

A.I. 6(2006)

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

AND

IN THE MATTER OF an application by
Insurance Corporation of Newfoundland
(the “Applicant”) to implement revised rates
for its Private Passenger class of business.

On October 27, 2005 pursuant to legislative changes enacted on August 1, 2005, the
Applicant submitted for the Board’s review and approval a revised private passenger
automobile insurance rating program for use with effect from August 1, 2005.

Legislation

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

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

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:
3 the Applicant's projected loss experience; expenses; investment income for the
4 company's automobile insurance business for the province; and other elements
5 considered appropriate by the Board. While each of these components is, with certain
6 exceptions, relatively easy to calculate, it is the aspect of the reasonableness of each
7 component that must be assessed by the Board in determining if rates are "too high".
8 Where the Board determines that an insurer's loss experience is not relevant,
9 inadequate or otherwise unreasonable for use in establishing rates, the Board has
10 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
14 provided 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*
17 *insurer for private passenger automobile insurance as approved by the*
18 *Board shall be reduced by at least 5%.*
19 *(3) Not later than September 1, 2005, an insurer that is reducing its rates by at*
20 *least 5% shall file with the Board the rates for all types of coverage it*
21 *proposes to charge for private passenger automobile insurance."*
22

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,*
26 *2005, apply to the Board for the approval of rates that have not been reduced*
27 *by at least 5% and the Board shall approve, prohibit or vary the rates*
28 *proposed to be charged by the insurer."*
29

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

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

- 34
35 a. Elimination of Age, Sex and Marital Status as rating variables;
36 b. Establishment of a new Class of Use system and definitions;
37 c. Permitting the use of the number of years licensed for rating purposes;

- 1 d. Additions to the Prohibited Underwriting Regulations;
 2 e. Additions to the elements prohibited in a company's Risk Classification
 3 System;
 4 f. Additions to restrictions on the grounds that can be used to decline, terminate
 5 or 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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 10
 11 On July 29, 2005 following the announced changes to the automobile insurance
 12 product and changes to the method of rate regulation, the Board issued new Filing
 13 Instructions to industry participants. These Filing Instructions detailed the
 14 requirements arising from the new legislation and in particular the changes to the
 15 information requirements respecting rate filings. Extracts from the Filing Instructions
 16 providing definitions of the two types of filing categories appear below:

17
 18 **“3.1 CATEGORY - 1**

19
 20 **3.1.1 Category 1 - Definition**

21
 22 *An insurer is considered to have made a Category 1 filing where:*

- 23
 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*
 26 *least 5% and there is no increase to any rate for any coverage for*
 27 *any insured;*
 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*
 30 *coverage for any insured; or*
 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.*

33
 34 *Any filings not meeting this requirement will be considered a Category 2*
 35 *filing.*
 36
 37

1
2 **3.2 CATEGORY 2- GENERAL FILING**
3

4 **3.2.1 Category 2 - Definition**
5

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*
8 *increase in a rate for any coverage for any insured, the filing will be*
9 *considered a Category 2 filing.”*
10

11 As part of the Filing Instructions the Board also issued a guidance document which
12 sets 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*
16 *Document which is attached to these Filing Guidelines as Appendix A. Insurers*
17 *should note that this document sets out guidance on completion requirements and*
18 *various assumptions for such parameters as the trend factor, loss development*
19 *factors, credibility, ROE, ROI and premium to surplus ratio. To the extent that*
20 *insurers vary from the Category 2 Rate Application Guidance Document they will be*
21 *required to provide complete justification for consideration by the Board. Insurers*
22 *should note that the Board may have reference to advice from its consultants or may*
23 *hold a hearing to consider these proposals.”*
24

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

29
30 **The Application**
31

32 On October 27, 2005 the Applicant submitted to the Board for consideration a
33 detailed filing of private passenger automobile insurance rates. A copy of the filing
34 was forwarded to the Board’s actuarial consultants, Mercer Oliver Wyman (MOW)
35 for their review and report. Throughout the ensuing weeks various information
36 requests were issued by MOW to the Applicant and responses received such that, it
37 was not until November 14, 2005 that a final filing was considered to have been made
38 and MOW could complete its review and issue its report.

