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REGULATOR FAILED TO WARN OF ICBC's FINANCIAL CRISIS

The financial crisis at ICBC should have been anticipated, and corrective action taken, long before the NDP government was forced to act to curb the rapid increase in costs. Instead of directly addressing the unsustainable increase in the cost of injury claims, the previous government deliberately depleted ICBC's once healthy capital reserves to subsidize the compulsory Basic program. The structural deficit grew larger as annual costs increasingly outpaced the increase in premium and other revenue.

While government policies resulted in the current financial crisis, the B.C. Utilities Commission (BCUC) also contributed by not providing a timely warning of the unsustainable situation. The BCUC allowed ICBC to structure the annual Basic budget requests (the rate request) to avoid a link to actual year end results, and the lack of multi-year operating, and capital expenditure forecasts kept the focus on the short term.

This paper will explain how the BCUC's rate review process failed to provide a transparent tool for financial planning and accountability, and suggests appropriate reforms.

The BCUC's Role

The BCUC is responsible for setting the price of ICBC's monopoly Basic insurance program. It must use the standard Accepted Actuarial Practice (AAP) methods to ensure that the anticipated expenditures for a 12-month "policy year" are matched by sufficient revenue (including investment income) to result in a break-even operation. Until this year the BCUC was required to ensure that the capital reserve met a minimum level at year-end.[1]

In 2013, the government seriously constrained the BCUC's rate-setting authority by limiting the annual allowed rate change, and later by eliminating the Commission's authority to modify the level of the capital reserve.[2] The requirement to set the annual Basic rate change based on AAP is now modified as "subject to legislation," meaning subject to what cabinet orders.

ICBC has been vigilant in suggesting that the BCUC accept a narrow mandate to approve annual rate requests. It has argued that multi-year forecasts are of little use and that the

[1] The government suspended the requirement for a minimum capital reserve, expressed as the minimum capital test ratio, for four years beginning 2018/19; see OIC 67/18.

[2] http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_15_bcuc_independence_27_october_2016/pdf/occasional_paper_no_15_bcuc_independence_27_october_2016.pdf

regulator should not comment on government policy (subsidizing short-term rates by depleting the capital reserve, for example), even though the BCUC is also responsible for ensuring the long-term health of the Basic program.

In general, the BCUC has accepted this legislated narrow focus and refrained from warnings about the Basic program's unsustainable finances.

The Rate-Setting Process

The BCUC uses an incremental process for establishing the annual Basic budget and changes to rates. The review of ICBC's rate request has suffered because:

- the budget year (the test period) is not aligned to the fiscal year,
- the major budget cost categories are not replicated in the year-end financial report,
- there is no multi-year forecast of revenue, expenditures and equity, and
- there is no standard set of performance measures to compare the forecast (budget) to the actual results.

Aligning the Policy Year and Fiscal Year--Castles of Sand

For the last four years the BCUC has approved changes in the Basic rates based on forecasted expenditures and revenues for a November to October policy year. ICBC's annual forecast included many assumptions about changes to the previous year's rate forecast based on more recent claims cost information.

The difficulty with this approach is obvious; it bases the policy year forecast on the forecast requirement for the prior year. There is no grounding of the request on actual audited results because ICBC's fiscal year spans April to March (until 2016/17 the year was January to December) while the policy year was different.[3] There is no way to analyze the accuracy of ICBC's policy year forecast because the actuals are for a different fiscal period.

This method does not conform to the normal planning-budgeting-reporting management cycle because of the mis-alignment of the policy year and the fiscal year. This alignment issue will be resolved in the next rate submission because the government has decreed that the policy year will align with the fiscal year. Unfortunately, ICBC's current 2019/20 rate request shows the increase changes compared to the 2017 policy year request, which is based on the old November to October policy year.

[3] In 2016 the government changed ICBC's fiscal year from January to December to April to March, which disrupted the financial trend data because ICBC did not report on a 12-month basis for FY2016/17.

