

**A.I. 9(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 Scottish and York Insurance Co. Limited  
9 (the “Applicant”) to implement revised rates  
10 for its Private Passenger class of business.  
11

12  
13 On September 19, 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 automobile  
15 insurance rating program for use with effect from August 1, 2005. On November 3, 2005 the  
16 Applicant submitted a second private passenger automobile insurance rating program replacing  
17 its original September 19, 2005 submission.  
18

19 **Legislation**  
20

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.  
27

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

1 regulations, if a proposed rate is “too high”. Where such a finding is made the Board is required  
2 to prohibit, or vary the rates.

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

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

17  
18 *“62.1 (2) Effective August 1, 2005, the rates for all types of coverage charged by an insurer for*  
19 *private passenger automobile insurance as approved by the Board shall be reduced by at*  
20 *least 5%.*  
21 *(3) Not later than September 1, 2005, an insurer that is reducing its rates by at least 5%*  
22 *shall file with the Board the rates for all types of coverage it proposes to charge for*  
23 *private passenger automobile insurance.”*  
24

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

26  
27 *“(4) Notwithstanding subsection (2), an insurer may, not later than September 1, 2005, apply*  
28 *to the Board for the approval of rates that have not been reduced by at least 5% and the*  
29 *Board shall approve, prohibit or vary the rates proposed to be charged by the insurer.”*  
30

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

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

35

- 1 a. Elimination of Age, Sex and Marital Status as rating variables;
- 2 b. Establishment of a new Class of Use system and definitions;
- 3 c. Permitting the use of the number of years licensed for rating purposes;
- 4 d. Additions to the Prohibited Underwriting Regulations;
- 5 e. Additions to the elements prohibited in a company's Risk Classification System;
- 6 f. Additions to restrictions on the grounds that can be used to decline, terminate or refuse to
- 7 renew coverage; and
- 8 g. Elimination of the prohibition on group rates and group rating.

## 10 **Filing Instructions**

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

### 20 ***"3.1 CATEGORY - 1***

#### 22 **3.1.1 Category 1 - Definition**

23  
24 *An insurer is considered to have made a Category 1 filing where:*

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

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

35  
36

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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% mandated by*  
7           *legislation on September 1, 2005 or in any other case an increase in a rate for any*  
8           *coverage for any insured, the filing will be considered a Category 2 filing.”*  
9

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

13  
14           *“Insurers should have reference to the Category 2 Rate Application Guidance Document which is*  
15           *attached to these Filing Guidelines as Appendix A. Insurers should note that this document sets*  
16           *out guidance on completion requirements and various assumptions for such parameters as the*  
17           *trend factor, loss development factors, credibility, ROE, ROI and premium to surplus ratio. To*  
18           *the extent that insurers vary from the Category 2 Rate Application Guidance Document they will*  
19           *be required to provide complete justification for consideration by the Board. Insurers should*  
20           *note that the Board may have reference to advice from its consultants or may hold a hearing to*  
21           *consider these proposals.”*  
22

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

26  
27   **The Application**

28  
29   On September 19, 2005 the Applicant submitted to the Board for consideration a detailed filing  
30   of private passenger automobile insurance rates. On November 3, 2005 the Applicant submitted  
31   a second rating program to replace its original submission. A copy of the filing was forwarded to  
32   the Board’s actuarial consultants, Mercer Oliver Wyman (MOW) for their review and report.  
33   Throughout the ensuing weeks various information requests were issued by MOW to the  
34   Applicant and responses received such that it was not until December 9, 2005 that a final filing  
35   was considered to have been made and MOW could complete its review and issue its report.  
36

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

<b>Scottish &amp; York Coverage</b>	Company Indications	Company Proposal
Third Party Liability	-1.2%	-2.4%
Accident Benefits	13.3%	10.0%
Collision	-15.3%	-10.0%
Comprehensive	-32.2%	-20.0%
All Perils	-9.7%	-13.3%
Specified Perils	-7.9%	5.0%
Uninsured Motorist	-1.1%	0.0%
Total	-6.7%	-5.2%

6  
 7 Where a person who is insured with the Applicant would upon renewal experience an increase as  
 8 a result of changes flowing from this application or the amended legislation, the Applicant  
 9 proposes to cap rate increases at 0% on a vehicle basis. This may result in a revenue shortfall as  
 10 these insureds may pay less than they otherwise should pay. The Applicant has adjusted the  
 11 proposed Third Party Liability rates to recover the shortfall in premium associated with capping.  
 12

