

FURTHER QUESTIONS CONCERNING THE ERNST YOUNG REPORT ON ICBC

SUMMARY

This paper reviews in greater detail some of the key features of the Ernst Young (EY) report on ICBC. The EY report does not provide sufficient detail, nor the key assumptions used to develop the cost mitigation options proposed.

More detailed analysis is required for the following:

- The Basic and Optional capital positions as of 31 December 2016, and future years,
- The impact on indicated rate increases of lowering the capital management targets for Basic and Optional, and
- The actual reduction in claims costs from capping minor pain and suffering claims, as the EY savings estimates appear highly optimistic.

PART 1 -- OPTIONAL PROFITS: IS THE GOOSE THAT LAYS GOLDEN EGGS EXTINCT?

The extremely profitable Optional insurance program has been used to reduce the government's direct debt borrowing requirements, and to re-capitalize the Basic program. From 2010 to 2015, almost \$1.2 billion of Optional policyholders' "excess" capital was appropriated by the provincial government, and ICBC was directed to transfer \$486 million to the Basic capital reserve, plus another \$450 million tranche after the 2015 year-end.

The infusion of Optional capital allowed the government to subsidize Basic rates (with the policyholders' rainy-day fund savings), and keep the Basic capital reserve ratio from falling below the government's regulatory minimum requirement of 100%.

Table 1 CHANGE IN THE CAPITAL RESERVE EQUITY-- 2009 TO ADJUSTED 2015

(\$=millions)

----- BASIC ----- --- OPTIONAL --- COMBINED

		\$	MCT	\$	MCT	\$	MCT
1	Actual 2009	1,597		2,019		3,616	
2	Net Income	(432)		2,114		1,682	
3	OCE & Other	(580)		(382)		(962)	
4	2015 Pre-Transfer	585	46	3,751	544	4,336	217
5	Transfer to Basic	486		(486)		nil	
6	Transfer to Gov't	nil		(1,190)		(1,190)	
7	2015 Actual	1,071	84	2,075	300	3,146	157
8	Post 2015 Transfer	450		(450)		nil	
9	2015 Adjusted	1,521	117	1,625	236	3,146	157

Source: ICBC annual reports, and OIC 596/15 for item 8.

Line 4 shows what the capital reserve reserves would have been prior to the transfers of the Optional capital, with the Basic MCT ratio reduced to 46% (about \$680 million below the 100% regulatory minimum requirement). The amounts on Line 7 are shown in the 2015 annual report.

The addition of \$936 (line 5 and line 8) raised the Basic capital ratio to 117% to begin fiscal year 2016/17, while the Optional ratio was reduced to 236%.

Table 2 shows the cumulative rate increase and the return on equity (ROE) from 2010 to 2015.

Table 2 RATE CHANGE AND RETURN ON EQUITY 2010 to 2015 (percent)

	BASIC	OPTIONAL
Cumulative Rate Change (6 years)	26.6	(10.6)
Fiscal 2015	5.5	2.2
Average Return on Equity (6 years)	(5.2)	18.7
Fiscal 2015	(15.7)	19.5

Source: Derived from ICBC annual reports.

Table 2 shows that despite a cumulative rate increase of 26% from 2010 to 2015 the annual average Basic ROE was a negative, with a sharp decline in 2015. The opposite pattern was evident with respect to the Optional program, where the cumulative rate increase was a negative 10.6%, while the ROE averaged 18.7% for the six years.

CAPITAL POSITION FOR 31 DECEMBER 2016

The adjusted capital reserve for 1 January 2016 (Table 1, line 9) was \$1,521 million for Basic and \$1,625 million for Optional. In August 2017, the government ordered (OIC 614/16) that \$172 million in Optional capital be transferred to Basic by 31 August 2016, and \$201 million of Optional net income be transferred on 1 November 2016.

With these transfers included, and assuming no other changes, the initial 31 December 2016 capital position would be \$1,894 million for Basic and \$1,252 million for Optional.

In its report, EY states that on 31 December 2016 Basic capital was \$1,607 million, while the Optional capital was \$814 million. Table 3 summarizes the changes.

Table 3 CAPITAL RECONCILIATION FOR 2016 (\$=million)

	BASIC	OPTIONAL
Start 1 January 2016	1,521	1,625
Add Capital Transfer	172	(172)
Add Operational Transfer	201	(201)
Revised Start 1 January	1,894	1,252
Ernst Young 31 Dec 2016	1,607	814
Loss for 2016	(287)	(438)

Source: Table 1 and EY Report, pages 88 and 89.

Given the actual results for 2014 and 2015, is a \$438 million loss in Optional capital realistic?

A closer review of the EY financial summaries (pages 65 and 68) shows the 2016 Optional net income losing \$253 million, compared to a gain of \$387 million for the prior year, or a swing of \$640 million in 12 months. Claims costs increased by \$513 million (43%), and premium taxes and commissions rose by \$115 million (32%).