The corporation should have modified the 2019/20 request by adding the 2018/19 fiscal year forecast to provide a comparison. This simple change would have established a proper accountability cycle a year before it will be forced on the parties. But perhaps perpetuating the lack of accountability for another year that explains why ICBC failed to adopt the new method sooner.

Cost Categories in the Request Not Compatible to the Annual Report

The categories used in the rate request to describe various costs are significantly different from the cost categories used in the annual report. This makes comparison between the forecast and the actuals difficult or impossible. The cost and revenue chart of accounts should be the same for both the budget request and the annual year-end statements. This standardization of revenue and expenditure categories would allow proper comparison at various levels of aggregation.

The BCUC should insist on this alignment for the current and future rate requests.

No Longer-Term Forecast

The lack of a standard multi-year forecast of net income and the capital reserve is a serious flaw in the current request model. Multi-year forecasts are a standard part of any good planning and budgeting system, but until recently ICBC has resisted the notion.

The BCUC seemed content to review annual incremental rate requests without a longer-term perspective until the 2016 rate review, when it asked ICBC to publicly submit a five-year income and capital forecast. ICBC initially balked at complying, but when it eventually complied it down-played the significance of hypothetical scenarios "that represents inaccurate depictions of expected Basic rate increases and capital levels over the next five years. The information request appears to run counter to the legislative framework under which ICBC is bound to operate."[4]

Strangely, ICBC argued that publishing the "hypothetical" scenarios would confuse Basic policyholders about future Basic insurance rates. Then vice president (now president) Nicolas Jimenez also warned the BCUC that requesting a multi-year forecast is beyond the Commission's mandate!

> In light of our continued concerns about long-term hypothetical scenarios, ICBC respectfully advises that, going forward, it will assess the appropriateness of objecting from the outset on the basis that long-term hypothetical scenarios directed by the

[4] https://www.bcuc.com/Documents/Proceedings/2016/DOC_48181_B-6_ICBC-Response-to-Ex-A-9.pdf ICBC also argued against multi-year forecasts in its 2015 reply argument of March 2016; https://www.bcuc.com/Documents/Arguments/2016/DOC_46035_03-31-2016_ICBC-Reply-Argument.pdf p. 3. One wonders if it makes the same arguments when the government asks for its annual three-year forecast to incorporate into the province's three-year fiscal plan.

BCUC (a) have no bearing on the determination of rates that are the subject of this particular Application and (b) appear to run counter to the legislative framework itself, which the Commission has previously determined goes beyond the Commission's mandate.[5]

In the 2017 rate review the BCUC seemed to have lost interest in reviewing a multi-year operating and capital forecast, but ICBC showed no hesitation in filing a five-year forecast in response to my request. Perhaps this marks a new appreciation of the need to lengthen the time horizon for rate-setting, because the single year forecast is too short to adequately plan and implement corrective action.

Unfortunately, ICBC did not incorporate a multi-year operating and capital forecast in its current 2019/20 rate request. We are left to speculate as to how quickly the Basic liabilities may outstrip the assets, forcing a taxpayer bailout to satisfy claims costs.

Lack of Key Measures

The BCUC has allowed ICBC to file annual rate requests that lack a summary of what capacity is being funded. The concept is that a given funding level should create a certain claims processing capacity, or the ability to issue a certain number of policies (or drivers' licenses in the Non-Insurance program).

ICBC does forecast certain claims processing metrics (and average settlements) to develop its annual claims costs forecast, but these need to be more explicit. The same measures should also be reported at fiscal year-end to determine whether ICBC performed at the budgeted level, or to explain variances.

The BCUC has not focused on this type of input/output analysis, nor required ICBC to develop a representative or standard number of cost driver measures (such as the number of claims and the average cost per claim) linked explicitly to the funding level.[6] The lack of the concept of a contract between the funder (the BCUC) and the service provider to fund a given level of service is another weakness of the rate approval exercise.

