

**REVIEW OF MANDATORY
FILING SUBMITTED BY
FACILITY ASSOCIATION:
PRIVATE PASSENGER VEHICLES**

Province of Newfoundland and Labrador
Board of Commissioners of Public Utilities

August 6, 2021

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1. EXECUTIVE SUMMARY

1.1. Purpose

At the request of the Newfoundland and Labrador Board of Commissioners of Public Utilities (Board) Oliver, Wyman Limited (Oliver Wyman) reviewed the private passenger vehicles (hereafter referred to as PPV) rate filing submitted by the Facility Association (FA).

Rate Indication Summary

This filing proposes the introduction of a profit provision for FA PPV risks in Newfoundland and Labrador. FA estimates that its current Newfoundland and Labrador PPV insurance rate level needs to be increased by 10.7%, on average, to achieve a return of 6.0% percent of premium.

FA's indicated and proposed rate changes by coverage are as follows:

Table 1: Indicated and Proposed Rate Changes

Coverage	Indicated	Proposed
Bodily Injury Tort	+15.5%	+12.0%
Property Damage Tort	+15.5%	+12.0%
Direct Compensation Property Damage	+15.5%	+12.0%
Uninsured Automobile	+11.3%	+11.3%
Mandatory Coverages	+15.4%	+12.0%
Underinsured Motorist	+3.5%	+3.5%
Accident Benefits	+8.4%	+8.4%
Collision	-0.70%	+0.0%
Comprehensive	-6.3%	+0.0%
Specified Perils	+25.9%	+0.0%
Optional Coverages	-0.1%	+1.8%
Total	+10.7%	+8.9%

FA's rate level indications in Table 1 assume an effective date of January 1, 2022 for new business and renewal business.

The rate indications in this application were derived using loss experience prior to the COVID-19 pandemic, and the proposed effective date assumes no adjustments are needed to be made for the effect of the pandemic on the forecast claims experience for 2022 and beyond.

1.2. Findings and Conclusions

We reviewed the rate level indications developed by FA, and, in so doing, examined all aspects of FA's ratemaking procedure. There are aspects of FA's analysis of its rate level needs where we believe that alternate calculations and/or assumptions should be considered by the Board.

Following FA's general methodology for determining its rate level needs, but with alternate assumptions, judgments, and calculations that we believe to be more appropriate, we find its overall rate level change need to be less than the +8.9% change proposed by FA. In this report, we present the basis for our conclusion.

Our findings are based on the information contained in the application, responses provided by FA to our questions, and our review of insurance industry statistical experience in Newfoundland and Labrador as published by the General Insurance Statistical Agency (GISA).

* * * * *

Please direct all questions related to this report to the undersigned.

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2. BACKGROUND

In its letter dated May 31, 2021, Facility Association submitted its PPV rate application(s) to the Board for an overall proposed rate level change of +8.9% with a target effective date of January 1, 2022 for new business and renewals. Oliver Wyman received a copy of the rate application on June 1st from Board staff. On June 7, 2021, we provided our questions on the rate application to FA and received FA's responses on June 17, 2021. Additional follow-up questions were provided to FA on June 29th, and we received FA's responses on July 8th. In addition, we were provided with FA's response to the Board staff interrogatories dated July 16, 2021.

Other than the recent Reform Filing and CLEAR Filing, FA's prior Mandatory type filing (e.g., Category 2) was for a +4.0% rate change effective April 1, 2020.

3. DETERMINING RATE LEVEL NEEDS

As support for FA's proposed changes, FA calculates and presents a rate level need by coverage based on its Newfoundland and Labrador (NL) loss experience arising from the latest five accident years (2015 to 2019) ending December 31, 2019 as compiled by GISA. We refer to this five-year period as the experience period¹. We reviewed the rate level indications developed by FA, and in so doing have examined all aspects of the ratemaking procedure. The key assumptions in FA's rate application are:

- *Selection of Ultimate Losses (Loss Development)* – FA relies upon its PPV NL experience² in selecting development factors that it applies to its reported incurred losses. (FA's reported incurred losses do not include allocated loss adjustment expenses.) FA's selected ultimate losses by accident year and coverage are its Appointed Actuary's (AA) selected ultimate NL PPV losses by accident half-year and coverage, evaluated as of December 31, 2020.

