

A.I. 5(2006)

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

5 **AND**
6

7 **IN THE MATTER OF** an application by
8 S&Y Insurance Company (the “Applicant”)
9 to implement revised rates for its Private
10 Passenger class of business.
11

12
13 On September 14, 2005, pursuant to legislative changes enacted on August 1, 2005, the
14 Applicant submitted for the Board’s review and approval a revised private passenger
15 automobile insurance rating program for use with effect from August 1, 2005.
16

17 **Legislation**
18

19 On August 1, 2005 the Government of Newfoundland and Labrador enacted legislation
20 amending the *Automobile Insurance Act* and the *Insurance Companies Act* in relation to
21 the conduct of participants in the automobile insurance industry and the regulation of
22 rates in the province. Among other things, the changes eliminated the benchmarking
23 system of rate review and approval used by the Board since inception of automobile
24 insurance rate regulation and substituted new rate review requirements.
25

26 Under the revised automobile insurance legislation, rate decreases take effect no sooner
27 than thirty days following filing with the Board. Rate increases are subject to prior
28 approval and in connection therewith, the Board must determine, in accordance with
29 provisions outlined in regulations, if a proposed rate is “too high”. Where such a finding
30 is made the Board is required to prohibit, or vary the rates.
31

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

11
12 In addition to the new rate regulation process generally, the amended legislation also
13 provided for a one time reduction in rates. The legislation states as follows:

- 14
15 *"62.1 (2) Effective August 1, 2005, the rates for all types of coverage charged by an*
16 *insurer for private passenger automobile insurance as approved by the Board*
17 *shall be reduced by at least 5%.*
18 *(3) Not later than September 1, 2005, an insurer that is reducing its rates by at least*
19 *5% shall file with the Board the rates for all types of coverage it proposes to*
20 *charge for private passenger automobile insurance."*
21

22 Where rates are not reduced by at least 5%, the legislation states:

- 23
24 *"(4) Notwithstanding subsection (2), an insurer may, not later than September 1,*
25 *2005, apply to the Board for the approval of rates that have not been reduced by*
26 *at least 5% and the Board shall approve, prohibit or vary the rates proposed to*
27 *be charged by the insurer."*
28

29 It is under this latter provision that the within filing has been made.

30
31 Other significant revisions affecting rates or the rating of insureds introduced with the
32 amended 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;

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

7

8 **Filing Instructions**

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

17

18

18 **“3.1 CATEGORY - 1**

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20

20 **3.1.1 Category 1 - Definition**

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

23

24

24 a) *In the case of private passenger rates filed in accordance with s.62.1,*
 25 *filed and adjusted base rates for every coverage are reduced by at least*
 26 *5% and there is no increase to any rate for any coverage for any*
 27 *insured;*

28

29

28 b) *In the case of private passenger rates other than those filed in*
 29 *accordance with s.62.1, there is no increase to any rate for any coverage*
 30 *for any insured; or*

30

31

31 c) *In the case of commercial or miscellaneous vehicle rates there is no*
 32 *increase to any rate for any coverage for any insured.*

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

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2 **3.2 CATEGORY 2- GENERAL FILING**

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4 **3.2.1 Category 2 - Definition**

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6 *Where a rate filing contemplates changes to base rates less than the 5%*
7 *mandated by legislation on September 1, 2005 or in any other case an increase*
8 *in a rate for any coverage for any insured, the filing will be considered a*
9 *Category 2 filing.”*
10

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

14
15 *“Insurers should have reference to the Category 2 Rate Application Guidance Document*
16 *which is attached to these Filing Guidelines as Appendix A. Insurers should note that*
17 *this document sets out guidance on completion requirements and various assumptions for*
18 *such parameters as the trend factor, loss development factors, credibility, ROE, ROI and*
19 *premium to surplus ratio. To the extent that insurers vary from the Category 2 Rate*
20 *Application Guidance Document they will be required to provide complete justification*
21 *for consideration by the Board. Insurers should note that the Board may have reference*
22 *to advice from its consultants or may hold a hearing to consider these proposals.”*
23

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

28
29 **The Application**

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31 On September 14, 2005 the Applicant submitted to the Board for consideration a detailed
32 filing of private passenger automobile insurance rates. A copy of the filing was forwarded
33 to the Board’s actuarial consultants, Mercer Oliver Wyman (MOW) for their review and
34 report. Throughout the ensuing weeks various information requests were issued by
35 MOW to the Applicant and responses received such that it was not until October 20, 2005
36 that a final filing was considered to have been made and MOW could complete its review
37 and issue its report.
38

