DECISION

2014 NSUARB 175
M06082

NOVA SCOTIA UTILITY AND REVIEW BOARD

IN THE MATTER OF THE INSURANCE ACT

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- and -

IN THE MATTER OF AN APPLICATION by **FACILITY ASSOCIATION** for approval to modify its rates and risk-classification system for miscellaneous vehicles

BEFORE:	Murray E. Doehler, CA, P.Eng., Member
APPLICANT:	**FACILITY ASSOCIATION**
FINAL SUBMISSIONS:	September 19, 2014
DECISION DATE:	October 23, 2014
DECISION:	**Application is approved.**

I INTRODUCTION

[1] Facility Association ("Facility" or "Company") filed supporting documents and materials ("Application") with the Nova Scotia Utility and Review Board ("Board") for approval to modify its rates and risk-classification system for miscellaneous vehicles: all-terrain vehicles ("ATV"), and snow vehicles. The Application, dated January 24, 2014, was filed electronically on January 27, 2014, and the original documents were received on January 30, 2014.

[2] Information Requests ("IRs") were sent to the Company on February 11, March 4 and 5, 2014, and responses were received on February 21, March 5 and 6, 2014, respectively.

[3] As a result of a review by Board staff, a staff report dated March 17, 2014, was prepared and provided to the Company for review on the same date. The Company responded on March 28, 2014, indicating that it had reviewed the report and had comments, and a revision to the proposed rates.

[4] Staff prepared a response to the reply which was provided to Facility on April 22, 2014, to which it responded on April 30, 2014. Simultaneously with this Application, Facility had applied to change its rates for private passenger vehicles. The rates for ATV and snow vehicles use the same loss trends as for private passenger vehicles. A major error was discovered in the model that calculated the indications for private passenger vehicles. As a consequence, Facility asked for time to reconsider its Application for miscellaneous vehicles.

[5] Facility provided the revised indications for miscellaneous vehicles on August 21, 2014. An IR about the revision was sent on September 2, 2014, to which a

response was received on September 10, 2014. A supplemental staff report was prepared on September 11, 2014, and sent to Facility on the same date. The Company responded on September 19, 2014, stating that they had no further comments.

[6] The Board did not deem it necessary to hold an oral hearing on the Application.

II ISSUE

[7] The issue in this Application is whether the proposed rates and changes to the risk-classification system are just and reasonable and in compliance with the *Insurance Act* ("*Act*") and its *Regulations*.

III ANALYSIS

[8] Facility sought approval to change its rates and its risk-classification system for miscellaneous vehicles. The Application was made in accordance with the Board's *Rate Filing Requirements for Automobile Insurance – Section 155G Prior Approval* ("*Rate Filing Requirements*"). The Company's mandatory filing date was January 1, 2014.

[9] The proposed effective date for new and renewal business is 100 days after the issuance of the Order in this matter.

Rate Level Changes

[10] The Company proposed to change its rates and risk-classification system. The proposed change represents an overall rate level increase of 13.9% for ATV and 7.4% for snow vehicles.

[11] In considering Facility's Application, Board staff reviewed all aspects of the ratemaking procedure, including the following:

- Loss trends and the effects of reform;
- Loss development;
- Credibility standards and procedure;
- Premium (rate group drift) trends;
- Expense provisions, including Unallocated Loss Adjustment Expenses;
- Experience period and weights;
- Premium to surplus leverage ratio; and
- Target Return on Equity

[12] Based on the review of the filing, the only issues that arose surrounding Facility's analysis of its rate level needs were the selection of loss trends and the profit/cost of capital provision. Any other concerns that were raised in Information Requests were resolved satisfactorily.

Loss Trends and the Effects of Reform

[13] Because miscellaneous vehicles lack sufficient experience to develop trends directly, Facility used the loss trends it had selected for private passenger vehicles. Because of the paucity of specific data, the use of private passenger vehicles loss trends, as a proxy for miscellaneous vehicle trends, is common in the industry.

[14] With the release of the industry claims experience data through to December 2012, Oliver Wyman ("OW"), the Board's consulting actuaries, were asked to develop assumptions for loss trends for private passenger vehicles.

[15] In developing its selections, OW tended to focus on the trends for the industry loss costs while still reviewing and commenting on frequency and severity trends. OW selected trends after examining both five and 10 years of data. For Bodily Injury and Accident Benefits, the past trend was split into two time periods to reflect observed changes in trend patterns (some of which were caused by insurance reforms).

[16] After selecting Bodily Injury past loss cost trends, OW selected future trends to match the selections for past trends. For Bodily Injury and Accident Benefits, the selection for the more recent time period was used for the future trend.