Last year ICBC sought approval to delete a series of performance measures just when major changes were underway in the design of both coverage and rates. This proposal was opposed by most interveners, and the BCUC rejected the proposal. ICBC is again seeking to eliminate or change many key measures in its 2019 request. This is an unfortunate development that suggests that ICBC finds this form of accountability to be a burden rather than a chance to explain to policyholders and the public what is occurring with the Basic program.

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[5] Ibid.

[6] In its decision on the 2016 rate request the BCUC expected ICBC to file a review of key Basic performance measures the next year; this never happened (https://www.bcuc.com/Documents/Other/2016/DOC_46429_G-74-16_ICBC-2015-RRA-Decision-WEB.pdf p. 23).

Other Regulatory Practices of No Value?

ICBC has consistently taken the view that the BCUC has nothing to learn from the regulation of the public monopoly auto insurance programs in Manitoba or Saskatchewan. Last year, for example, it stated that cross-jurisdictional comparisons are difficult, and any comparison with the rate review process in Manitoba would be of "no value" to the BCUC.[7]

The Manitoba regulator just completed a detailed review that included multi-year forecasts and a detailed review of capital using a standard stress test.[8] Perhaps ICBC believes that because of the tight control exercised by cabinet over the BCUC's discretion to set rates such a through review is unnecessary?

Building a Warning System

The BCUC is a creature of the government.[9] For the last six years its discretion to set Basic insurance rates has been severely limited by the government's rate smoothing order. Yet, it retains a responsibility to ICBC's Basic policyholders and claimants to promote prudent operations, and that revenues are sufficient to ensure a healthy balance sheet.

ICBC argued that the BCUC should refrain from commenting on government decisions which affect the viability of ICBC's finances. Essentially, ICBC asserts that the Commission should stick to its assigned knitting and continue to take a narrow view of its role.

Jim Quail, the experienced administrative lawyer representing the union MoveUp as an intervener, has stated that the BCUC has a function that goes beyond complying with prescriptive cabinet directives. It has a significant role to play "including assisting in that process by creating a record and providing an analysis, which should be foundational for the work that has to be done to put the Corporation back on its feet."[10] He noted that in regulating ICBC the Commission has an enhanced statutory role respecting its service to the public and the Basic policyholders compared to its role in regulating utilities.

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[7] See Moveup IR 1, 6.2 https://www.bcuc.com/Documents/Proceedings/2017/DOC_50367_B-2_ICBC-Responses-to-IR-1.pdf pdf 1079/1513.

[8] Known as the Dynamic Capital Adequacy Test (DCAT) this is a formalized stress test to determine the appropriate level of reserve capital.

[9] http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_15_bcuc_independence_27_october_2016/pdf/occasional_paper_no_15_bcuc_independence_27_october_2016.pdf

[10] https://www.bcuc.com/Documents/Transcripts/2017/DOC_50400_12-05-2017_Transcript_ICBC-RR-PHC-Vol-1.pdf p. 19.

Summary

In July 2017 the NDP government inherited a financial crisis at ICBC. It has made some important changes to reduce claims costs by enhancing the no-fault benefits and capping claims for pain and suffering for minor injuries. These coverage changes take effect on 1 April 2019. It has also changed the Basic rate design formula to place more of the cost to inexperienced (younger) drivers and those who caused an accident. It has even taken some tepid steps to increase traffic enforcement through greater use of intersection cameras.

It is time for the government to institute reforms to the rate approval process to make it a meaningful management tool, and to ensure that there are robust structures to warn of future funding problems before they become a full-fledged crisis. It can do this by instructing ICBC to fully institute a more transparent planning, budgeting and reporting system with multi-year forecasts.

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

APPENDIX

ICBC's Claims Costs Forecasts Have Been Optimistic

Since 2015 ICBC has had a poor record of forecasting the increase in claims costs for the coming year. Table 1 shows the initial claims costs increase as a percentage of the required rate increase for the base or initial year, and the retroactive increase for the base year requested in the subsequent year's request.

ICBC's forecast adjustment factor (the Loss Cost Forecast Variance) in the subsequent year is designed to incorporate positive or negative changes to the previous year's rate change based on more recent claims settlement information. It is still a forecast adjustment to a previous forecast. There is no grounding in the actual audited year-end financial results.