1 The filing proposed a schedule of rates based on a Return on Equity (ROE) of 12.5%, a
 2 Return on Investment (ROI) of 3.7% and a Premium to Surplus Ratio of 2:1. These
 3 parameters, as well as the assumptions made by the Applicant in connection with other
 4 factors considered in the rate making process are reflected in the indications and the
 5 proposed rate changes shown below:

6

S & Y	Company	Company
Coverage	Indications	Proposal
Third Party Liability	13.1%	7.5%
Accident Benefits	7.4%	4.8%
Collision	-13.5%	-5.0%
Comprehensive	-31.8%	-7.5%
All Perils	-6.9%	-5.8%
Specified Perils	-4.5%	-7.5%
Uninsured Motorist	-7.0%	0.0%
Total	2.8%	3.3%

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8 Where a person insured with the Applicant would upon renewal experience an increase as
 9 a result of changes flowing from this application the Applicant proposes to cap the rate
 10 increase at 10% for each coverage for each vehicle. This may result in a revenue
 11 shortfall as these insureds may pay less than they otherwise should pay. The Applicant
 12 has adjusted its proposed Third Party Liability rates to recover the shortfall in premiums
 13 associated with capping.

14

15 The Applicant proposes to offer the following discounts:

Discounts	%	Coverages
Multi Vehicle	10%	Third Party Liability, Collision, All Perils (Collision Portion), Accident Benefits and Uninsured Automobile - All Classes
Farmers	40%	Third Party Liability, Collision, All Perils and Comprehensive - Classes 03, 10, 11, 12 and 13
Age (55-75)	10%	All Coverages - All Classes
Full Package	5%	All Coverages - All Classes
Short Commute	10%	Third Party Liability, Collision and All Perils (Collision Portion) - Class 02
University	50%	Third Party Liability, Collision, All Perils (Collision Portion) - Class 05

1

2 The proposed discounts are consistent with those previously approved by the Board. The
3 discounts relate to the risk, are not subjective or arbitrary and are otherwise in accordance
4 with the legislative provisions. In addition the impact of the discounts has been
5 appropriately reflected in the rate filings, as reviewed by MOW.

6

7 The Applicant has filed the Class of Use definitions as established by the Superintendent
8 of Insurance without deviation. MOW finds that the selected class differentials are
9 reasonable.

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11 **Detailed Analysis**

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13 In its review of rate filings the Board is mandated to prohibit or vary a rate which it
14 determines is “too high”. The Board makes this determination following a thorough
15 review of all information submitted by the Applicant and careful consideration of the
16 reports and findings of its expert consultants. In exercising its jurisdiction the Board
17 reviews the base rates for each coverage and a determination is made as to whether or not
18 they are “too high”. That is to say, the review is on a coverage by coverage basis. This is
19 consistent with the amended legislation and is in keeping with the historical practice of
20 the Board which was adopted to avoid the cross subsidization of rates between coverages.
21 Allowing the establishment of a rate for one coverage lower than is justified and
22 permitting a rate for another coverage to be higher than is justified by the actuarial and
23 other evidence would result in rates which are not reflective of costs and, depending on
24 the coverage chosen, may cause some insureds to pay more than actuarially justified.

25

26 After reviewing the filing, the Board notes that the recovery associated with the capping
27 proposed by the Applicant may result in the costs associated with a shortfall in recovery
28 associated with the premium on a variety of coverages for the capped customers being
29 recovered in the premiums collected from other customers on other coverages. This may
30 be considered to be cross-subsidization and contrary to the established policy of the
31 Board. The legislative provisions allow an insurer to charge less to an insured than

1 would otherwise be charged as a result of certain legislative changes, but it does not
2 permit an insurer to charge more than is actuarially justified for any coverages.

3
4 As identified in the Board's detailed filing instructions, the Applicant is required to
5 provide justification of any rate increases. Where the Applicant does not utilize the
6 specific parameters set out in the filing guidelines the Applicant is required to provide the
7 Board with sound reasoning and justification for the deviation. For example, in
8 connection with ROI, the guidelines provide the Board's acceptable range of factors but
9 state, "*The Board will consider other return on investment assumptions or calculations;*
10 *however, full rationale for any deviations must be provided, based on recently available*
11 *2004 financial data.*" Similar cautions and directions are provided in connection with the
12 remaining guideline factors and assumptions, where appropriate.