39
40 The final filing proposed a schedule of rates based on a Return on Equity (ROE) of
41 12.5%, a Return on Investment (ROI) of 5% and a Premium to Surplus Ratio of

1 2.25:1. These parameters, as well as the assumptions made by the Applicant in
 2 connection with other factors considered in the rate making process are reflected in
 3 the indications and proposed rate changes shown below:

4

ICON	Company	Company
Coverage	Indications	Proposal
Third Party Liability	6.2%	-5.0%
Accident Benefits	6.0%	-1.3%
Collision	-23.2%	-5.1%
All Perils	-23.2%	-5.1%
Comprehensive	-15.2%	-1.5%
Specified Perils	-15.2%	-1.5%
Uninsured Auto	6.0%	-1.3%
Total	-0.5%	-4.2%

5

6 Where a person who is insured with the Applicant would upon renewal experience an
 7 increase as a result of changes flowing from this application or the amended
 8 legislation, the Applicant proposes to cap rate increases at 0% on a vehicle basis until
 9 the next rate filing. This may result in a revenue shortfall as these insureds may pay
 10 less than they otherwise should pay. The Applicant has stated that the 0% cap on
 11 premiums prevents them from attaining full indication by coverage.

12

13 The Applicant proposes to offer the following discounts:

14

Discounts	%	Coverage
Multi Vehicle	12%	All Coverages - All Classes
Auto - Home	5%	All Coverages - All Classes
Mature Driver age 55 - 70 ¹	15%	All Coverages - All Classes
Mature Driver age 71 - 79 ¹	5%	All Coverages - All Classes
Mature Driver age 55 - 70 ²	20%	All Coverages - All Classes
Mature Driver age 71 - 79 ²	10%	All Coverages - All Classes
Driving Experience 22 - 27 Years ^{1,3}	5%	All Coverages - All Classes
Driving Experience >27 Years ^{1,3}	10%	All Coverages - All Classes
Driving Experience 22 - 27 Years ^{2,3}	10%	All Coverages - All Classes
Driving Experience >27 Years ^{2,3}	15%	All Coverages - All Classes
Student Away from Home	50%	All Coverages - All Classes
Employees	10%	All Coverages - All Classes
<small>¹ Insured with a Class 05 operator</small>		
<small>² Insured without a Class 05 operator</small>		
<small>³ Principal Operator must be under age 55</small>		

15

1 The proposed discounts are consistent with those previously approved with the
2 addition of a new discount based on years driving. The Driving Experience discount
3 maintains a reference to the age of the operator and therefore is a violation of the
4 legislation. ICON was not able to provide support for this discount. The remaining
5 discounts relate to the risk, and are not subjective or arbitrary and are in accordance
6 with the legislative provisions. In addition, the impact of the discounts has been
7 appropriately reflected in the rate filing, as reviewed by MOW.

8
9 The Applicant proposes Class of Use definitions that vary from those recently
10 amended in the Statistical Plan of the Superintendent of Insurance. The first variation
11 relates to the length of years licensed and was not evident in the Applicant's last rate
12 filing. The second variation in relation to the distance of commute was in a previous
13 filing and was accepted as reasonable by the Board at that time. MOW finds that the
14 proposed Class of Use definitions are similar to the recently amended Superintendent
15 of Insurance's Statistical Plan and concludes that the selected class differentials are
16 reasonable.

17
18 **Detailed Analysis**

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

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

11

12 Actuarial

13

14 The December 5, 2005 report of the Board's actuarial consultants identified a number
15 of issues and provided rate indications based on alternate assumptions found in their
16 report to be reasonable and supported by the information contained in the Applicant's
17 filings, or, reasonable on the basis of industry factors.

18

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

25 ○ Loss Trend – the Applicant provided an analysis of industry loss experience for 3,
26 5 and 7 years. In selecting its loss trend rates, the Applicant selects its severity
27 analysis and opts for a frequency rate of zero for all coverages excluding
28 comprehensive and specified perils for which it selects both its severity and
29 frequency analysis. MOW finds that the Applicant has not supported its selection
30 of a zero frequency loss trend and therefore substitutes its own frequency trend
31 rate based on its analysis of industry experience.

32

33 ○ Credibility Standard/Procedure – The Applicant used a credibility standard of
34 3,246 for Third Party Liability transformed to a premium volume basis. By using

1 this approach, a credibility factor cannot be determined for the sub component
 2 parts of the Third Party Liability coverage. MOW uses the same number of claims
 3 for the property damage portion of Third Party Liability but a lower number, 1082
 4 claims, for the bodily injury portion, neither of which is transformed to a premium
 5 volume. This is consistent with past practice of the Board and is the standard used
 6 by the Board's consultant in the past.