As in prior FA filings, the AA considers several methods: Link Ratio, Expected Loss Ratio (ELR), Bornhuetter-Ferguson (B-F) and Weighted. The B-F is based on implicit weights applied to the Link Ratio and ELR methods, whereas the Weighted method is based on weights selected by the AA using judgment applied to the Link Ratio and ELR methods. After consideration of the results of these methods, the AA selects his or her "best estimate"³ which, in this case, is generally the result of the Link Ratio method for the older accident years and is either the result of the B-F method or Weighted method for the more recent accident years. FA uses the AA's ultimate loss selections in estimating its rate level needs.

We find the AA's selection of either the B-F or Weighted method to appear arbitrary; albeit it is the AA's best estimate based on his judgment. Another actuary based on their judgment could select a different best estimate.

While we are not in full agreement with the selection of the ultimate loss amounts, we find them to be reasonable.

- *Selection of Ultimate Claim Counts (Claim Count Development)* – FA relies upon its PPV NL experience⁴ in selecting development factors that it applies to its reported claim counts. We find these selections to be reasonable.
- *Loss Trends* – FA selects loss trend rates based on its review of insurance industry PPV data as of December 31, 2019 to project its historical loss experience to the average accident date of its proposed rate program. We asked FA to provide the rate indications based on the Board's Guideline loss trend rates as of June 30, 2020. FA calculates the overall rate level indication would increase from +10.7% to +12.1%, with most of the difference attributed to a higher rate indication for the

¹ FA presents 10 years of data, but only 5 years are included in the experience period.

² In some cases, due to the limited FA data, the Appointed Actuary selects the factors based on industry-wide experience.

³ The Canadian Institute of Actuaries standards guide the AA and provide a definition of "best estimate" where the best estimate is meant as an unbiased estimate that is neither too conservative or optimistic. Due to the numerous judgments in the process of selecting a best estimate, another actuary fulfilling the AA role for FA would not likely have the identical best estimate.

⁴ In some cases, due to the small volume of FA data, the AA selects factors based on the industry-wide experience.

physical damage coverages. Given the relatively small difference, we do not discuss this issue further, but note this difference may be a consideration for the Board in its final Decision.

- *Premium Trends and On-Level Factors* – FA adjusts its premiums to consider rate level changes in the recent past and premium drift. We find these adjustments to be reasonable.
- *Experience Period Weights* - For each coverage, FA combines its experience over the five accident years by assigning a 20% weight to each year. We find the weights to be reasonable and consistent with prior FA filings.
- *Loss Adjustment Expense (LAE)* – FA’s LAE provision (for both internal and external claim settlement related expenses) is based on the contractual arrangement between FA and its servicing carriers, which, in turn, is based upon the FA’s loss ratio results. We find these estimates to be consistent with the contractual arrangements and, therefore, accept them as reasonable. However, the actual LAE costs are not provided by FA to support these provisions.
- *Health Levy (HL)* – FA has included a \$28.95 fixed per vehicle provision for the HL. This is consistent with the Board’s recent April 2021 guideline.
- *Full Credibility Claim Count Standards* – FA selects full credibility claim count standards consistent with its prior filing, and we therefore accept these as reasonable.
- *Complement of Credibility* - To the extent that FA determines its own loss experience is not statistically credible, FA assigns the balance of credibility to the approved loss ratio underlying the current rates, adjusted for the net loss/premium trend rate since the effective date of its most recent prior rate change. We find this to be reasonable.
- *Expense Provision* – FA assumes a total expense provision of 28.87% allocated as follows:

Table 2: FA Expense Provisions

Expense Provision	Percent of Premium
Variable Expenses	25.47%
Standard Commissions	10.30%
Premium Tax	5.00%
Servicing Carrier Fee	1.00%
Miscellaneous Regulatory Fees	0.17%
Servicing Carrier Operating Costs	9.00%
Fixed Expenses	3.40%
Driving Record Abstracts	1.40%
Central Office Expenses	2.00%

The 10.3% commission rate is based on the FA Board’s Plan of Operation. The 5% premium tax rate is set by the provincial government.

The servicing carrier fee of 1% and servicing carrier operating costs of 9% are based on a compensation agreement between the FA Board and its servicing carriers, rather than the actual costs and expenses of the servicing carriers for processing policies. In response to our request, FA

reiterates that these expenses are supported based on the agreements, however, there is no additional specific actual expense cost data.

