

1 **A.I. 11(2006)**

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4 **IN THE MATTER OF** THE *Automobile,*
5 *Insurance Act*, R.S.N.L. 1990, c. A-22, as
6 amended (the “*Act*”)
7

8 **AND**

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10 **IN THE MATTER OF** an application by
11 Canadian Union Insurance Company
12 (the “Applicant”) to implement revised rates
13 for its Private Passenger class of business.
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15 On September 12, 2005, pursuant to legislative changes enacted on August 1, 2005, the
16 Applicant submitted for the Board’s review and approval a revised private passenger automobile
17 insurance rating program for use with effect from August 1, 2005.
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19 **Legislation**

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21 On August 1, 2005 the Government of Newfoundland and Labrador enacted legislation
22 amending the *Automobile Insurance Act* and the *Insurance Companies Act* in relation to the
23 conduct of participants in the automobile insurance industry and the regulation of rates in the
24 province. Among other things, the changes eliminated the benchmarking system of rate review
25 and approval used by the Board since inception of automobile insurance rate regulation and
26 substituted new rate review requirements.
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28 Under the revised automobile insurance legislation, rate decreases take effect no sooner than
29 thirty days following filing with the Board. Rate increases are subject to prior approval and in
30 connection therewith the Board must determine, in accordance with provisions outlined in
31 regulations, if a proposed rate is “too high”. Where such a finding is made the Board is required
32 to prohibit, or vary the rates.

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2 In arriving at a determination with respect to rate increases the Board considers the
3 documentation available with respect to the justification of the rate levels including: the
4 Applicant's projected loss experience; expenses; investment income for the company's
5 automobile insurance business for the province; and other elements considered appropriate by
6 the Board. While each of these components is, with certain exceptions, relatively easy to
7 calculate, it is the aspect of the reasonableness of each component that must be assessed by the
8 Board in determining if rates are "too high". Where the Board determines that an insurer's loss
9 experience is not relevant, inadequate or otherwise unreasonable for use in establishing rates, the
10 Board has discretion to establish the elements and information upon which the insurer shall file
11 its projected loss experience.

12
13 In addition to the new rate regulation process generally, the amended legislation also provided
14 for a one time reduction in rates. The legislation states as follows:

- 15
16 *"62.1 (2) Effective August 1, 2005, the rates for all types of coverage charged by an insurer for*
17 *private passenger automobile insurance as approved by the Board shall be reduced by at*
18 *least 5%.*
19 *(3) Not later than September 1, 2005, an insurer that is reducing its rates by at least 5%*
20 *shall file with the Board the rates for all types of coverage it proposes to charge for*
21 *private passenger automobile insurance."*
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23 Where rates are not reduced by at least 5%, the legislation states:

- 24
25 *"(4) Notwithstanding subsection (2), an insurer may, not later than September 1, 2005, apply*
26 *to the Board for the approval of rates that have not been reduced by at least 5% and the*
27 *Board shall approve, prohibit or vary the rates proposed to be charged by the insurer."*
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29 It is under this latter provision that the within filing has been made.

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31 Other significant revisions affecting rates or the rating of insureds introduced with the amended
32 legislation to take effect from August 1, 2005 include:

- 33
34 a. Elimination of Age, Sex and Marital Status as rating variables;
35 b. Establishment of a new Class of Use system and definitions;

- c. Permitting the use of the number of years licensed for rating purposes;
- d. Additions to the Prohibited Underwriting Regulations;
- e. Additions to the elements prohibited in a company's Risk Classification System;
- f. Additions to restrictions on the grounds that can be used to decline, terminate or refuse to renew coverage; and
- g. Elimination of the prohibition on group rates and group rating.

Filing Instructions

On July 29, 2005, following the legislated changes to the automobile insurance product and changes to the method of rate regulation, the Board issued new Filing Instructions to industry participants. These Filing Instructions detailed the requirements arising from the new legislation and in particular the changes to the information requirements respecting rate filings. Extracts from the Filing Instructions providing definitions of the two types of filing categories appear below:

“3.1 CATEGORY - 1

3.1.1 Category 1 - Definition

An insurer is considered to have made a Category 1 filing where:

- a) *In the case of private passenger rates filed in accordance with s.62.1, filed and adjusted base rates for every coverage are reduced by at least 5% and there is no increase to any rate for any coverage for any insured;*
- b) *In the case of private passenger rates other than those filed in accordance with s.62.1, there is no increase to any rate for any coverage for any insured; or*
- c) *In the case of commercial or miscellaneous vehicle rates there is no increase to any rate for any coverage for any insured.*

Any filings not meeting this requirement will be considered a Category 2 filing.