13
14 Actuarial

15
16 The November 15, 2005 report of the Board's actuarial consultants identified a number of
17 issues and provided rate indications found in their report to be reasonable and supported
18 by the information contained in the Applicant's filings or reasonable on the basis of
19 industry factors.

20
21 With respect to assumptions made in the determination of rates, these are matters of
22 actuarial judgment and are reviewed in the context of reasonableness. MOW reviewed
23 the assumptions made by the Applicant and expressed the opinion that certain of the
24 assumptions were not fully supported. In their place, MOW substituted alternate
25 assumptions they felt more appropriate or reflective of market or other conditions as
26 follows:

- 27 o Underwriting Profit – in its review, MOW determined that the Applicant did not
28 treat its investment income from premium cash flow and expenses in a manner
29 consistent with its treatment of cash flow for claims payments. MOW made the
30 adjustment necessary to provide for consistent treatment. The effect of this

1 adjustment was approximately a 2% reduction on the Applicant's overall
2 indications.

- 3
- 4 o Effects of Reform - the Applicant did not provide for any savings arising from the
5 Collateral Sources provision in recent legislative changes thus overstating the cost
6 of the product. The savings were provided as part of the Filing Instructions and
7 amount to 1.1%. The impact of this on rates is a 0.5% reduction.
 - 8
 - 9 o Credibility Standard/Procedure – the Applicant used a credibility standard of
10 3,246 claims for third party liability, 1,082 for property damage coverages and
11 2,164 for accident benefits. MOW uses 3,246 claims for the bodily injury portion
12 of third party liability, 1,082 for property damage coverages and 2,164 for
13 accident benefits. This is consistent with past practice of the Board and is the
14 standard used by the Board's consultant. The issue MOW has raised is that the
15 Applicant did not determine the credibility level for third party liability on the sub
16 coverages separately. The impact of this is approximately a 3% difference in
17 indication.

18

19 The impact of these alternative assumptions is provided in detail as an appendix to the
20 consultant's report and is summarized in the table below:

21

S & Y	Company	Company	MOW
Coverage	Indications	Proposal	Indications
Third Party Liability	13.1%	7.5%	1.3%
Accident Benefits	7.4%	4.8%	2.0%
Collision	-13.5%	-5.0%	-18.9%
Comprehensive	-31.8%	-7.5%	-36.0%
All Perils	-6.9%	-5.8%	-13.8%
Specified Perils	-4.5%	-7.5%	-11.6%
Uninsured Motorist	-7.0%	0.0%	-8.2%
Total	2.8%	3.3%	-6.3%

1 The MOW indications are based on the Board's guideline factors for ROE, ROI and
 2 Premium to Surplus Ratio. These indications were forwarded to the Applicant with the
 3 full MOW report for review.

4
 5 **Revised Proposal**

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 7 On December 12, 2005 the Applicant notified the Board that it wished to amend its rating
 8 proposal having given consideration to the report of the Board's Actuarial Consultants.
 9 The Applicant's revisions and the consultants' indications were reviewed in an addendum
 10 report received on December 22, 2005 and are contained in the following table:

11

S & Y	Company	Company	MOW
Coverage	Indications	Proposal	Indications
Third Party Liability	6.4%	7.5%	1.3%
Accident Benefits	6.3%	4.8%	2.0%
Collision	-15.8%	-5.0%	-18.9%
Comprehensive	-33.6%	-7.5%	-36.0%
All Perils	-12.1%	-5.8%	-13.8%
Specified Perils	-10.7%	-7.5%	-11.6%
Uninsured Motorist	-7.9%	0.0%	-8.2%
Total	-2.0%	3.3%	-6.3%

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20 In this proposal, only the company indications were revised and not the proposed rate
 21 changes. The revised indications reflect a different approach with respect to the
 22 Credibility Standard/Procedure but reflect the MOW assumptions with respect to Effects
 23 of Reform and Credibility Standard/Procedure.

