

1 **ORDER NO. A. I. 5 (2007)**

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

8 **AND**

9
10 **IN THE MATTER OF** an application by
11 Federation Insurance Company of Canada
12 (the “*Applicant*”) to implement revised rates
13 for its Private Passenger class of business.
14

15 **Application Filing**

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17 On November 7, 2006 the Board received the Applicant’s rate filing dated November 3, 2006
18 requesting approval of a revised private passenger automobile insurance rating program for use
19 with effect from February 1, 2007 for new business and April 1, 2007 for renewal business.
20

21 **Legislation**

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23 On August 1, 2005 the Government of Newfoundland and Labrador enacted legislation
24 amending the *Automobile Insurance Act* and the *Insurance Companies Act* in relation to the
25 conduct of participants in the automobile insurance industry and the regulation of rates in the
26 Province. Under the revised automobile insurance legislation rate increases are subject to prior
27 approval and the Board must prohibit or vary a proposed rate which is found to be “too high”.
28

29 In determining if a rate is too high the Board considers the documentation available with respect
30 to the justification of the rate levels including: i) the Applicant’s projected loss experience; ii)
31 expenses; iii) investment income for the company’s automobile insurance business for the
32 Province; and iv) other elements considered appropriate by the Board. Where the Board

1 determines that an insurer's loss experience is not relevant, inadequate or otherwise unreasonable
 2 for use in establishing rates, the Board has discretion to establish the elements and information
 3 upon which the insurer shall file its projected loss experience.

4 5 **Filing Instructions**

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7 In the context of existing legislation the Board issued Filing Instructions and a Guidance
 8 Document for use by insurers in connection with rate filings, hereinafter referred to as Filing
 9 Guidelines. The Filing Guidelines detail the requirements respecting rate filings and provides
 10 the following definitions of two types of filing categories:

11 12 ***“3.1 CATEGORY - 1***

13 14 ***3.1.1 Category 1 - Definition***

15
16 *An insurer is considered to have made a Category 1 filing where:*

- 17
18 a) *In the case of private passenger rates filed in accordance with s.62.1, filed and*
 19 *adjusted base rates for every coverage are reduced by at least 5% and there is no*
 20 *increase to any rate for any coverage for any insured;*
 21 b) *In the case of private passenger rates other than those filed in accordance with*
 22 *s.62.1, there is no increase to any rate for any coverage for any insured; or*
 23 c) *In the case of commercial or miscellaneous vehicle rates there is no increase to*
 24 *any rate for any coverage for any insured.*

25
26 *Any filings not meeting this requirement will be considered a Category 2 filing.*

27 28 29 ***3.2 CATEGORY 2- GENERAL FILING***

30 31 ***3.2.1 Category 2 - Definition***

32
33 *Where a rate filing contemplates changes to base rates less than the 5% mandated by*
 34 *legislation on September 1, 2005 or in any other case an increase in a rate for any*
 35 *coverage for any insured, the filing will be considered a Category 2 filing.”*

36
37 The Filing Guidelines include a Guidance Document, which sets out specific detailed direction
 38 with respect to Category 2 filings. Specifically the Filing Guidelines state:

39
40 *“Insurers should have reference to the Category 2 Rate Application Guidance Document which is*
 41 *attached to these Filing Guidelines as Appendix A. Insurers should note that this document sets*
 42 *out guidance on completion requirements and various assumptions for such parameters as the*
 43 *trend factor, loss development factors, credibility, ROE, ROI and premium to surplus ratio. To*

1 *the extent that insurers vary from the Category 2 Rate Application Guidance Document they will*
 2 *be required to provide complete justification for consideration by the Board. Insurers should*
 3 *note that the Board may have reference to advice from its consultants or may hold a hearing to*
 4 *consider these proposals.”*
 5

6 While an Applicant may utilize factors at variance with those set out in the Filing Guidelines, it
 7 is required to provide sufficient evidence for the Board to assess these factors. It is in the context
 8 of the foregoing that this filing is reviewed.

