALARMING ICBC FORECAST REQUIRES IMMEDIATE ACTION

On February 21, 2017, the government released ICBC's three-year service plan which included the financial forecast for 15-month 2016/17 fiscal year.[1] The forecast showed a massive decline ($590 million) in the combined capital reserve (equity) compared to the prior year, and almost $430 million less than what had ICBC had forecast for the current fiscal year in February 2016.[2]

ICBC policyholders have enjoyed subsidized rates, while their accumulated capital reserve has been degraded to below minimum levels (and far below levels that ICBC considers necessary). The forecast for continuing increases in claims costs will lower the 2017/18 capital reserves to critical levels.

The government must take immediate actions to reduce the growing claims costs and other expenditures, and abandon its detrimental rate suppression policy.

ESTIMATING BASIC AND OPTIONAL CAPITAL RESERVE LEVELS

To understand the real meaning of the impact of the loss of capital it is necessary to examine the Basic and Optional finances separately, as they have different capital requirements.

ICBC does not provide separate financial forecasts for the compulsory Basic insurance, or the Optional insurance program. The service plan, and the single page quarterly financial summary, are deficient in this regard because the Basic and Optional programs have different minimum capital requirement targets. They also have different operating, or management, targets designed to provide an additional margin to ensure claims will be paid in the event of an unanticipated financial shock.

In 2003 and 2004, the government regulated the Basic and Optional minimum capital requirements, based on the guidelines developed by the federal Office of the Superintendent of Financial Institutions (OSFI).[3] The OSFI guidelines apply varying risk discounts to an insurer's assets and liabilities to produce a minimum capital test (MCT) ratio.

Based on the recommendations of ICBC's external actuary, the BC Utilities Commission initially set the Basic capital MCT at 130%, and in 2014 it increased the ratio to 145%. The Optional MCT operational MCT is currently established by the board of directors at 260%.

[1] See page 15 in http://www.icbc.com/about-icbc/company-info/Documents/Service-Plan-201718-201920.pdf

[2] See page 14 in http://www.icbc.com/about-icbc/company-info/Documents/service-plan-2016-2018.pdf The abnormally severe winter weather in the southwest part of BC resulted in more claims; see http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_26_19_march_2017/pdf

[3] As a Crown corporation ICBC is not subject to regulation by OSFI, but the government adopted the federal regulator's capital adequacy guidelines. For a detailed review of the capital ratios see Chapter 3 in http://www.bcuc.com/Documents/Arguments/2015/DOC_43293_03-12-2015_McCandless_Final-Argument.pdf

In 2016, the government amended the Insurance Corporation Act to allow cabinet to over-ride the advice of ICBC's actuaries, and set the operational MCT levels by cabinet.

When the 2016/17 aggregate capital reserve of $2.56 billion is separated between the Basic requirement first (assuming the regulatory minimum equates to $1.395 billion), the amount remaining for Optional is $1.161 billion (see Appendix I, Table 1).

This analysis shows that the Optional year-end capital will be approximately $280 million less than the **regulatory minimum** requirement for 2016/17**.**

Using the currently approved **operational targets**, the Basic capital reserve will be approximately $630 million below the target level, and the Optional capital reserve will be approximately $710 below the ICBC board approved level (Appendix I, Table 2).

IMPLICATIONS FOR 2017/18

In its February 2017 forecast for 2017/18, ICBC shows the combined capital reserve at $2.449 billion. Table 1 shows my estimate of the capital split, assuming the Basic capital is funded at the minimum 100% level.

Table 1 CAPITAL RESERVE AND MCT AFTER TRANSFERS ($=millions)

	2014	**2015**	**E2016/17**	**E2017/18**
BASIC - Equity	1,633	1,521	1,395	1,470
MCT %	136	119	100	100
OPTIONAL - Equity	1,983	1,625	1.161	979
MCT %	298	234	161	132
COMBINED - Equity	3,616	3,146	2,556	2,449
MCT %	193	157	116	110

Source: ICBC annual reports and 2017/18 to 2019/20 Service Plan; Basic 2016/17 from BCUC, ICBC 2016 RRA, IR 1, RM 1.1 of October 20, 2016.

At the 200% regulatory minimum ratio, the Optional program will end the year some $280 million below the required funding level, and the shortfall will (using ICBC's optimistic forecast) grow to approximately $500 million by March 31, 2018.

CAN ICBC MANAGE WITH LOWER CAPITAL RESERVES?

In a relatively steady financial environment it is certainly possible for the Basic and Optional programs to manage with lower operational capital reserve ratios. The Saskatchewan and Manitoba public auto insurers have operational target capital ratios of 100% for their Basic programs. Because ICBC has approximately 90% of the Optional insurance market, it is possible to reduce both the 260% operational capital ratio, and the 200% minimum regulatory ratio.[4]

[4] Intact Financial, which has the largest market share of the auto insurance market in Canada, operates with a 170% operational capital reserve ratio, although it usually achieves a higher reserve.

To mitigate the risk of the capital reserve falling below the operating targets there must be a capital rebuild mechanism, which adds capital as required by adding a surcharge on the premiums. The BC Utilities Commission had approved a capital rebuild/rebate policy, but this was negated by a cabinet orders in 2010, 2011 and 2016.[5]

Lowering the operational capital ratios to, for example, 100% for the Basic program and 150% for the Optional program is probably an acceptable option. But if the government continues to suppress the growth in Basic rates, and fails to restrain the growth in annual claims costs, lowering the operating capital ratios will mean nothing. The capital will continue to decline to subsidize the Basic rates.