Claims costs for the Basic program, however, only increased by 3.6% in the same period, while premium taxes and commissions declined by 40%; with a combined loss of only \$7 million.

The EY Basic capital forecast of \$1,607 million for 31 December 2016 is \$221 million higher than ICBC's 20 October 2016 forecast for the same period of \$1,386 million, with both forecasts including the August 2016 government-ordered transfers from the Optional program.¹ This further suggests that the EY report contains an error in the apportionment of claims costs between the Basic and the Optional programs

¹ See RM 1.1 (p. 610 of 735) in http://www.bcuc.com/Documents/Proceedings/2016/DOC_47830_B-2_ICBC-IR-No-1.pdf

Finally, given that approximately half of the Optional claims costs are for collision and comprehensive damage to the at-fault policyholder's vehicle, if the vehicle damage claims rose so quickly one would expect to see a similar rise in the damage claims in the Basic program, which pays the not at-fault property damage claims.

The same logic applies to bodily injury claims, where the first \$200,000 of the third-party liability is funded from the Basic program. If claims greater than \$200,000 – funded by Optional – were to rise by 43%, one would expect to see a similar increase in the Basic claims costs.

During the last year ICBC has been attempting to reduce the unpaid claim liability (backlog) by seeking faster settlements, but this effort seems directed at lower value claims. This would not result in a massive increase in Optional current year claims.

The other possible explanation for the sharp increase in Optional claims costs is a significant increase in the estimate of the value of prior year claims. Such a large change would also affect Basic prior year cost estimates.

A clear definition of the problem is a necessary first step to any subsequent policy analysis. Ensuring that the relative capital levels for the Basic and the Optional programs are correct is vital to developing creditable options for increasing revenues and/or decreasing claims costs.

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PART 2 – THE FUNDING GAP

The EY report correctly notes that because Basic revenues are less than costs the Basic program has developed a funding gap (a structural deficit). Each year the operating deficit continues further erodes the capital reserve.

EY stated that the 2019 Basic capital reserve gap would increase to \$1.1 billion by 2019, based on a 145% capital reserve target, while no Optional capital reserve projection was given.

I have argued that the current capital management targets are too high, forcing policyholders to pay more than necessary. In my 30 March 2017 paper, "Fixing ICBC's Finances a Priority for New Government," I calculated the 2018/19 capital shortfall for both programs using the regulatory minimum of 100% for Basic and 200% for Optional. The Table 4 is reproduced from that paper.

Table 4 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.

Using a different start point, my estimate of a \$1.2 billion Basic capital shortfall (gap) for 2018/19 is similar in size to the EY shortfall. But this is only a coincidence as the EY gap is to a 145% target ratio.

What this implies is that – all else being equal – the Basic rate increase required to achieve the 100% regulatory minimum capital by 2019 is about 43%, plus the increase required to balance the growth in costs for that year.

Under this scenario there would be capital available in the Optional program to mitigate the Basic increase if the Optional minimum was lowered to 150%, as discussed in Occasional Paper 27.²

The revenue increases and/or cost reductions contemplated depend on a clear understanding of the capital shortfall.

PART 3 -- SAVINGS FROM CAPPING PAIN AND SUFFERING

As I briefly discussed in Occasional Paper No. 37,³ the EY report suggests that significant savings are possible through capping minor pain and suffering claims.⁴ EY states that the average minor bodily injury (BI) claim paid for 2016 was \$30,038. The average non-minor bodily injury claim paid was \$38,014.⁵

² http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_27_24_march_2017/pdf

³ http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_37_ernst_young_icbc_6_august_2017/pdf

⁴ http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_37_ernst_young_icbc_6_august_2017/pdf

⁵ See page 12 in <http://www.icbc.com/about-icbc/company-info/Documents/Affordable-and-Effective-AutoInsurance-Report.pdf>

The EY report does not state what constitutes a minor BI claim, or the financial value demarking a minor compared to a non-minor bodily injury claim. In the past, ICBC has used a claim value of less than \$40,000 to equate to a minor BI claim.

THE EY REPORT OVER-STATES THE SAVINGS FROM CAPPING MINOR PAIN AND SUFFERING CLAIMS

The EY report states that the costs of the current system total \$2.37 billion, with the cost of “minor” injury claims exceeding the cost of more severe claims.⁶ The consultants costed three options to cap minor injury pain and suffering claim costs, and a fourth no-fault option.

EY states that the first capping option (\$7-9,000) would save \$770 million (p. 110), after increasing the Accident Benefits (Part 7) by 38% (the cost of this enhancement was not stated).

Using ICBC’s actual 2015 data for litigated closed BI settlements (Appendix A-2), approximately \$855 million was paid on these claims for general damages (pain and suffering) on 47,200 claims.⁷

During the 2016 rate review, ICBC provided information on the number and cost of mild soft tissue injury (STI), or whiplash, claim settlements for 2015.⁸ These claims comprise the great majority of minor injury claims. Of the 47,200 settled injury claims for 2015, approximately 22,000 were for mild STI claims, totaling \$285 million (\$240 million when claims over \$100,000 are excluded).⁹

If the 22,000 mild STI claims paid in 2015 (Appendix Table A-4) were limited to \$9,000, the cost would have been \$198 million, or a savings of only \$87 million. A \$5,000 limit applied to all 22,000 settled claims would save approximately \$130 million.