9
 10 **The Application**

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 12 This rate filing is the Applicant’s first Category 2 rate filing since the August 1, 2005 legislative
 13 changes (the “Application”). The Application proposes an overall increase in rates of 12.7%
 14 based on certain actuarial assumptions and methodologies. This Application follows a Category
 15 1 filing on August 30, 2005 reflecting the mandated reduction in rates and implementing a cap
 16 on certain rates. The Application proposals are reflected in the indications and the proposed rate
 17 changes shown below:
 18

| Coverage | Company Indications | Company Proposal |
|----------------------------|----------------------------|-------------------------|
| Third Party Liability | 14.4% | 14.4% |
| Accident Benefits | 49.3% | 49.3% |
| Collision | -1.0% | 0.0% |
| Comprehensive | 18.7% | 14.8% |
| Specified Perils | -7.9% | 14.8% |
| All Perils | -7.9% | 4.9% |
| Uninsured Motorist | -0.3% | 0.0% |
| SEF #44 | -0.9% | 0.0% |
| Compulsory Subtotal | 16.0% | 16.0% |
| Optional Subtotal | 3.7% | 3.7% |
| Total | 12.7% | 12.7% |

1 The Application proposes to offer the following discounts:
2

| Discounts | % | Coverages |
|---------------------------|----------|---|
| Existing Discounts | | |
| Age | 5% | All coverages excluding SEF premiums |
| Unison | 5% | Third Party, Collision, All Perils, Comprehensive and Specified Perils - All Classes excluding Occasional Operators |
| Farmers | 25% | All coverages excluding SEF premiums Classes A1, B1, C1, D1, E1, F1 |
| Multi Vehicle | 10% | All coverages excluding SEF premiums All Classes excluding Occasional Operators |
| New Discounts | | |
| Conviction Free | 10% | All coverages excluding SEF premiums All Classes including Occasional Operators |

3

4 The Application proposes no changes to the previously approved Class of Use definitions.
5

6

7 The Application proposes the following additional changes:

8

1. Removal of rate capping arising from the introduction of the new class of use structure and definitions in the company's August 2005 filing.

9

2. Adjusted Class differentials to provide a 10% rate reduction to policyholders in Class 'A' licensed more than 20 years.

10

11

3. Changes to the Accident and Conviction Surcharge schedule.

12

4. Changes to the Third Party Liability limit differentials.

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14 **Detailed Analysis**

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16 A copy of the Application was forwarded to the Board's actuarial consultants, Mercer Oliver
17 Wyman (MOW) for their review and report. Under the direction of Board staff, MOW reviewed
18 the Application, issued information requests and held a teleconference with the Applicant. On
19 February 27, 2007 MOW completed its review and issued its report, which identified a number
20 of issues. MOW reviewed the assumptions made by the Applicant and expressed the opinion
21 that the Applicant had not reasonably supported all the assumptions made in developing its rate
22 level indications and where appropriate MOW offered alternate assumptions. MOW addressed a

1 number of the Application proposals including: a) loss trends; b) underwriting profit margin; c)
2 expense provisions; d) credibility standard and procedure; and e) accident/conviction surcharges.

3

4 A copy of the MOW report was provided to the Applicant for comment. MOW issued a
5 subsequent report dated March 29, 2007 providing additional comment and findings based on the
6 Applicant's response to the February 27, 2007 report. The Applicant was also provided with a
7 copy of the March 29, 2007 report and provided further comments on April 4, 2007.

8

9 **Board Findings**

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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 the rates are "too high". This is consistent with the
16 current legislation and is in keeping with the historical practice of the Board.

17

18 In accordance with the legislation and as set out in the Board's detailed Filing Guidelines the
19 Applicant is required to provide detailed justification of any rate increases. Where the Applicant
20 does not utilize the specific parameters set out in the Filing Guidelines, the Applicant is required
21 to provide the Board with sound reasoning and justification for the deviation.

22

23 During the review process the Applicant provided additional explanation and information in
24 support of the Application. In addition the Applicant provided revised proposals with respect to
25 some issues. The Board also notes that, because its mandate is to ensure that rates are not too
26 high, it will not reject an Application for a discount or other rate decrease. The significant
27 remaining issues are discussed below.