7
 8 The impact of these alternative assumptions is provided in detail as an appendix to
 9 the consultant's report and is summarized in the table below:

ICON	Company	Company	MOW
Coverage	Indications	Proposal	Indications
Third Party Liability	6.2%	-5.0%	3.4%
Accident Benefits and Uninsured Auto	6.0%	-1.3%	-3.1%
Collision	-23.2%	-5.1%	-26.0%
All Perils	-23.2%	-5.1%	-26.0%
Comprehensive	-15.2%	-1.5%	-22.5%
Specified Perils	-15.2%	-1.5%	-22.5%
Uninsured Auto	6.0%	-1.3%	-3.1%
Total	-0.5%	-4.2%	-4.1%

11
 12 The MOW indications are based on the Board's guideline factors for ROE, ROI and
 13 Premium to Surplus Ratio. The Applicant was provided with a copy of these
 14 indications with the full MOW report.

15
 16 On January 23, 2006 the Applicant notified the Board that it wished to amend its
 17 rating proposal having given consideration to the report of the Board's Actuarial
 18 Consultants. The Applicant's revisions with the earlier MOW indications are
 19 contained in the following table:

20

1

ICON	Revised Company Proposal	MOW Indications
Coverage		
Third Party Liability	-1.7%	3.4%
Accident Benefits	-2.6%	-3.1%
Collision	-15.0%	-26.0%
All Perils	-15.0%	-26.0%
Comprehensive	-10.0%	-22.5%
Specified Perils	-10.0%	-22.5%
Uninsured Auto	-2.6%	-3.1%
Total	-4.4%	-4.1%

2

3 The Applicant comments on the MOW indications suggesting that the overall impact
4 should be considered as well as the individual coverages. The Applicant notes that
5 the proposed overall indications are very close to those of MOW and that the 0% cap
6 kept the Applicant from attaining the full indications by coverage.

7

8 Cost of Capital

9

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

12

13 “Return on Equity

14

- 15 ■ *In Order No. A.I. 1 (2005), after hearing from several experts relating to profit*
16 *margin, the Board determined a return on equity and premium to surplus ratio for*
17 *use under the benchmark system which, as the result of legislative changes, is no*
18 *longer in use. Nevertheless, the Board accepts the determination in Order No. A.I. 1*
19 *(2005) as the most comprehensive recent consideration of the appropriate return on*
20 *equity and premium to surplus ratio for rate making purposes for automobile insurers*
21 *in Newfoundland & Labrador. Therefore, the Board accepts as reasonable for use in*
22 *rate filings a target after-tax Return on Equity of 10.0% and a premium to surplus*
23 *ratio of 2.25.*

24

- 25 ■ *Other return on equity or premium to surplus assumptions or calculations will be*
26 *considered, but rationale for any deviations must be provided and the Company must*
27 *provide a comparison of the assumptions or calculations with those made by the*
28 *Company in preparing filed rate level indications for other coverages and lines of*
business in Newfoundland & Labrador as well other provinces.

29

Return on Investments

30

- 31 ■ *The Board also considered the appropriate return on investments for ratemaking*
purposes for automobile insurers in Newfoundland and Labrador in Order No. A.I. 1

1 (2005). The Board accepted that "...setting ROI based on levels of risk and
2 commensurate returns relative to the actual investment profile of Canadian
3 automobile insurers is most appropriate," but noted the lack of available information
4 to assist in this determination. In light of the lack of information and the changed
5 regulatory environment, the Board will not set out a target return on investment for
6 rate making purposes, but expects that the return on investment will be in the range
7 identified by the Board in Order No. A.I. 1 (2005) of 5.4%-7.04%.

- 8 ▪ The Board will consider other return on investment assumptions or calculations;
9 however, full rationale for any deviations must be provided, based on recently
10 available 2004 financial data."

11
12 The filing was reviewed by the Board's cost of capital consultants, National
13 Economic Research Associates (NERA), as relates to the ROE and ROI inputs.
14 During this review information requests and responses were exchanged with the
15 Applicant. The Applicant suggested that a higher ROE was appropriate on the basis
16 that it has a higher risk, since it operates only in this Province. The consultant's
17 report, dated March 13, 2006, details the pertinent aspects of these exchanges and
18 summarizes the position stated by the Applicant in support of the requested ROE and
19 ROI and NERA's consideration thereof. NERA concluded that ICON's claim of
20 higher risk than industry average was unsubstantiated.