3.2 CATEGORY 2- GENERAL FILING

3.2.1 Category 2 - Definition

Where a rate filing contemplates changes to base rates less than the 5% mandated by legislation on September 1, 2005 or in any other case an increase in a rate for any coverage for any insured, the filing will be considered a Category 2 filing.”

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As part of the Filing Instructions the Board also issued a guidance document which sets out details as to how the filing is to be made and the standards to be applied. Specifically, insurers were advised:

“Insurers should have reference to the Category 2 Rate Application Guidance Document which is attached to these Filing Guidelines as Appendix A. Insurers should note that this document sets out guidance on completion requirements and various assumptions for such parameters as the trend factor, loss development factors, credibility, ROE, ROI and premium to surplus ratio. To the extent that insurers vary from the Category 2 Rate Application Guidance Document they will be required to provide complete justification for consideration by the Board. Insurers should note that the Board may have reference to advice from its consultants or may hold a hearing to consider these proposals.”

While an Applicant may utilize factors at variance with those set out in the filing guidelines, it is required to provide compelling information to assist in the Board’s assessment of these factors. It is in the context of the foregoing that the within application is reviewed.

The Application

On September 12, 2005 the Applicant submitted to the Board for consideration a detailed filing of private passenger automobile insurance rates. A copy of the filing was forwarded to the Board’s actuarial consultants, Mercer Oliver Wyman (MOW) for their review and report. Throughout the ensuing weeks various information requests were issued by MOW to the Applicant and responses received such that it was not until October 18, 2005 that a final filing was considered to have been made and MOW could complete its review and issue its report.

The Applicant proposed a schedule of rates based on a Return on Equity (ROE) of 10%, a Return on Investment (ROI) of 3.76% and a Premium to Surplus Ratio of 2.25:1. These parameters, as well as the assumptions made by the Applicant in connection with other factors considered in the rate making process are reflected in the indications and the proposed rate changes shown below:

Canadian Union	Company	Company
Coverage	Indications	Proposal
Third Party Liability	10.8%	-5.0%
Accident Benefits	-1.4%	-5.0%
Collision	-11.6%	0.0%
Comprehensive	-44.0%	0.0%
Specified Perils	-24.5%	0.0%
Uninsured Motorist	5.4%	0.0%
Total	2.0%	-3.6%

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2 The Applicant proposes to offer the following discounts:

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Discounts	%	Coverages
Years Licensed	4% - 10%	Third Party; Collision - Classes 01,02,03,07 and 15
Multi Vehicle	10%	Third Party; Collision - Classes 01,02,03,07 and 15
Student	50%	Third Party; Collision - Class 05

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Detailed Analysis

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In its review of rate filings the Board is mandated to prohibit or vary a rate which it determines is “too high”. The Board makes this determination following a thorough review of all information submitted by the Applicant and careful consideration of the reports and findings of its expert

1 consultants. In exercising its jurisdiction the Board reviews the base rates for each coverage and
2 a determination is made as to whether or not they are “too high”. That is to say, the review is on
3 a coverage by coverage basis. This is consistent with the amended legislation and is in keeping
4 with the historical practice of the Board which was adopted to avoid the cross subsidization of
5 rates between coverages. Allowing the establishment of a rate for one coverage lower than is
6 justified and permitting a rate for another coverage to be higher than is justified by the actuarial
7 and other evidence would result in rates which are not reflective of costs and, depending on the
8 coverage chosen, may cause some insureds to pay more than actuarially justified.

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10 As identified in the Board’s detailed Filing Instructions, the Applicant is required to provide
11 justification of any rate increases. Where the Applicant does not utilize the specific parameters
12 set out in the filing guidelines the Applicant is required to provide the Board with sound
13 reasoning and justification for the deviation. For example, in connection with ROI, the
14 guidelines provide the Board’s acceptable range of factors but state, “*The Board will consider*
15 *other return on investment assumptions or calculations; however, full rationale for any*
16 *deviations must be provided, based on recently available 2004 financial data.*” Similar cautions
17 and directions are provided in connection with the remaining guideline factors and assumptions,
18 where appropriate.

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20 Actuarial

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22 The November 15, 2005 report of the Board’s actuarial consultants identified a number of issues
23 and provided the rate indications found by MOW to be reasonable and supported by the
24 information contained in the Applicant’s filing or reasonable on the basis of industry factors.