Capping minor BI injury claims does not result in significant savings on legal fees and disbursements. ICBC’s 2015 data show that of the 47,200 BI closed claims, some 35,500 claimants were unrepresented by a lawyer. Of the 22,000 mild STI claims settled, only some 5,330 were represented by a lawyer.

⁶ I assume that they mean the BI costs only. See Ibid., p. 110.

⁷ General damages from ICBC RRA 2016, IR 1, BCUC 13.4, and the number of claims is from IR 1 RM 3.1-4.2; http://www.bcuc.com/Documents/Proceedings/2016/DOC_47830_B-2_ICBC-IR-No-1.pdf

⁸ See IR 1, RM 3.1-4.2 in http://www.bcuc.com/Documents/Proceedings/2016/DOC_47830_B-2_ICBC-IR-No-1.pdf

⁹ ICBC did not explain why a settled claim valued at more than \$100,000 was considered minor.

In summary, the \$770 million savings assumed by EY for the first capping option appears highly optimistic. The savings assumed from lower cap options are also overstated.

WHAT WOULD BE THE SAVINGS FROM A FULL NO-FAULT OPTION?

The 2015 cost of general damages for settled BI claims were \$855 million, together with the estimated Optional third-party costs of approximately \$530 million shown in Appendix Table A-1, would all be saved if the no-fault (no claims for pain and suffering) model was adopted.

If the no-fault model was adopted ICBC could probably reduce its legal fees and disbursements by 60%, or \$85 million, while third party disbursements could decline by 50%, saving another \$70 million. Significant staff savings would also be realized in ICBC's claims processing and adjudication department.

The initial estimate of combined Basic and Optional savings would be approximately \$1.5 billion, based on the 2015 data. This initial estimate would be reduced by the additional cost of accident benefit (Part 7) coverage limits.

This is similar in size to the \$1.4 billion in savings noted (page 110) in the EY report.

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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 an intervener in the Commission's current review BC Hydro's rate request.

APPENDIX

ESTIMATED COST of CLAIMS INCURRED in 2015

Table A-1 was derived from the information in ICBC's annual report for the year ending 31 December 2015. The property damage split between Basic and Optional was estimated from other ICBC data.

This table shows the estimated cost of claims that were submitted during the year, and any re-estimation of the cost to settle unpaid claims from prior years.

A-1 INCURRED CLAIMS COSTS 2015 (\$=million)

	BASIC	OPTIONAL	COMBINED
Bodily Injury – Current year	1,952	528	2,460
Prior year	238	6	244
Accident Benefits (Part 7)	183	nil	183
Total	2,373	534	2,907
Property Damage	505	650	1,155
TOTAL	2,878	1,184	4,042

Source: Derived from ICBC annual Report 2015, p. 87 and p. 21.

ACTUAL CLAIMS PAID in 2015

Table A-2 is ICBC data on bodily injury claims that were closed or settled during 2015. It shows the major claim components of all the settled claims.

A-2 PAYMENTS ON CLOSED LITIGATED BODILY INJURY CLAIMS Fiscal Year 2015

Bodily Injury Litigated	<u>\$=mil</u>
General Damage (Pain and Suffering)	855
Accident Benefits (Pt. 7) & Spec. Damage	528
Other	13
Plaintiff Disbursements & Other	152
ICBC Legal Fees & Disbursements	<u>156</u>

TOTAL	1,704
Not Represented	<u>205</u>
TOTAL ALL	1,909

Source: ICBC RRA 2015, IR 1, BCUC 13.4, and RM 3.4-4.1.

COST of SETTLED MILD SOFT TISSUE INJURY CLAIMS for 2015

Tables A-3 and A-4 show the number of claims, the amount paid, and the average paid for mild soft tissue injuries in 2012 and 2015.

A-3 PAYMENTS FOR MILD SOFT TISSUE INJURY CLAIMS 2012

	CLAIMS	\$ PAID (mil)	AVERAGE PAID
Unrepresented	13,126	52.4	3,990
Represented	3,376	141.6	43,276
Total	16,504	194.0	11,756

Source: ICBC RRA 2016, IR 1, RM 3.4-4.1.

A-4 PAYMENTS FOR MILD SOFT TISSUE INJURY CLAIMS 2015

	CLAIMS	\$ PAID (mil)	AVERAGE PAID
Unrepresented	16,682	103.6	6,212
Represented	5,331	181.5	34,046
Total	22,014	285.1	12,952

Source: ICBC RRA 2016, IR 1, RM 3.4-4.1.

During the four years, the total mild STI claims settled increased 33% (unrepresented increased 27%), the total paid increased 47% (unrepresented increased 98%), and the average paid per claim increased 10% (unrepresented increased by 56%).