21
22 NERA's final report findings are as follows:

23
24 ROE – "ICON has not provided sufficient evidence to support its request for an ROE
25 higher than set out in the guidelines."

26
27 ROI – "ICON's requested ROI of 5% is reasonable."
28

29 A copy of the MOW report and the NERA report was forwarded to the Applicant for
30 comment.

31
32 **Findings**

33
34 The Board has reviewed the application, the supporting material, responses to
35 information requests, consultants' reports and all other information relevant to this
36 rate filing. The Board finds the proposed Class of Use definitions are acceptable as
37 they are similar to those approved by the Superintendent of Insurance as well as those

1 previously accepted by the Board. As well the associated differentials were found by
2 MOW to be reasonable.

3

4 The Applicant's proposed discount program is consistent with that previously
5 approved and with one exception is consistent with the legislative provisions. The
6 Applicant proposes a Driving Experience discount for insureds licensed over 21 years.
7 The discount applies to only those insureds not having attained the age of 55. One of
8 the recent legislative changes was the elimination of rating based on age, sex or
9 marital status. The legislation includes a specific exception for a discount based on
10 age, where the operator of the vehicle is at least 55 years of age. Other than this
11 exception, age cannot be reflected in the rates or discounts of the insurer. The
12 restriction of the Driving Experience discount to insureds under the age of 55 is
13 contrary to the Regulations and cannot be accepted by the Board.

14

15 Based on the review of the available information in connection with this rate filing the
16 Board is not satisfied that some of the other elements of the Applicant's rate proposals
17 are reasonably supported by the available information. A review of the rate proposals
18 confirms that the Applicant has chosen to establish rates for certain coverages which
19 are higher than the actuarially justified indications. The Applicant has stated that the
20 0% cap prevents it from attaining full indications by coverage. As discussed earlier
21 the Board will not approve rates that are too high and therefore will not approve the
22 proposed rates for any coverages which are higher than the indications.

23

24 In connection with the actuarial analysis, the Board has reviewed the assumptions
25 provided by the Applicant and the alternate assumptions provided by the Board's
26 actuarial consultants, MOW, in respect of loss trend and credibility standard. While
27 the Board and MOW sought clarification and support for the proposals, the Applicant
28 did not fully support its position on each of the elements of the rate proposal. The
29 Board notes that the Applicant was provided with a copy of the MOW report and was
30 given an opportunity to further comment on and challenge the rationale used by
31 MOW. The Applicant did not challenge the MOW assumptions. The Applicant's
32 subsequent comments relate solely to the impact of the capping issue which has
33 already been addressed. The Board finds the alternate assumptions of MOW are fully

1 supported and accepts them as reasonable. The Board therefore will require the
2 Applicant to reflect these alternate assumptions in its rate filing.

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

- 10
- 11 • In connection with the Applicant's proposed ROE of 12.5%, the Board finds
12 that the Applicant has not fully supported the proposal. The Applicant did not
13 provide either financial information or expert opinion supporting the
14 suggested greater than average risk or the proposed ROE. NERA determined
15 that insufficient evidence was provided to support an ROE higher than 10%.
16 The Board finds that the Applicant has not provided sound rationale or
17 additional compelling evidence to support the use of an ROE other than 10%.
18
 - 19 • In connection with the Applicant's proposed ROI of 5%, the Applicant has
20 provided sufficient information to justify the requested ROI. NERA after a
21 full review of the available information found that the requested ROI of 5%
22 was reasonable in the circumstances. Based on all the available information,
23 the Board accepts the proposed ROI as reasonable.

24

25 **Costs**

26

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

30

1 **IT IS THEREFORE ORDERED THAT:**

2

3 1. The proposed rates are prohibited.

4

5 2. The Applicant shall file revised rate indications reflecting the findings of the
6 Board which specifically include an ROE of 10% and the alternate
7 assumptions of MOW with respect to Loss Trend and Credibility
8 Standard/Procedure.

9

10 3. The Applicant shall submit for the approval of the Board a revised rate
11 proposal, setting out the effective dates, which for each coverage shall be no
12 more than the indications filed with the Board.

13

14 4. The proposed discount program is approved with the exception of the Driving
15 Experience discount, which is prohibited.

16

17 5. The proposed Class of Use definitions are accepted for use.

18

19 6. The Applicant shall pay all the expenses of the Board arising from this
20 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