25
26 With respect to assumptions made in the determination of rates, these are matters of actuarial
27 judgment and are reviewed in the context of reasonableness. MOW reviewed the assumptions
28 made by the Applicant and expressed the opinion that certain of the assumptions were not fully
29 supported. In their place, MOW substituted alternate assumptions they felt more appropriate or
30 reflective of market or other conditions as follows:

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- 1 o Premium Trend – MOW identified and made an adjustment for a small calculation
2 error in the Applicant’s premium trending.
- 3
- 4 o Loss Trend – the Applicant utilizes fifteen years loss data to determine its loss trends
5 with future frequency trends for physical damages capped at half of past trends.
6 MOW used ten years data for third party liability bodily injury and five years data for
7 all other coverages in arriving at their estimates as the longer period used by the
8 Applicant was not felt to be reflective of current trends.
- 9
- 10 o Expense Provision – the Applicant includes a provision for reinsurance costs even
11 though the loss experience used includes losses that may be recoverable under
12 reinsurance agreements, which MOW concludes may lead to double recovery.
- 13

14 The impact of these alternative assumptions is provided in detail as an appendix to the
15 consultant’s report and is summarized in the table below:

Canadian Union	Company	Company	Mercer
Coverage	Indications	Proposal	Indications
Third Party Liability	10.8%	-5.0%	1.8%
Accident Benefits	-1.4%	-5.0%	-10.5%
Collision	-11.6%	0.0%	-15.9%
Comprehensive	-44.0%	0.0%	-47.9%
Specified Perils	-24.5%	0.0%	-26.1%
Uninsured Motorist	5.4%	0.0%	-3.3%
Total	2.0%	-3.6%	-5.8%

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27 The MOW indications are based on the Board’s guideline factors for ROE, ROI and Premium to
28 Surplus Ratio. These indications were forwarded to the Applicant with the full MOW report for
29 review.

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1 Revised Proposal

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3 Following their review of the MOW report, the Applicant on December 5, 2005 provided
4 additional information and comment on the MOW findings with a revised proposal. After
5 reviewing this additional information, MOW reviewed their findings and noted that they now
6 agreed that the Applicant's Premium Trend and Expense Provision were reasonable in the
7 circumstances noting that the Applicant accepted the MOW assumptions in relation to Loss
8 Trend. As a result, the following revised indications were provided in a January 12, 2006
9 addendum to the MOW report:

11 Canadian Union	Company	Company	Mercer
12 Coverage	Indications	Proposal	Indications
13 Third Party Liability	10.8%	-0.0%	5.0%
14 Accident Benefits	-1.4%	-5.0%	-7.7%
15 Collision	-11.6%	-10.0%	-15.8%
16 Comprehensive	-44.0%	-20.0%	-47.8%
17 Specified Perils	-24.5%	-20.0%	-24.0%
18 Uninsured Motorist	5.4%	0.0%	-0.2%
19 Total	2.0%	-3.5%	-3.4%

20 Cost of Capital

21 The Category 2 Rate Application Guidance Document set out the parameters regarding ROE,
22 ROI and Premium to Surplus Ratio as follows:

24 "Return on Equity"

- 25
- 26 ■ *In Order No. A.I. 1 (2005), after hearing from several experts relating to profit margin, the Board*
27 *determined a return on equity and premium to surplus ratio for use under the benchmark system*
28 *which, as the result of legislative changes, is no longer in use. Nevertheless, the Board accepts*
29 *the determination in Order No. A.I. 1 (2005) as the most comprehensive recent consideration of*
30 *the appropriate return on equity and premium to surplus ratio for rate making purposes for*
31 *automobile insurers in Newfoundland & Labrador. Therefore, the Board accepts as reasonable*
32 *for use in rate filings a target after-tax Return on Equity of 10.0% and a premium to surplus ratio*
33 *of 2.25.*
- 34 ■ *Other return on equity or premium to surplus assumptions or calculations will be considered, but*
35 *rationale for any deviations must be provided and the Company must provide a comparison of the*

1 *assumptions or calculations with those made by the Company in preparing filed rate level*
 2 *indications for other coverages and lines of business in Newfoundland & Labrador as well other*
 3 *provinces.*

4 *Return on Investments*

- 5 ■ *The Board also considered the appropriate return on investments for ratemaking purposes for*
 6 *automobile insurers in Newfoundland and Labrador in Order No. A.I. 1 (2005). The Board*
 7 *accepted that "...setting ROI based on levels of risk and commensurate returns relative to the*
 8 *actual investment profile of Canadian automobile insurers is most appropriate," but noted the*
 9 *lack of available information to assist in this determination. In light of the lack of information*
 10 *and the changed regulatory environment, the Board will not set out a target return on investment*
 11 *for rate making purposes, but expects that the return on investment will be in the range identified*
 12 *by the Board in Order No. A.I. 1 (2005) of 5.4%-7.04%.*
- 13 ■ *The Board will consider other return on investment assumptions or calculations; however, full*
 14 *rationale for any deviations must be provided, based on recently available 2004 financial data."*

15
 16 The filing was reviewed by the Board's cost of capital consultants, National Economic Research
 17 Associates (NERA), as relates to the ROE and ROI inputs. During this review information
 18 requests and responses were exchanged with the Applicant. NERA's report, dated March 14,
 19 2006, details the pertinent aspects of these exchanges and summarizes the position stated by the
 20 Applicant in support of the requested ROE and ROI and NERA's consideration thereof.