Other than noting that the Board may wish to address that the 10% servicing carrier fees are not supported by actual costs, we do not discuss FA's total expense provision, 28.87%, further.

- *Contingent Commissions* – In calculating its rate level change need, FA does not include a contingent commission provision as no contingent commission arrangements exist.
- *Finance Fee Revenues* – FA considers the fees paid by policyholders for the monthly payment plans offered by including an estimated provision of 0.75% of premiums. Since this data was not provided to FA from the servicing carriers, FA is unable to provide an exact estimate. We find this estimate to be reasonable in the circumstances.
- *Profit Provision (Return on Equity)* – FA believes its rate level needs should provide for a target 12% after-tax return on equity (ROE). However, FA presents⁵ its (Appendix A summary) indicated rates based on 6% percent of premium provision as it understands this is within the Board's Guideline of 5% to 6%. We discuss this issue in Section 4.
- *Investment Income on Cash Flow (ROI)* – FA estimates its ROI to be 1.44%. We discuss this issue in Section 4.
- *HST Adjustment* – FA accounts for the change in the HST rate July 1, 2016 (from 13% to 15%) through its determination of loss trend rates. We find this to be reasonable in the circumstances.
- *Reform Adjustment* – FA adjusts the bodily injury historical loss experience for the recent deductible reforms via its loss trend model; which we find to be reasonable.

In the following sections we discuss the profit and investment income rate assumptions for the Board's consideration.

⁵ Within the detailed filing documentation, FA presents rate indication based on both a 12% target ROE and 6% of premium basis.

4. PROFIT PROVISION

In this filing FA proposes to introduce a profit provision for its NL PPV rates. NL is currently the only jurisdiction that FA operates in which a profit provision has not been approved by the regulator. As in previous rate applications, FA states its Board of Directors target profit provision is an after-tax return on equity of 12%⁶. However, FA has presented a rate indication (Appendix A) based on a 6% of premium profit provision, as 6% falls within the Board's Guideline profit provision of 5% to 6% of premium.

This change to include the profit provision has a material impact on the rate indication. Without the profit provision (6% of premium), FA calculates that its indicated rate change is +1.5%; a 9.2 percentage point decrease, from +10.7% to +1.5%.

We understand any changes to the profit provision is a policy issue for the Board.

Return on Investment Rate

Associated with profit provision is the assumption of the return on investment (ROI) rate on cash flows on the premiums insurers collect and the timing of claims payments and other expenses.

FA selects a pre-tax ROI rate on cash flows of 1.44% based on government bond rates.

With respect to the ROI, the Board's Mandatory filing guidelines state:

"The insurer must provide the basis of the selected investment return assumption for discounting, and compare it with the actual investment returns earned in the recent past as reported in the annual P&C-1 financial statements. While the expected investment return selected should consider new money rates, the Board anticipates that the selected expected investment return will be close to the actual investment return the insurer earned within the recent past and reflect the mix of all investment assets expected to be held by the insurer. Significant differences must be explained and justified."

In June 2005 FA changed its operating plan such that it does not hold the funds (i.e., premiums), but instead, transfers to the insurers the funds not required to meet FA's short term cash flow needs, thus allowing member companies to invest these funds based upon their own investment plans and policies while subject to FA's on-demand callability of the funds. Hence, the insurers, not FA, receive and hold these funds for investment purposes. As stated by FA, "As such, FA is not monitoring/auditing how members are investing funds related to either their FA business or (obviously) their regular business."

As noted, FA's selected 1.44% pre-tax investment rate (ROI) assumes any investment funds only earn a government bond rate of return – essentially, risk free rates. In contrast, insurer invested funds include a mix of asset classes, typically not all government bonds. As provided by FA, its estimated government and corporate bond rates are 1.59% and 3.20%, respectively. However, FA assigns 100% weight to government bonds, 1.59%, further reduced for an expense fee of 0.15%, for a selected (net) ROI of 1.44%. FA does not present the investment rates for other asset classes, such as stocks, held by insurers. FA states that its exclusion of investment in stocks is based on its *assumption* that insurers do not hold

⁶ FA calculates the rate indication based on a target after-tax ROE of 12% is +14.1%, higher than the 6% of premium basis at +10.7%.

stocks. Specifically, FA states, "...we believe it is reasonable to *assume* that the funds held by FA's member companies backing FARM business would be invested in highly liquid low risk assets." {Emphasis added}

However, in Newfoundland and Labrador, the average⁷ pre-tax return on investment rate for automobile insurers operating in the Province was 2.00%, 3.61%, and 3.48% for, 2018, 2019 and 2020, respectively; an average of 3.03%. We asked FA to provide its rate indication assuming an ROI of 3.0%, instead of 1.44%, and no other changes in assumptions. FA calculates its overall rate level indication would reduce from +10.7% to +6.4%.⁸

We find FA's selected ROI rate, +1.44%, to be low compared to returns actually earned by insurers who hold and invest the funds.