13 The Applicant proposes to offer the following discounts:  
 14

<b>Discounts</b>	<b>%</b>	<b>Coverages</b>
Multi Vehicle	10%	All Common Coverages Except Comp and Specified Perils – All Classes except 05
Age 55+	10%	All Coverages – All Classes including 05
Full Package	10%	Third Party Liability, Accident Benefits, All Perils, Collision, Comprehensive and Specified Perils – All Classes except 05
Short Commute	10%	Third Party Liability, Accident Benefits, All Perils, Collision, and Uninsured Auto – Class 02 only
University	50%	All Coverages - Class 05 only
Preferred Driver	10%	All Coverages – All Classes except 05

15  
 16 The proposed discounts are consistent with those previously approved by the Board. The  
 17 discounts relate to the risk, are not subjective or arbitrary and are otherwise in accordance with

1 the legislative provisions. In addition the impact of the discounts has been appropriately  
2 reflected in the rate filing, as reviewed by MOW.

3  
4 The Applicant proposes Class of Use definitions that vary slightly from those established by the  
5 Superintendent of Insurance. MOW finds that the proposed Class of Use definitions are similar  
6 to the Superintendent of Insurance's recently revised Statistical Plan and concludes that the  
7 selected class differentials are reasonable.

8  
9 **Detailed Analysis**

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

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

31

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

10

### 11 Actuarial

12

13 The January 10, 2006 report of the Board's actuarial consultants identified a number of issues  
14 and provided rate indications found in their report to be reasonable and supported by the  
15 information contained in the Applicant's filing or reasonable on the basis of industry factors.

16

17 With respect to assumptions made in the determination of rates, these are matters of actuarial  
18 judgment and are reviewed in the context of reasonableness. MOW reviewed the assumptions  
19 made by the Applicant and expressed the opinion that the assumption in relation to the Large  
20 Loss Adjustment was not fully supported. In its place MOW substituted an alternate assumption  
21 they felt more appropriate:

22

- 23 ○ Large Loss Adjustment – in its review MOW found that the adjustment of the Third Party  
24 Liability loss experience to reflect a pattern more like that of a sister company, S&Y, was not  
25 justified. MOW concluded that the lower credibility assigned minimizes the effect of the  
26 lower loss experience. Removing this adjustment reduces the overall indications 0.8%.

27

1 The impact of this alternative assumption is provided in detail as an appendix to the consultant's  
 2 report and is summarized in the table below:

<b>Scottish &amp; York</b>	Company	Company	MOW
Coverage	Indications	Proposal	Indications
Third Party Liability	-1.2%	-2.4%	-4.7%
Accident Benefits	13.3%	10.0%	10.1%
Collision	-15.3%	-10.0%	-17.8%
Comprehensive	-32.2%	-20.0%	-35.1%
All Perils	-9.7%	-13.3%	-9.9%
Specified Perils	-7.9%	5.0%	-7.9%
Uninsured Motorist	-1.1%	0.0%	-1.6%
Total	-6.7%	- 5.2%	-9.9%

4  
 5 The MOW indications are based on the Board's guideline factors for ROE, ROI and Premium to  
 6 Surplus. These indications were forwarded to the Applicant with the full MOW report for  
 7 review.

### 9 **Revised Proposal**

10  
 11 On January 31, 2006 the Applicant notified the Board that it wished to amend its rating proposal  
 12 having given consideration to the report of the Board's actuarial consultants. The Applicant's  
 13 revisions and the consultants' indications are contained in the following table:

<b>Scottish &amp; York</b>	Company	Company	MOW
Coverage	Indications	Proposal	Indications
Third Party Liability	-2.5%	-1.7%	-4.7%
Accident Benefits	13.3%	13.3%	10.1%
Collision	-15.3%	-15.3%	-17.8%
Comprehensive	-32.2%	-32.2%	-35.1%
Specified Perils	-7.9%	-7.9%	-7.9%
Uninsured Motorist	-1.1%	-1.1%	-1.6%

15  
 16 The revised indications reflect the removal of the Large Loss Adjustment as suggested by MOW  
 17 but reflect capping and maintain the proposed ROE, ROI and Premium to Surplus Ratio.



1 Cost of Capital

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

5  
6 “Return on Equity

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

21 Return on Investments

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

32  
33 The Applicant’s proposals reflect a Premium to Surplus Ratio of 2 to 1 rather than the 2.25 to 1  
34 as set out in the filing guidelines. The support provided for this alternate assumption is a  
35 statement in relation to the experience under the minimum capital test used by the Office of the  
36 Superintendent of Financial Institutions (OSFI) to monitor the health of certain insurers. The  
37 Applicant did not provide supporting professional opinion or supporting financial information as  
38 sought by the filing guidelines and requests for information.