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 22 The Applicant's filing reflected an ROE of 10% and a Premium to Surplus Ratio of 2.25 to 1 as
 23 set out in the filing guidelines. However, the Applicant proposed an ROI of 3.76% for input in
 24 the underwriting profit calculation as shown on Exhibit 3-Sheet 2 and stated in responses for
 25 information that it would be very difficult to achieve a yield of 5.4%. While the Applicant
 26 provided information in support of the proposed ROI it did not provide the necessary information
 27 on the investment portfolio for NERA to confirm that the proposed ROI was reasonable. Instead
 28 NERA constructed a proxy portfolio to determine an appropriate ROI.

29
 30 NERA's final report findings are as follows:

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 32 ROE – *"Canadian Union's requested ROE of 10% is in line with the Board's guidelines."*

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 34 ROI – *"Canadian Union's requested ROI of 3.76% is not justified. Based on the proxy investment*
 35 *portfolio, NERA's calculated ROI for Canadian Union is 4.76%."*

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A copy of the NERA report was forwarded to the Applicant for comment.

Findings

The Board has reviewed the application, the supporting material, responses to information requests, consultants' reports and all other information relevant to this rate filing. The Board finds the proposed Class of Use definitions are acceptable as they are similar to those approved by the Superintendent of Insurance as well as those previously accepted by the Board. As well the associated differentials were found by MOW to be reasonable. The Applicant's proposed discount program is consistent with that previously approved and the legislative provisions and is reasonable and justified in the circumstances.

In connection with the actuarial analysis, MOW after reviewing the material available agreed with the assumptions made by the Applicant and noted that the Applicant adopted MOW's Loss Trend assumptions. Therefore, the Board finds that the actuarial assumptions on which the December 5, 2005 proposals are based to be reasonable.

In connection with the cost of capital analysis the Board notes that the filing guideline factors for ROE, ROI and Premium to Surplus Ratio were based on the recent order of the Board issued following a comprehensive hearing with expert testimony. Proposals incorporating alternate factors for ROE, ROI and Premium to Surplus Ratio are approved when fully supported. In the context of the supporting materials the Board makes the following determinations in relation to these factors:

- The Applicant's proposed ROE of 10% is consistent with the filing guidelines and is supported in the circumstances.
- In connection with the Applicant's proposed ROI of 3.76%, the Applicant has not provided sufficient information to justify the requested ROI. NERA after a full review of the available information found that the information necessary to confirm the proposal

1 was not provided. The proxy portfolio suggested an appropriate ROI of 4.76%. Based
2 on all the available information, the Board accepts 4.76% as a reasonable ROI in place of
3 the 3.76% as presented in the rate application, to be used in the calculation of
4 underwriting profit.

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- 6 • The Applicant's proposed Premium to Surplus Ratio of 2.25 to 1 is consistent with the
7 filing guidelines and is supported in the circumstances.
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9 Costs

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11 As set out in the Filing Instructions, pursuant to section 57 of the *Automobile Insurance Act* and
12 section 90 of the *Public Utilities Act*, the Applicant will be required to pay the costs of the Board
13 associated with this application.

14 **IT IS THEREFORE ORDERED THAT:**

- 15
- 16 1. The proposed rates are prohibited.
 - 17
 - 18 2. The Applicant shall file with the Board revised rate indications reflecting the findings of
19 the Board which specifically include an ROE of 10%, an ROI of 4.76%, a Premium to
20 Surplus Ratio of 2.25 to 1, and the assumptions of MOW with respect to Loss Trend.
21
 - 22 3. The Applicant shall submit for the approval of the Board a revised rate proposal, setting
23 out the effective dates, which for each coverage shall be no more than the indications
24 filed with the Board, in accordance with this Order.
25
 - 26 4. The proposed Class of Use definitions are accepted for use.
 - 27
 - 28 5. The proposed discount program is approved.
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 - 30 6. The Applicant shall pay all the expenses of the Board arising from this application.

DATED at St. John's, Newfoundland and Labrador, this 30th day of March 2006.

Robert Noseworthy
Chair & Chief Executive Officer

Darlene Whalen, P.Eng.
Vice-Chair

G. Cheryl Blundon
Board Secretary