1 i) Loss Trends

2

3 The Applicant's proposed rates utilize loss trends at variance with those outlined in the Board's
4 Filing Guidelines. MOW reviewed the proposed loss trends and notes that there may be
5 differences in the application of actuarial judgement to the same data. MOW concluded that,
6 while the Applicant's selected loss trends vary from those set out in the Board's Filing
7 Guidelines, the selected loss trends are not unreasonable. The Board finds that the Applicant has
8 justified the proposed loss trends and will therefore accept the Applicant's selections.

9

10 ii) Underwriting Profit Margin

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12 The Applicant's proposed rates are based on a target ROE of 12.5%, an ROI of 4.25% and a
13 premium to surplus ratio of 2 to 1. The Board's Filing Guidelines set out as acceptable for rate
14 determination an ROE of 10%, an ROI of 5.4% - 7.04%, and a premium to surplus ratio of 2.25
15 to 1. The Board may accept alternate underwriting profit margin assumptions provided sufficient
16 cost of capital evidence is provided in support of the proposals. This approach allows a company
17 to elect to make a rate filing without the expense and burden of a detailed cost of capital review.
18 A cost of capital review would generally involve expert evidence and detailed financial
19 information particular to the company and in relation to the markets in general.

20

21 MOW reviewed the Underwriting Profit Margin proposals in the filing. MOW did not comment
22 on the reasonableness of the request as these are financial parameters and outside the scope of its
23 review. MOW did comment on the lack of evidence and support for the alternative underwriting
24 profit margin assumptions in the Application. With a view to quantifying the impact of the
25 alternate assumptions MOW provided alternate rate indications based on the profit margin that is
26 set out in the Board's Filing Guidelines.

27

28 The Applicant explained the request for an ROE of 12.5% on the basis that it is a mutual
29 company which cannot raise capital other than through internally generated funds and is subject
30 to greater minimum capital regulatory requirements. The Applicant stated that it is necessary to
31 target a higher ROE to attain a long term return of 10%. After reviewing the filing MOW

1 reported that the Applicant has not provided the evidence contemplated by the Board and in
2 particular evidence that is unique to the Applicant. The Applicant in its April 4, 2007
3 correspondence acknowledged that it did not provide the Board with any “hard statistical
4 support” for the target ROE. The Applicant stated that it would in the interests of proceeding
5 with the filing “choose not to pursue this at this time”.

6

7 In respect to ROI and premium to surplus, the Applicant stated that the proposals are based on
8 actual experience and are not assumptions, modeled or based on judgement and therefore
9 suggests that there is no need for a detailed cost of capital review. MOW stated in its March 29,
10 2007 report that the company failed to provide the information set out in the Filing Guidelines as
11 being required in the case of a request for a unique premium to surplus ratio. In support of the
12 premium to surplus ratio the Applicant provided its actual premium to surplus ratios for 2004 to
13 2006. In relation to the proposed ROI the Applicant proposed an after tax ROI of 3.0% based on
14 its actual distribution of invested assets at December 31, 2006. MOW provided the investment
15 returns for Federation for 2001 to 2006. The Board notes that information available in support of
16 these proposals may form a starting point for the review but would expect that the Application
17 would also be accompanied by support and analysis which demonstrates that the proposals are
18 appropriate in the context of prospective rate setting. This support may then be subject to further
19 analysis by a qualified cost of capital expert.

20

21 The Applicant has effectively withdrawn its request for an ROE of 12.5% in favour of the Filing
22 Guideline ROE of 10%. The Board accepts this as a withdrawal of the request and an acceptance
23 of the 10% set out in the Filing Guidelines. While the Applicant has provided some information
24 in relation to the proposed ROI and premium to surplus ratio it is not the type of information and
25 level of review required by the Filing Guidelines. As clearly indicated in the Filing Guidelines
26 detailed cost of capital evidence must be filed in support of an application unless the Filing
27 Guideline figures are proposed. The Board therefore will not approve the proposed ROI of
28 4.25% and premium to surplus ratio of 2 to 1 as these proposals have not been sufficiently
29 justified. The Applicant will be required to revise the proposed rates to reflect an ROE of 10%,
30 an ROI of 5.4% and a premium to surplus ratio of 2.25 to 1.