CLAIMS COSTS TRENDS

Table 2 shows the rapid increase in the combined Basic and Optional annual claims costs. The current year change are shown, as well as the total current year as modified by additions or deletions for adjustments to previous years pending claims.

Table 2 CHANGE IN COMBINED CLAIMS COSTS ($=million)

		2010/12	**2013**	**2014**	**2015**	**2016/17**	**2017/18**
Current Year	$	125	141	211	419	689	500
	%	4.7	4.7	6.7	10.1	18.1	11.1
Current+Prior	$	101	159	450	480	610	440
	%	3.7	5.4	14.4	13.5	15.1	9.0

Source; ICBC annual reports (2010 to 2015), and February 2016 and 2017 service plans.
Notes: 2010/12 is the three-year average; 2016/17 is the February 2017 service plan forecast (15 months) discounted by 20% (approximate 12 months). For 2017/18 the comparison is the February 2017 to the February 2016 service plan change, as the comparison to the discounted 2016/17 result was believed to be unrealistically low.

From 2010 to 2013, the annual growth in claims costs was relatively steady, but began to escalated in 2014. When the prior year adjustments are included a similar upward shift is evident. The 2017/18 is based on ICBC's February 2017 service plan with my adjustments, but should not be relied on; it is included as illustration as to the effect of the prior year adjustment on the claims costs variance in any year.

In 2014 and 2015 current and prior years' claims costs jumped by $930 million; the Basic program accounted for almost $700million. ICBC policyholders have not felt the full effect of the cost increases in the price of Basic insurance because the government has suppressed the rate increases, and funded the resulting operating deficit with policyholders' capital accumulated in the highly profitable Optional program.[6]

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[5] See OIC 287/10, 560/11 and 614/16 which prevented the BCUC from raising rates to achieve the 145% capital reserve ratio.
[6] Between 2015 and 2016/17 the government ordered ICBC to transfer $922 million ($622 million in capital and $300 million in operating) from the Optional program to the Basic program.

THE 2017/18 OUTLOOK

In December, 2016, I had estimated that ICBC's capital reserves would decline to $2.75 billion by March 2018.[7] In its February 2017 service plan ICBC is forecasting the year-end 2017/18 capital reserve at $2.45 billion, or $300 million less. If 70% of the $300 million ($210 million) is assumed to relate to the Basic program, its capital reserve would drop to approximately $700 million, or 50% of the minimum requirement. The Optional would be at approximately 200%.[8]

To achieve the required 100% capital reserve ratio Basic rates would need to increase by 25% on April 1, 2017, plus 5% on November 1st, to cover normal cost increases. If the increase was delayed until November, the combined rate increase would be in the order of 45% to achieve the minimum capital reserve level by year-end.

Dropping the Optional regulatory minimum capital ratio to 150% for 2017/18 would allow $375 million to be transferred to the Basic program to lessen the rate impact. This would still leave the Basic capital $325 million short, or the equivalent of a 12% rate increase for April. If the rate increase was delayed until November, a combined increase of some 25% will be required.

The government's rate suppression policy has given ICBC policyholders a false impression that the rapid growth in claims costs can be managed. To date, the government has "managed" the issue by draining policyholders' capital reserves to the point that they are now below the regulatory minimums. The capital reserves act as a buffer against unexpected adverse events forcing major rate increases.[9] This is known as "rate shock."

Even if the government increases the risk level by reducing the Optional capital minimum regulatory funding level to 150%, policyholders will still be facing a major rate shock in 2017.[10]

Clearly, the financial crisis at ICBC will require immediate action by the new government following the May election. Occasional Paper 27.1 will offer some suggestions that the government might consider to restore ICBC's financial health.

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.

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[7] The Basic reserve would be $902 million (64% ratio) and Optional at $1.65 billion (216% ratio); see tables IV and V in http://www.bcpolicyperspectives.com/media/attachments/view/doc/bcuc_icbc_2016_final_20_dec_2016/pdf

[8] Assuming that $14.2 million in Basic capital is required for a 1% MCT, and $7.5 million in Optional capital is required for a 1% MCT.

[9] The spike in claims this last winter is a good example of an unexpected adverse event.

[10] As I had forewarned in my November 23, 2016, "Comment" article in the *Times Colonist*; http://www.timescolonist.com/opinion/op-ed/comment-be-prepared-for-icbc-rate-increase-shock-1.3101218

APPENDIX I

Table 1 DIFFERENCE TO MINIMUM REGULATORY LEVELS

	Actual 2015		Est. 2016/17	
	$=Million	MCT %	$=Million	MCT%
BASIC	1,521	119	1,395	100
100%	1,278	100	1,395	100
Difference	243	19	0	0
OPTIONAL	1,625	234	1,161	161
200%	1,388	200	1,440	200
Difference	480	24	(279)	(13)
COMBINED	3,146	157	2,556	116
Minimum	2,666	133	2,835	129
Difference	480	24	(279)	(13)

Note: Year-end after Optional transfers to Basic.

Table 2 DIFFERENCE TO MANAGEMENT TARGET LEVELS

	Actual 2015		Est. 2016/17	
	$=Million	MCT%	$=Million	MCT%
BASIC				
Required	1,853	145	2,023	145
Shortfall	(332)	(26)	(628)	(45)
OPTIONAL				
Required	1,804	260	1,872	260
Shortfall	(179)	(26)	(711)	(93)
COMBINED				
Required	3,657	183	3,895	177
Shortfall	(511)	(26)	(1,339)	(61)

Note: Year-end after Optional transfers to Basic.