

A.I. 7(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 Elite 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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10

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**

19

20

20 **3.1.1 Category 1 - Definition**

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22

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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33

34

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

35

36

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

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 15%, 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

Elite		
Coverage	Company Indications	Company Proposal
Third Party Liability	2.4%	3.0%
Accident Benefits	5.0%	5.0%
Collision	-2.6%	0.0%
Comprehensive	-8.4%	-7.5%
All Perils	-2.1%	-2.5%
Specified Perils	4.5%	0.0%
Uninsured Motorist	-2.0%	0.0%
Total	1.5%	2.3%

7

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

14

15 The Applicant proposes to offer the following discount:

16

Discount	%	Coverage
Multi Vehicle	10%	Third Party Liability, Collision and Collision portion of All Perils - All Classes except 05

17

18 The proposed discount is consistent with those previously approved by the Board. The
 19 discount relates to the risk, is not subjective or arbitrary and is otherwise in accordance
 20 with the legislative provisions. In addition the impact of the discount has been
 21 appropriately reflected in the rate filing, as reviewed by MOW.

22

1 The Applicant has filed the Class of Use definitions as established by the Superintendent
2 of Insurance without deviation. MOW also found that the selected class differentials
3 were reasonable.

4
5 **Detailed Analysis**
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7 In its review of rate filings the Board is mandated to prohibit or vary a rate which it
8 determines is “too high”. The Board makes this determination following a thorough
9 review of all information submitted by the Applicant and careful consideration of the
10 reports and findings of its expert consultants. In exercising its jurisdiction the Board
11 reviews the base rates for each coverage and a determination is made as to whether or not
12 they are “too high”. That is to say, the review is on a coverage by coverage basis. This is
13 consistent with the amended legislation and is in keeping with the historical practice of
14 the Board which was adopted to avoid the cross subsidization of rates between coverages.
15 Allowing the establishment of a rate for one coverage lower than is justified and
16 permitting a rate for another coverage to be higher than is justified by the actuarial and
17 other evidence would result in rates which are not reflective of costs and, depending on
18 the coverage chosen, some insureds may pay more than actuarially justified.

19
20 After reviewing the filing, the Board notes that the capping proposed by the Applicant
21 may result in the costs associated with a shortfall in premium on a variety of coverages
22 for the capped customers being recovered in the premiums collected from other
23 customers on other coverages. This may be considered to be cross-subsidization and
24 contrary to the established policy of the Board. The legislative provisions allow an
25 insurer to charge less to an insured than would otherwise be charged as a result of certain
26 legislative changes but does not permit an insurer to charge more than is actuarially
27 justified for any coverages.

28
29 As identified in the Board’s detailed Filing Instructions, the Applicant is required to
30 provide justification of any rate increases. Where the Applicant does not utilize the
31 specific parameters set out in the filing guidelines the Applicant is required to provide the
32 Board with sound reasoning and justification for the deviation. For example, in

1 connection with ROI, the guidelines provide the Board's acceptable range of factors but
2 state, "*The Board will consider other return on investment assumptions or calculations;*
3 *however, full rationale for any deviations must be provided, based on recently available*
4 *2004 financial data.*" Similar cautions and directions are provided in connection with the
5 remaining guideline factors and assumptions, where appropriate.

6
7 Actuarial

8 The November 15, 2005 report of the Board's actuarial consultants identified a number of
9 issues and provided rate indications found by MOW to be reasonable and supported by
10 the information contained in the Applicant's filings or reasonable on the basis of industry
11 factors.

12
13 With respect to assumptions made in the determination of rates, these are matters of
14 actuarial judgment and are reviewed in the context of reasonableness. MOW reviewed
15 the assumptions made by the Applicant and expressed the opinion that certain of the
16 assumptions were not fully supported. In their place, MOW substituted alternate
17 assumptions they felt more appropriate or reflective of market or other conditions as
18 follows:

- 19
- 20 ○ Underwriting Profit – in its review, MOW determined that the Applicant did not treat
21 its investment income from premium cash flow and expenses in a manner consistent
22 with its treatment of cash flow for claims payments. MOW made the adjustment
23 necessary to provide for consistent treatment. The effect of this adjustment was
24 approximately a 2% reduction on the Applicant's overall indications.
 - 25
 - 26 ○ Effects of Reform - the Applicant did not provide for any savings arising from the
27 Collateral Sources provision in recent legislative changes thus overstating the cost of
28 the product. The savings were provided as part of the Board's Filing Instructions and
29 amount to 1.1%. The impact on rates is a 0.5% reduction.