[17] Facility selected loss trends that differ from those selected by OW. Facility based their selected loss trend rates primarily on a review of industry experience in Nova Scotia through to December 31, 2012. Facility reviewed loss experience, excluding Allocated Loss Adjustment Expense ("ALAE"), from 1990-2009 to develop its "indemnity only" loss cost trend selections. The time frame is longer than that used by OW and Facility explains:

> As we understand, the OW loss trend analysis uses industry historical accident year loss and loss adjustment expenses data, developed to ultimate using the link ratio assumptions they selected as deemed appropriate for that data. The Facility's loss trend analysis uses industry historical accident year indemnity only, developed to ultimate through our internal processes.
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> As indicated in the OW paper, they consider the most recent 10 accident years, but give more weight to the more recent experience. As we understand the OW approach, they are interested in establishing "trends" (that is, rates of change) that can then be applied to applicable experience.
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> In contrast, we develop a trend structure model that we feel is appropriate the latest 20 accident years, including trends (rates of change or "slopes") and "scalar" adjustments (one-time increase or decrease in the metric being analyzed). We believe that this approach allows us to see historical impacts better, and seems (to us) to clearly show that trend changes and / or scalar adjustments tend to occur at or around product reforms.

> We believe our filing shows that in general, the trend structures selected explain a significant portion of the historical changes in the metrics we were modeling.
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> [IR-1, question 2]

[18] Facility goes on to explain the potential difference in trends for "indemnity only" costs versus the loss cost plus ALAE as follows:

> We believe that it is reasonable to suspect trend models selected on indemnity and ALAE could be significantly different than indemnity alone. For instance, over time, insurers may change the level of outsourced claims adjudication; claimant use of legal counsel may change over time, resulting in more or less external resources required by an insurer to adjudicate claims; times of product reform may require additional external expertise and resources during "learning phases" as insurers (and claimants) learn to work within the system; as well, during product reforms, there may be more rigorous litigation early on until such time as appropriate precedents are established.
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> Due to the Facility Associations unique claims fee arrangement with the Servicing Carriers, we believe it makes intuitive sense that, as indemnity only data is readily available and required for our process anyway, trends structures on this same basis is appropriate.
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> [IR-1, question 3]

[19] The loss trend rates used by Facility are generally higher than those selected by the Board's consulting actuaries. As expected, when the indications are recalculated using the OW loss trends, the results show that smaller overall increases are suggested.

[20] The OW selections produce much lower indicated changes. It is difficult to determine if the lower indicated changes are caused by the OW use of "indemnity plus ALAE" as opposed to Facility's use of "indemnity only" data or by the longer time frame used by Facility. Board staff believe that the major reason for the difference between the loss trends is the experience period over which the trends are selected. OW uses three to five years of experience while Facility goes back to 1990 (20 years). Facility argues that the longer term is inherently more stable. That may be true but, Board staff state that it is also less responsive to changes. OW's approach is much more

more responsive to changes but may introduce instability in the calculation of future indications.

[21] The Board asked Facility if it actually reviewed loss trends on an "indemnity plus ALAE" basis before opting to use the "indemnity only" data. Facility advised that it does not develop loss trends on the "indemnity plus ALAE" basis as it has no direct use for the results.

[22] In the past, the Board has selected the shorter time horizon as opposed to that used in applications made by Facility. Despite the potential future instability, Board staff recommends the use of the OW selected trends for the purpose of developing indications against which to judge the appropriateness of Facility's proposal.

[23] The Board accepts the use of OW trends in the calculation of indications.

Cost of Capital Provisions

[24] As it has for applications made after the Board decided that Facility could incorporate a cost of capital provision in its rate indications, the Company included a provision using a 12% after-tax return on equity ("ROE") and a 2:1 premium-to-surplus ratio. Facility used, in the opinion of Board staff, a low investment return on surplus assets in the development of its indications.

[25] The Board, in recent decisions, has made the finding that a reasonable ROE should be in the 10-12% range. The ROE selected by Facility is within the range, albeit at the top end. A 12% selection was often used (or had been ordered to be used) in many applications from automobile insurers. The Board has become concerned, however, that the level of profits in the industry exceeding the levels the Board has

approved. The higher level of profits has been reported in the General Insurance Statistical Agency Financial Information Report that had been released in the fall of 2013.

[26] The Board asked why Facility should be treated differently from other companies where the ROE was lowered to 10% (especially when it is financially supported by the industry). Facility responded:

> Our discussion of returns generally focuses on the "Cost of Capital", being the return required of capital providers that is in excess of an available "risk-free" return. This "cost" is the incentive needed for capital providers to put their capital at risk.
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> In relation to the appropriate level of a Cost of Capital provision, at a hearing before the Nova Scotia Insurance Review Board in November of 2004, that Board's actuarial advisor (Mr. Ted Zubulake of Mercer Oliver Wyman) acknowledged that Facility Association operations are inherently more uncertain that those of the voluntary market and that appropriate levels of return on equity should vary directly with the levels of uncertainty facing the enterprise (from the transcripts, page 604):
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>> Mr. Zubulake: "...to the extent a target -- a cost of capital provision is allowed the Facility Association and to then -- and to the extent that a target or a cost of capital or a profit contingency provision is -- a standard one is identified and selected for the regular market that perhaps I would certainly suggest or believe that consideration should be given to perhaps a slightly higher return for the Facility Association. How much higher, what the absolute number is, I don't know." We believe that the volatility in both the size of Facility Association and in its net operating results pose a significant business risk to member companies due to their compulsory participation in Facility Association.
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> ...
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> [IR-1, question 18]

[27] The Board notes, with interest, that, despite this argument, Facility, in past applications, asked for a 12% ROE using a premium-to-surplus ratio of 2:1, reflecting the standard industry provision at the time. The Company did not seek higher returns in those applications.