1 The filing was reviewed by the Board's cost of capital consultants, National Economic Research  
2 Associates (NERA), as relates to the ROE and ROI inputs. During this review information  
3 requests and responses were exchanged with the Applicant. NERA's report, dated March 13,  
4 2006, details the pertinent aspects of these exchanges and summarizes the position stated by the  
5 Applicant in support of the requested ROE and ROI and NERA's consideration thereof.

6

7 NERA's final report findings are as follows:

8

9 ROE – *“Scottish and York has not provided sufficient evidence to support its request for a higher*  
10 *ROE than set out in the filing guidelines.”*

11

12 ROI – *“Scottish and York's requested ROI should be 5.4%, rather than the requested rate of*  
13 *3.7%.”*

14

15 The Applicant states that the shareholders expect an ROE of 15% and further that the proposed  
16 ROE of 12.5% is consistent with the standard used and recently approved in other provinces.  
17 The Applicant also cites some testimony of experts appearing before the Board at its recent  
18 hearing in relation to cost of capital. The Applicant did not provide expert opinion not already  
19 considered by the Board or substantive evidence found persuasive in other jurisdictions. Nor did  
20 the Applicant provide a justification for the statement that shareholders expect an ROE of 15%.  
21 In relation to ROI, NERA notes that the Applicant did not provide its investment guidelines and  
22 therefore the proposed ROI was not justified.

23

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

27

## 28 **Findings**

29

30 The Board has reviewed the application, the supporting material, responses to information  
31 requests, consultants' reports and all other information relevant to this rate filing. The proposed  
32 Class of Use definitions are similar to those set out by the Superintendent of Insurance and are  
33 acceptable by the Board. As well associated differentials were found by MOW to be reasonable.

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

9  
10 Based on the review of the available information in connection with this rate filing the Board is  
11 not satisfied that some of the actuarial assumptions in the Applicant's rate proposals are  
12 reasonably supported by the available information. The Applicant was provided with a copy of  
13 the MOW report and was given an opportunity to further comment on and challenge the rationale  
14 used by MOW. The Applicant revised its proposal to reflect the assumption of MOW in relation  
15 to the Large Loss Adjustment. The Board accepts the revision in relation to the Large Loss  
16 Adjustment as reasonable and fully justified.

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

- 24
- 25 • In connection with the Applicant's proposed ROE of 12.5%, the Board finds that the  
26 Applicant has not fully supported the proposal. The Applicant did not provide sufficient  
27 financial information or expert opinion to support the proposed ROE. NERA determined  
28 that insufficient evidence was provided to support an ROE higher than 10%. The Board  
29 finds that the Applicant has not provided sound rationale or additional compelling  
30 evidence to support the use of an ROE other than 10%.

- 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 notes that the  
3       Applicant did not provide investment guidelines so there was insufficient information to  
4       calculate an appropriate alternate ROI for the Applicant. The Board finds that the  
5       Applicant has not provided sound rationale to support an ROI lower than 5.4%.  
6
- 7       • The filing guidelines set out a 2.25 to 1 Premium to Surplus Ratio as reasonable. The  
8       Applicant proposes a ratio of 2 to 1 without providing support for the figure. The Board  
9       will not accept the proposed Premium to Surplus ratio and will instead require the use of  
10      2.25 to 1 as reasonable and appropriate in the circumstances.  
11

## 12      Costs

13

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

## 18      IT IS THEREFORE ORDERED THAT:

- 19
- 20      1.     The proposed rates are prohibited.  
21
- 22      2.     The Applicant shall file with the Board revised rate indications reflecting the findings of  
23      the Board which specifically include an ROE of 10%, an ROI of 5.4%, a Premium to  
24      Surplus Ratio of 2.25 to 1, the assumptions of MOW with respect to Large Loss  
25      Adjustment, and the exclusion from rates of any revenue shortfall arising from the  
26      proposed capping program.  
27
- 28      3.     The Applicant shall submit for the approval of the Board a revised rate proposal, setting out  
29      the effective dates, which for each coverage shall be no more than the indications filed with  
30      the Board in accordance with this Order.  
31

- 1 4. The proposed discount program is approved.  
2  
3 5. The proposed Class of Use definitions are accepted for use.  
4  
5 6. The Applicant shall pay all the expenses of the Board arising from this application.  
6

**DATED** at St. John's, Newfoundland and Labrador, this 30<sup>th</sup> day of March 2006.

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Robert Noseworthy  
Chair & Chief Executive Officer

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Darlene Whalen, P.Eng.  
Vice-Chair

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G. Cheryl Blundon  
Board Secretary