30

- 1 ○ Credibility Standard/Procedure – The Applicant used a credibility standard of 3,246
 2 claims for third party liability, 1,082 for property damage coverages and 2,164 for
 3 accident benefits. MOW uses 3,246 claims for the bodily injury portion of third party
 4 liability, 1,082 for property damage coverages and 2,164 for accident benefits. This is
 5 consistent with past practice of the Board and is the standard used by the Board’s
 6 consultant. The issue MOW has raised is that the Applicant did not determine the
 7 credibility level for third party liability on the sub coverages separately. The impact
 8 of this is approximately a 0.8% decrease in indication.

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

Elite	Company	Company	MOW
Coverage	Indications	Proposal	Indications
Third Party Liability	2.4%	3.0%	-1.6%
Accident Benefits	5.0%	5.0%	3.8%
Collision	-2.6%	0.0%	-10.3%
Comprehensive	-8.4%	-7.5%	-15.9%
All Perils	-2.1%	-2.5%	-9.6%
Specified Perils	4.5%	0.0%	-3.5%
Uninsured Motorist	-2.0%	0.0%	-3.6%
Total	1.5%	2.3%	-2.9%

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

25
 26 **Revised Proposal**

27
 28 On December 12, 2005 the Applicant notified the Board that it wished to amend its rating
 29 proposal having given consideration to the report of the Board’s actuarial consultants.
 30 The Applicant’s revisions and the consultants’ indications were reviewed in an addendum
 31 report received on January 12, 2006 and are contained in the following table:

1

Elite	Company	Company	MOW
Coverage	Indications	Proposal	Indications
Third Party Liability	1.2%	3.0%	-1.6%
Accident Benefits	3.7%	5.0%	3.8%
Collision	-6.7%	0.0%	-10.3%
Comprehensive	-12.2%	-7.5%	-15.9%
All Perils	-8.4%	-2.5%	-9.6%
Specified Perils	-3.2%	0.0%	-3.5%
Uninsured Motorist	-2.2%	0.0%	-3.6%
Total	-0.1%	2.3%	-2.9%

2

3 In this proposal, only the company indications were revised and not the proposed rate
4 changes. The revised indications reflect a different approach with respect to the
5 Credibility Standard/Procedure but otherwise did not deviate from the MOW
6 assumptions.

7 Cost of Capital

8

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

11

12 “Return on Equity

13

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

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

1 Return on Investments

- 2 ▪ *The Board also considered the appropriate return on investments for ratemaking*
3 *purposes for automobile insurers in Newfoundland and Labrador in Order No. A.I. 1*
4 *(2005). The Board accepted that "...setting ROI based on levels of risk and*
5 *commensurate returns relative to the actual investment profile of Canadian automobile*
6 *insurers is most appropriate," but noted the lack of available information to assist in this*
7 *determination. In light of the lack of information and the changed regulatory*
8 *environment, the Board will not set out a target return on investment for rate making*
9 *purposes, but expects that the return on investment will be in the range identified by the*
10 *Board in Order No. A.I. 1 (2005) of 5.4%-7.04%.*
- 11 ▪ *The Board will consider other return on investment assumptions or calculations;*
12 *however, full rationale for any deviations must be provided, based on recently available*
13 *2004 financial data."*

14
15 The Applicant's proposals reflect a Premium to Surplus Ratio of 2 to 1 rather than the
16 2.25 to 1 as set out in the filing guidelines. The support provided for this alternate
17 assumption is a statement in relation to the experience under the minimum capital test
18 used by the Office of the Superintendent of Financial Institutions (OSFI) to monitor the
19 health of certain insurers. The Applicant did not provide supporting professional opinion
20 or supporting financial information as sought by the filing guidelines and requests for
21 information.

22
23 The filing was reviewed by the Board's cost of capital consultants, National Economic
24 Research Associates (NERA), as relates to the ROE and ROI inputs. During this review
25 information requests and responses were exchanged with the Applicant. NERA's report,
26 dated March 13, 2006, details the pertinent aspects of these exchanges and summarizes
27 the position stated by the Applicant in support of the requested ROE and ROI and
28 NERA's consideration thereof.

29
30 The Applicant argues that it should receive a higher ROE than average based on the fact
31 that it writes substandard business. The Applicant suggests that this business has greater
32 risk. However this argument was found by NERA to be unsubstantiated on the basis that
33 the argued increased risk is firm specific. In relation to the ROI NERA notes that the
34 Applicant did not provide the necessary information in relation to the investment
35 portfolio.

1 NERA's final report findings are as follows:

2

3 ROE – *“Elite has not provided sufficient evidence to support its request for a higher*
4 *ROE than set out in the filing guidelines.”*

5

6 ROI – *“Elite's requested ROI is not justified. Based on the proxy portfolio, NERA's*
7 *calculated ROI for Elite is 5.14%.”*

8

9 The NERA report was forwarded to the Applicant for comments. The Applicant initially
10 provided commentary and additional information but later withdrew this information and
11 commentary.