Impact of Change from Prior Profit Assumptions: 0% ROE⁹ and 2.8% ROI Combined

As a measure of the change in the rate indication due to the change in the profit provision assumptions made by FA in this rate application, we provide the rate indications based on the following profit provision assumptions as approved for use by the Board for the FA's prior rate application: a 0% ROE and after-tax ROI of 2.8%. On this basis, and no other changes in assumptions, we calculate¹⁰ the overall rate level indication would reduce from +10.7% to -3.9%; a 14.6 percentage point decline.

⁷ The average is calculated as a weighted average based on the written automobile premiums of each insurer operating in the Province.

⁸ Very roughly, a 1 percentage point increase in the ROI would reduce the overall rate level indications by approximately 2 percentage points.

⁹ In prior filings, the Board approved profit provision for FA was based on a 0% ROE basis. The Board's approach to profit provision guidelines changed for ease of use: from a target after-tax return of equity (ROE) to a percentage of premium (ROP) approach. The difference between a 0% ROE and 0% ROP is that the investment income on the capital is considered when calculating the rate level change need in the ROE approach. More specifically, the overall rate level indication is higher with a 0.0% ROP approach than a 0.0% ROE approach by roughly 2 percentage points in this example; from -3.9% to -2.0%.

¹⁰ See response to IR#1, question #6.3, dated July 7, 2021 for details by coverage.

5. DISTRIBUTION AND USE

Usage and Responsibility of Client – Oliver Wyman prepared this report for the sole use of the Board for the stated purpose. This report includes important considerations, assumptions, and limitations and, as a result, is intended to be read and used only as a whole. This report may not be separated into, or distributed, in parts except as needed, in the case of distribution to such client’s directors, officers, or employees. All decisions in connection with the implementation or use of advice or recommendations contained in this report are the sole responsibility of the Board.

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6. CONSIDERATIONS AND LIMITATIONS

Data Verification – For our analysis, we relied on data and information provided by FA without independent audit. Though we have reviewed the data for reasonableness and consistency, we have not audited or otherwise verified this data. Our review of data may not always reveal imperfections. We have assumed that the data provided is both accurate and complete. The results of our analysis are dependent on this assumption. If this data or information is inaccurate or incomplete, our findings and conclusions might therefore be unreliable.

Supplemental Data – Where historical data of FA was either (i) not available, (ii) not appropriate or (iii) not sufficiently credible to develop our actuarial assumptions, we supplemented it with external information, as we deemed appropriate. Although we believe these external sources may be more predictive of future experience of FA than any other data of which we are aware, the use of external data adds to the uncertainty associated with our projections.

Rounding and Accuracy – Our models may retain more digits than those displayed. Also, the results of certain calculations may be presented in the exhibits with more or fewer digits than would be considered significant. As a result, there may be rounding differences between the results of calculations presented in the exhibits and replications of those calculations based on displayed underlying amounts. Also, calculation results may not have been adjusted to reflect the precision of the calculation.

Internal / External Changes – The sources of uncertainty affecting our estimates are numerous and include factors internal and external to FA. Internal factors include items such as changes in claim reserving or settlement practices. The most significant external influences include, but are not limited to, changes in the legal, social, or regulatory environment surrounding the claims process. Uncontrollable factors such as general economic conditions also contribute to the variability.

Uncertainty Inherent in Projections – While this analysis complies with applicable Actuarial Standards of Practice and Statements of Principles, users of this analysis should recognize that our projections involve estimates of future events and are subject to economic and statistical variations from expected values. We have not anticipated any extraordinary changes to the legal, social, or economic environment that might affect the frequency or severity of claims. For these reasons, we do not guarantee that the emergence of actual losses will correspond to the projections in this analysis.

APPENDIX A.

A.1. LIST OF TABLES

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