24
 25 **Cost of Capital**

26
 27 The Category 2 Rate Application Guidance Document set out the parameters regarding
 28 ROE, ROI and Premium to Surplus Ratio as follows:

29

1 “Return on Equity

- 2
- 3 ▪ *In Order No. A.I. 1 (2005), after hearing from several experts relating to profit margin,*
- 4 *the Board determined a return on equity and premium to surplus ratio for use under the*
- 5 *benchmark system which, as the result of legislative changes, is no longer in use.*
- 6 *Nevertheless, the Board accepts the determination in Order No. A.I. 1 (2005) as the most*
- 7 *comprehensive recent consideration of the appropriate return on equity and premium to*
- 8 *surplus ratio for rate making purposes for automobile insurers in Newfoundland &*
- 9 *Labrador. Therefore, the Board accepts as reasonable for use in rate filings a target*
- 10 *after-tax Return on Equity of 10.0% and a premium to surplus ratio of 2.25.*
- 11 ▪ *Other return on equity or premium to surplus assumptions or calculations will be*
- 12 *considered, but rationale for any deviations must be provided and the Company must*
- 13 *provide a comparison of the assumptions or calculations with those made by the*
- 14 *Company in preparing filed rate level indications for other coverages and lines of*
- 15 *business in Newfoundland & Labrador as well other provinces.*

16 Return on Investments

- 17 ▪ *The Board also considered the appropriate return on investments for ratemaking*
- 18 *purposes for automobile insurers in Newfoundland and Labrador in Order No. A.I. 1*
- 19 *(2005). The Board accepted that “...setting ROI based on levels of risk and*
- 20 *commensurate returns relative to the actual investment profile of Canadian automobile*
- 21 *insurers is most appropriate,” but noted the lack of available information to assist in this*
- 22 *determination. In light of the lack of information and the changed regulatory*
- 23 *environment, the Board will not set out a target return on investment for rate making*
- 24 *purposes, but expects that the return on investment will be in the range identified by the*
- 25 *Board in Order No. A.I. 1 (2005) of 5.4%-7.04%.*
- 26 ▪ *The Board will consider other return on investment assumptions or calculations;*
- 27 *however, full rationale for any deviations must be provided, based on recently available*
- 28 *2004 financial data.”*

29 The Applicant’s proposals reflect a Premium to Surplus Ratio of 2 to 1 rather than the

30 2.25 to 1 as set out in the filing guidelines. The support provided for this alternate

31 assumption is a statement in relation to the experience under the minimum capital test

32 used by the Office of the Superintendent of Financial Institutions (OSFI) to monitor the

33 health of certain insurers. The Applicant did not provide supporting professional opinion

34 or supporting financial information as sought by the filing guidelines and requests for

35 information.

36

37 The filing was reviewed by the Board’s cost of capital consultants, National Economic

38 Research Associates (NERA), as relates to the ROE and ROI inputs. During this review

1 information requests and responses were exchanged with the Applicant. NERA's report,
2 dated March 13, 2006, details the pertinent aspects of these exchanges and summarizes
3 the position stated by the Applicant in support of the requested ROE and ROI and
4 NERA's consideration thereof.

5
6 The Applicant states that the shareholders expect an ROE of 15% and further that the
7 proposed ROE of 12.5% is consistent with the standard they have used and received
8 approval for in other provinces. The Applicant also cites the testimony of experts
9 appearing before the Board at its recent hearing in relation to cost of capital. The
10 Applicant did not provide an expert opinion not already considered by the Board or any
11 substantive evidence found persuasive in other jurisdictions. Nor did the Applicant
12 provide a justification for the statement that shareholders expect an ROE of 15%. In
13 relation to ROI the Applicant provided a statement of Investment Policies and
14 Procedures, information as to bond yields and expert opinion of 2006 expected returns.

15
16 NERA's final report findings are as follows:

17
18 ROE – *“S&Y has not provided sufficient evidence to support its request for a higher ROE*
19 *than set out in the filing guidelines.”*

20
21 ROI – *“S&Y's requested ROI of 3.7% is reasonable.”*

22
23 A copy of the NERA report was forwarded to the Applicant for comment. The Applicant
24 initially provided commentary and additional information but later withdrew the
25 information and commentary.