12

13 **Findings**

14

15 The Board has reviewed the application, the supporting material, responses to
16 information requests, consultants' reports and all other information relevant to this rate
17 filing. The proposed Class of Use definitions are the same as those set out by the
18 Superintendent of Insurance. As well, the associated differentials were found by MOW
19 to be reasonable.

20

21 The Applicant's proposed discount program is consistent with previous filings. The
22 program is consistent with the legislative provisions and has been determined to be
23 reasonable in the context of the rate filing. However, the recovery of the shortfall in
24 premium associated with the capping of rate increases as proposed by the Applicant is not
25 consistent with the policy of the Board or legislative provisions. While the proposed
26 capping may minimize rate impacts arising out of this application for some insureds
27 recovery of the revenue shortfall may mean that remaining insureds pay the associated
28 costs on a variety of coverages. Therefore the Board will not approve the inclusion in
29 rates of a revenue shortfall arising from the capping proposal.

30

31 Based on the review of the available information in connection with this rate filing the
32 Board is not satisfied that some of the actuarial assumptions in the Applicant's rate
33 proposals are reasonably supported by the available information. The Board has

1 reviewed the assumptions provided by the Applicant and the alternate assumptions
2 provided by the Board's actuarial consultants, MOW, in respect of Underwriting Profit,
3 Effects of Reform, and Credibility Standard/Procedure. While the Board and MOW
4 sought clarification and support for the proposals, the Applicant did not provide the
5 necessary support for each of the elements of the rate proposal. The Board notes that the
6 Applicant was provided with a copy of the MOW report and was given an opportunity to
7 further comment on and challenge the rationale used by MOW. The Board finds that the
8 detailed and comprehensive analysis offered by MOW in its report is persuasive. While
9 the Applicant, subsequent to the MOW report, provided alternate indications based on
10 different assumptions in relation to the Credibility Standard/Procedure, it did not provide
11 substantiation for the same. The Board accepts the MOW assumptions as reasonable and
12 will require the Applicant to reflect these alternate assumptions in its rate filing.

13
14 In connection with the cost of capital analysis the Board notes that the filing guideline
15 factors for ROE, ROI and Premium to Surplus Ratio were based on the recent order of
16 the Board issued following a comprehensive hearing with expert testimony. Proposals
17 incorporating alternate factors for ROE, ROI and Premium to Surplus Ratio are approved
18 when fully supported. In the context of the supporting materials the Board makes the
19 following determinations in relation to these factors.

- 20
- 21 • In connection with the Applicant's proposed ROE of 15%, the Board finds that
22 the Applicant has not fully supported the proposal. The Applicant did not provide
23 sufficient financial information or expert opinion to support the proposed ROE.
24 NERA determined that insufficient evidence was provided to support an ROE
25 higher than 10%. While the Applicant proposes a higher ROE on the basis of the
26 fact that it writes substandard risks, NERA provided its opinion that this would
27 not justify an increased ROE in the circumstances. The Board finds that the
28 Applicant has not provided sound rationale or additional compelling evidence to
29 support the use of an ROE other than 10%.
- 30

- 1 • In connection with the Applicant's proposed ROI of 3.7%, the Applicant has not
2 provided the necessary information to support the requested ROI. NERA, after a
3 full review of the available information, constructed a proxy investment portfolio
4 and calculated an ROI of 5.14% for the Applicant. Based on all the available
5 information, the Board accepts 5.14% as a reasonable rate of return on
6 investment.
- 7
- 8 • The filing guidelines set out a 2.25 to 1 Premium to Surplus Ratio as reasonable.
9 The Applicant proposes a ratio of 2 to 1 without providing support for the figure.
10 The Board will not accept the proposed Premium to Surplus Ratio and will
11 instead require the use of 2.25 to 1 as reasonable and appropriate in the
12 circumstances.

13

14 **Costs**

15

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

19

20 **IT IS THEREFORE ORDERED THAT:**

- 21
- 22 1. The proposed rates are prohibited.
- 23
- 24 2. The Applicant shall file with the Board revised rate indications reflecting the
25 findings of the Board which specifically include an ROE of 10%; an ROI of
26 5.14%; a Premium to Surplus Ratio of 2.25 to 1, the alternate assumptions of
27 MOW with respect to Underwriting Profit, Loss Trend and Credibility
28 Standard/Procedure and the exclusion from rates of any revenue shortfall arising
29 from the proposed capping program.
- 30

- 1 3. The Applicant shall submit for the approval of the Board a revised rate proposal,
2 setting out the effective dates, which for each coverage shall be no more than the
3 indications filed with the Board.
4
- 5 4. The proposed discount program is approved.
6
- 7 5. The proposed Class of Use definitions are accepted for use.
8
- 9 6. The Applicant shall pay all the expenses of the Board arising from this
10 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