Table 1 – RATE INCREASE ATTRIBUTED TO CLAIMS COSTS (Per Cent)

	2013	2014	2015	2016	2017	2019*
Initial Year Forecast	4.4	2.9	4.2	5.0	8.0	15.5
Retroactive Adjust.	(1.5)	5.8	5.2	4.9	14.0	n/a
Total Increase	2.9	8.7	9.4	9.9	22.0	n/a

Source: ICBC annual Basic rate requests. (*)The 2019 increase incorporates 17 months of costs representing the transition from the old to the new policy/fiscal year. It excludes the savings resulting from the product coverage changes, particularly the cap on pain and suffering claims for minor injuries.

The poor claims costs forecasting record is a concern, but it is not the focus of this paper. The reason for the poor results is to be found in the forecasting methodology, and the pattern of claims settlements.

The annual rate requests for the November to October policy years were structured to have revenues match forecasted costs and keep the capital reserve ratio at about 100%. The 2019 rate request has abandoned the notion of keeping the MCT ratio at 100%, in fact it appears to be forecasted at just 4% by 31 March 2019 and the same for the following year.

Annual Rate Increase Accelerating

During the last four years the forecast increase in the cost of claims (the combined retroactive adjustment and the future period forecast) has been accelerating. This rate of increase is unsustainable, and resulted in the change to coverage limits and the cap on pain and suffering claims for minor injuries.

Table 2 summarizes the annual requested rate increase by major component. Also shown is the offset due to the Optional funding transfer, or the anticipated savings in 2019/20 because of the product reform.

Table 2 – COMPONENTS of ANNUAL RATE INCREASE FORECAST (Per Cent)

		2013	2014	2015	2016	2017	2019*
1	Replace Opt. Funds	0	6.6	0	5.5	10.1	12.8
2	Retro Claims Adjust.	6.6	(1.5)	5.8	5.2	4.9	14.0
3	Claims forecast	4.4	2.9	4.2	5.0	8.0	15.5
4	Other Changes (net)	0.8	(2.8)	1.2	(0.2)	(3.0)	1.4
5	**Initial Increase**	**11.8**	**5.2**	**11.2**	**15.5**	**20.0**	**43.7**
6	Optional Transf.	(6.6)	0	(5.8)	(10.7)	(13.6)	0
7	Net Product Change	0	0	0	0	0	(37.4)
8	**Net Rate Increase**	**5.2**	**5.2**	**5.5**	**4.9**	**6.4**	**6.3**

Source: ICBC annual Basic rate requests.

Components:

1) The Optional transfers are one-time funds that must be funded the following year.
2) Funding required to adjust the prior year forecast,
3) Funding for anticipated claims costs increase that year,
4) Combination of changes in various categories of expenditures and revenues including investment income,
5) Rate increase required before transfers or other major changes,
6) The reduction in the rate requirement because of transfers from the Optional program,
7) Forecast reduction due to coverage changes instituted 1 April 2019,
8) The net rate request.

Matching the planned break-even year-end with the actual result is not possible because ICBC does not produce 31 October year-end reports. We can infer that the results were much worse than the rate forecast by reviewing the Basic program 31 December year-end results for 2014 and 2015, and the 31 March year-end results for 2016/17 and 2017/18.

Table 3 summarizes the net operating loss and the change in the capital (equity) reserve after the transfers from the Optional program. The 2018/19 equity forecast is from ICBC's recent 2019 rate request submission.

Table 3 – Annual Change in Basic Net Operating and Equity ($=million)

		2014	2015	2016/17*	2017/18	2018/19
	Operating Income**	87	(381)	(128)	(1,001)	No forecast
	Equity Change	(83)	(621)	389	(466)	(856)
	Remaining Equity	1,633	1,071	1,456	826	70
	MCT %	136	83	103	53	4

Source: ICBC annual reports and 2018/19 from the 2019 rate request. (*) is 12 months, and the 2019/20 is my estimate.