26
27 **Findings**

28
29 The Board has reviewed the application, the supporting material, responses to
30 information requests, consultants' reports and all other information relevant to this rate
31 filing. The proposed Class of Use definitions are the same as those set out by the

1 Superintendent of Insurance. As well the associated differentials were found by MOW to
2 be reasonable.

3
4 The Applicant's proposed discount program is consistent with previous filings and the
5 legislative provisions, and has been determined to be reasonable in the context of the rate
6 filing. However, the recovery of the revenue shortfall associated with the capping of rate
7 increases as proposed by the Applicant is not consistent with the policy of the Board or
8 legislative provisions. While the proposed capping may minimize rate impacts arising
9 out of this application for some insureds recovery of the revenue shortfall may mean that
10 remaining insureds pay the associated costs on a variety of coverages. Therefore the
11 Board will not approve the inclusion in rates of a revenue shortfall arising from the
12 capping proposal.

13
14 Based on the review of the available information in connection with this rate filing the
15 Board is not satisfied that some of the actuarial assumptions in the Applicant's rate
16 proposals are reasonably supported by the available information. The Board has
17 reviewed the assumptions provided by the Applicant and the alternate assumptions
18 provided by the Board's actuarial consultants, MOW, in respect of Underwriting Profit,
19 Effects of Reform, and Credibility Standard/Procedure. While the Board and MOW
20 sought clarification and support for the proposals, the Applicant did not provide the
21 necessary support for each of the elements of the rate proposal. The Board notes that the
22 Applicant was provided with a copy of the MOW report and was given an opportunity to
23 further comment on and challenge the rationale used by MOW. The Board finds that the
24 detailed and comprehensive analysis offered by MOW in its report is persuasive.
25 Subsequent to the MOW report the Applicant provided alternate indications based on
26 different assumptions in relation to the Credibility Standard/Procedure, however it did not
27 provide substantiation for the same. The Board accepts the MOW assumptions as
28 reasonable and will require the Applicant to reflect these alternate assumptions in its rate
29 filing.

30

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

- 7
- 8 • In connection with the Applicant's proposed ROE of 12.5%, the Board finds that
9 the Applicant has not fully supported the proposal. The Applicant did not provide
10 sufficient financial information or expert opinion to support the proposed ROE.
11 NERA determined that insufficient evidence was provided to support an ROE
12 higher than 10%. The Board finds that the Applicant has not provided sound
13 rationale or additional compelling evidence to support the use of an ROE other
14 than 10%.
 - 15
 - 16 • In connection with the Applicant's proposed ROI of 3.7%, the Applicant has
17 provided information with respect to the requested ROI including a Statement of
18 Investment Policies and Procedures. NERA, after a full review of the available
19 information including a weighted average yield for insurers operating in
20 Newfoundland and Labrador, found that the requested ROI of 3.7% was
21 reasonable in the circumstances. Based on all the available information, the
22 Board accepts the proposed rate of return as reasonable.
 - 23
 - 24 • The filing guidelines set out a 2.25 to 1 Premium to Surplus Ratio as reasonable.
25 The Applicant proposes a ratio of 2 to 1 without providing support for the figure.
26 The Board will not accept the proposed Premium to Surplus Ratio and will
27 instead require the use of 2.25 to 1 as reasonable and appropriate in the
28 circumstances.
 - 29

1 **Costs**

2
3 As set out in the Filing Instructions, pursuant to section 57 of the *Automobile Insurance*
4 *Act* and section 90 of the *Public Utilities Act*, the Applicant will be required to pay the
5 costs of the Board associated with this application.

6
7 **IT IS THEREFORE ORDERED THAT:**

- 8
9 1. The proposed rates are prohibited.
- 10
11 2. The Applicant shall file with the Board revised rate indications reflecting the
12 findings of the Board which specifically include an ROE of 10%, an ROI of 3.7%,
13 a Premium to Surplus Ratio of 2.25 to 1, the alternate assumptions of MOW with
14 respect to Underwriting Profit, Effect of Reforms and Credibility
15 Standard/Procedure and the exclusion from rates of any revenue shortfall arising
16 from the proposed capping program.
- 17
18 3. The Applicant shall submit for approval of the Board a revised rate proposal,
19 setting out the effective dates, which for each coverage shall be no more than the
20 indications filed with the Board.
- 21
22 4. The proposed discount program is approved.
- 23
24 5. The proposed Class of Use definitions are accepted for use.
- 25
26 6. The Applicant shall pay all the expenses of the Board arising from this
27 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