[28] Board staff understands that Facility may experience more uncertainty than the regular market, however, the Board considers this does not warrant the use of

a profit provision resulting from the use of a 12% ROE. The use of an ROE of 11%, which is higher than that ordered for other companies, in its indications, will produce a reasonable profit provision in the circumstances of this Application and concurrently address Board staff concerns about the low investment return.

Comparison of Proposed Rates to Staff Indications

[29] Using the amended Application that corrected the major error, plus the OW loss cost trends and an 11% ROE, new indications ("Staff Indications") were calculated by Facility. As expected Facility's indications are generally higher than the Staff Indications. Overall, the Staff Indications are 8.8% lower for ATV and 9.9% lower for snow vehicles. These lower indications are mainly caused by the use of the lower OW loss trends and the lower ROE.

[30] The Staff Indications are used by the Board as the target to measure whether Facility's proposed changes are just and reasonable.

[31] A comparison of Staff Indications to proposed changes, shows that for both ATV and snow vehicles the components for Third Party Liability rate changes are significantly below Staff Indications. The proposed changes for the other coverages lead to higher rates than those suggested by the Staff Indications. The proposed overall changes are far below the indications, resulting in negative ROEs.

[32] Requiring Facility to move the rates to the Staff Indications will see very large increases for many clients. However, leaving the rates as they stand will simply postpone the large increases for certain coverages that appear to be needed.

[33] According to Board staff, Facility appears to be willing to accept the rates as proposed. This will result in a more gradual move towards the indicated Third Party Liability component levels while taking some increases that may be larger than indicated for all other coverages. On the whole, Board staff concludes that the proposal is beneficial to most clients.

[34] The Board approves the proposed rate changes. In doing so the Board notes the large difference between indicated and proposed Third Party Liability component rates and the gradual approach used by Facility to narrow the gap. The Board expects Facility to maintain this gradual approach as it closes the gap for these components in future applications.

Other Changes

Multiple Uses

[35] Facility proposes to add a paragraph to its manual explaining that when a vehicle is used for more than one purpose (e.g. a motorcycle used for pleasure and for a courier business), the vehicle will be rated as the class which produces the higher premium. While this may resemble a risk-classification change, Facility indicates that this change is merely clarifying the process that is already being used.

[36] The Board approves this proposed change as filed.

Minor Conviction Definition

[37] Facility proposes to remove the phrase "Driving imprudently" from the list of minor convictions as it may be confused with "Careless driving" which is categorized as Major or Serious and not Minor.

[38] The Board approves this proposed change as filed.

Right Hand Drive Vehicles

[39] Facility is acting to add Right Hand Drive vehicles and imported vehicles to a list of "Home Made vehicle" that requires additional information at underwriting and places limits on the physical damage coverage.

[40] The Board approves this proposed change as filed.

Fleet Definition

[41] Facility proposes to change the fleet definition from five vehicles to 10. Once the fleet limit is reached, the vehicles are rated using fleet pricing. A number of changes to other rules are necessary to implement this new definition. This change will see more vehicles written individually (e.g. those clients who have between five to nine vehicles) rather than as a fleet.

[42] The Board approves this proposed change as filed.

Rate Manual Review

[43] Board staff have reviewed the rate manual on file and found no instances where the Company is in violation of the *Regulations*. The Company proposed no

changes to its rate manual other than those necessary to effect the changes noted in this Decision.

IV FINDINGS

[44] The Board finds that the Application complies with the *Act* and *Regulations*, as well as the *Rate Filing Requirements*.

[45] The financial information submitted by Facility satisfies the Board, pursuant to Section 155I(1)(c) of the *Act*, that the proposed changes are unlikely to impair the solvency or financial well-being of the member companies.

[46] The Board finds the proposed rates are just and reasonable.

[47] The Application included full actuarial indications and the required territorial analyses; therefore, it qualifies to set the new mandatory filing date for miscellaneous vehicles for Facility to February 1, 2017.

[48] The Board approves the effective date to be 100 days from the issuance of the Order in this matter for new and renewal business.

[49] Facility is required to post an electronic version of its updated Rate Manual to its website within 30 days of the issuance of the Order in this matter.

[50] An Order will issue accordingly.

DATED at Halifax, Nova Scotia, this 23rd day of October, 2014.

Murray E. Doehler