1 iii) Expense Provisions

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3 The Application proposes a one time charge to finance the cost of a strategic project identified by
4 the Applicant as PLR – Personal Lines Rehost. This is a new system which is intended to be in
5 place for some time. The rationale for the inclusion of the cost of this multi-million dollar
6 project on a one time basis in current rates was questioned by the Board given that the project
7 would produce costs savings and benefits well into the future. In its March 23, 2007
8 correspondence the Applicant proposed the amortization of the expense at 11.6% for fixed
9 expenses and 20% for variable expenses. MOW commented in its report that it found the
10 proposed amortization of the expenses at the average between the 2005 actual expense and the
11 projected expenses as not being unreasonable.

12

13 iv) Credibility Standard

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15 The Board’s Filing Guidelines provide guidance on the preferred credibility standard for Third
16 Party Liability Coverage based on a split of claims between the two sub headings in the coverage
17 of Property Damage (1,082 claims) and Personal Injury (3,246 claims). The Applicant proposed
18 a claims count of 3,246 but did not provide a split between the coverages sub headings. MOW in
19 its report recognized that the standard of credibility is a matter of actuarial judgement but
20 concluded that the Applicant’s proposal is unreasonable. MOW determined that the use of the
21 Applicant’s proposed standard would result in a rate level indication 4.7% higher on compulsory
22 coverage than determined using the approach in the Filing Guidelines. As set out in the Filing
23 Guidelines an insurer may use alternate justified credibility standards when shown to be based on
24 sound actuarial judgement and supporting data. Sound rationale as to why a particular method or
25 methodology is preferred or enhances the outcome beyond that established by the Board must be
26 provided.

27

28 The Applicant advised that it was not possible to split the claims as set out in the Filing
29 Guidelines since the specific company data was not split in this way. The Applicant reported
30 that it did not have the ability to produce the data split and that, to satisfy reporting requirements
31 for statistical reporting purposes, an “arbitrary split” between the two sub coverages is done.

1 While the Applicant may not track the specific data sets to which the credibility standards are
2 applied, the Board notes the availability of claims data on a provincial and regional basis through
3 other sources (the IBC “Green Book” reports). The Board notes that, as set out in the Filing
4 Guidelines, the Applicant may utilize primarily the Newfoundland and Labrador industry data or
5 secondarily the Atlantic Regional industry data.

6
7 The Board will not accept the Applicant’s proposals with respect to the credibility standard given
8 that there are alternate data sources available for the application of the credibility standard, that
9 MOW provided the opinion that the Applicant's proposal is not reasonable, and that MOW found
10 a resulting significant impact on rates. The Applicant will be required to apply the credibility
11 standards set out in the Board’s Filing Guidelines and demonstrate in its refiling how these
12 standards were applied and why the data source chosen was the most appropriate for use by the
13 company in the circumstances.

14
15 v) Accident/Conviction Surcharge

16
17 The Applicant proposed changes and additions to its currently filed Accident/Conviction
18 Surcharge schedule. These are comprised of a new surcharge for:

- 19 i.) two Minor Convictions (10% Surcharge);
20 ii.) three Minor Convictions (20% Surcharge); and
21 iii.) two at Fault Accidents (30% Surcharge).

22
23 Increases were proposed to some existing surcharges as follows:

- 24 i.) one Major Conviction (50% Surcharge);
25 ii.) each Additional Major Conviction after 1 (15% Surcharge);
26 iii.) serious Conviction (100% Surcharge);
27 iv.) each Additional Serious Conviction after 1 (15% Surcharge);
28 v.) three At Fault Accidents in 36 Months (50% Surcharge); and
29 vi.) each Additional At Fault Accident after 3 (20% Surcharge).

1 Several of these changes are intended to establish new surcharges for risks while others increase
2 the surcharge level on current risks. It is noted however that in many cases both the new and
3 increased surcharges are to be applied to risks the company currently does not write in
4 accordance with its underwriting rules on file with the Board. As an example, the Applicant
5 proposes a surcharge for a risk with 2 or more at fault accidents while its underwriting guidelines
6 state that a driver with two or more accidents within the preceding 36 months is to be declined.
7 The Applicant indicated these proposed changes are based on forward planning to allow the
8 Applicant to write this business in the future.

9
10 The Applicant also proposes to add a surcharge of 10% on risks with two Minor Convictions
11 under the Highway Traffic Act. The Applicant has provided no actuarial justification for this
12 proposal and cites marketing considerations as the basis for the proposal. The Applicant
13 explained that this proposal would mean that the surcharge for minor convictions would mirror
14 the surcharge for serious accidents which doubles with each additional accident. MOW found
15 that this proposal was not supported on actuarial analysis and further that it is not consistent with
16 the approach of other insurers in this jurisdiction.

17
18 MOW stated in its February 27, 2007 report that the accident surcharge structure is similar to
19 others in Newfoundland and Labrador except for the proposed 200% surcharge for each serious
20 accident. MOW found that this is supported only on the basis of marketing considerations and
21 rationale and not on actuarial analysis. In connection with proposed rate increases occasioned by
22 the addition of or increases to surcharges the Board requires more support than marketing
23 rationale. The Applicant would be expected to provide supporting evidence such as an analysis
24 of prevailing practices of other insurers as well as an actuarial review of the insurer's book of
25 business and the number of insureds affected by the proposals. The Board notes the requirement
26 for insurers to file with the Board their underwriting rules and grounds on which they intend to
27 refuse to write business. In this context the Board is not convinced it is necessary or appropriate
28 to establish rates for business that may or may not be offered at some time in the future. The
29 Applicant can re-file the proposed rates and underwriting changes together when a decision is
30 made to underwrite this business. In the absence of adequate supporting actuarial or other

1 evidence and the numerous inconsistencies with the corporate underwriting guidelines and the
2 proposed surcharge schedule the Board will not accept the proposed changes at this time.

3

4 vi) Discounts

5

6 MOW commented on the Applicant's proposal to introduce a Conviction Free discount modeled
7 after a similar discount offered by companies in Nova Scotia and New Brunswick. MOW
8 commented that this discount is inconsistent with the approach of other insurers in this
9 jurisdiction and is not actuarially justified. The Board's legislated responsibility is to ensure that
10 the proposed rates are not too high. Where an insurer proposes decreases in rates, either by
11 virtue of base rate decreases or by the introduction of or increases to discounts, the Board will in
12 ordinary circumstances accept the reductions. The Board finds the proposed discount program is
13 consistent with that previously approved and is reasonable and justified in the circumstances.
14 The discounts relate to risk, are not subjective or arbitrary, and are in accordance with the
15 legislative provisions. The impact of the discounts has also been appropriately reflected in the
16 rate filing.

17

18 vii) Costs

19

20 As set out in the Filing Guidelines, pursuant to section 57 of the *Automobile Insurance Act* and
21 section 90 of the *Public Utilities Act*, the Applicant will be required to pay the costs of the Board
22 associated with this filing, including the costs of the actuarial review.

1 **IT IS THEREFORE ORDERED THAT:**

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3 1. The proposed rates are prohibited.

4

5 2. The Applicant shall file with the Board revised rate indications reflecting the findings of the
6 Board which specifically include:

7 a. an ROE of 10%;

8 b. an ROI of 5.4%;

9 c. a premium to surplus ratio of 2.25 to 1;

10 d. the proposed amortization of the expense associated with the PLR system;

11 e. the credibility standard as set out in the Filing Guidelines; and

12 f. no changes to the currently approved Accident/Conviction Surcharge schedule.

13

14 3. The Applicant shall submit for the approval of the Board a revised rate proposal which
15 for each coverage shall be no more than the rate indications revised in accordance with
16 this Order, setting out the proposed effective dates for the rates to take effect.

17

18 4. The proposed discount program is approved.

19

20 5. The Applicant shall pay all the expenses of the Board arising from this filing.

DATED at St. John's, Newfoundland and Labrador, this 22nd day of May 2007.

Robert Noseworthy
Chair & Chief Executive Officer

Darlene Whalen, P.Eng.
Vice-Chair

G. Cheryl Blundon
Board Secretary