Newfoundland & Labrador

BOARD OF COMMISSIONERS OF PUBLIC UTILITIES

IN THE MATTER OF AN

APPLICATION BY FACILITY ASSOCIATION FOR APPROVAL OF REVISED RATES FOR ITS PRIVATE PASSENGER AUTOMOBILES CATEGORY OF AUTOMOBILE INSURANCE

DECISION AND ORDER OF THE BOARD

ORDER NO. A.I. 48(2021)

BEFORE:

Darlene Whalen, P. Eng., FEC
Chair and Chief Executive Officer

John O'Brien, FCPA, FCA, CISA
Commissioner

Christopher Pike, L.L.B., FCIP
Commissioner

NEWFOUNDLAND AND LABRADOR
BOARD OF COMMISSIONERS OF PUBLIC UTILITIES

AN ORDER OF THE BOARD

NO. A.I. 48(2021)

IN THE MATTER OF the *Automobile Insurance Act*, RSNL 1990, c. A-22, as Amended, and regulations thereunder; and

IN THE MATTER OF an application by Facility Association for approval of a revised rating program for its Private Passenger Automobiles category of automobile insurance.

BEFORE:

Darlene Whalen, P. Eng., FEC
Chair and Chief Executive Officer

John O'Brien, FCPA, FCA, CISA
Commissioner

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Commissioner

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1. The Application

Facility Association ("Facility"), as operator of the residual market mechanism for automobile insurance in the province, filed a revised rating program under the Board's Mandatory filing option on June 1, 2021 seeking approval of increased rates for its Private Passenger Automobiles ("PPA") category of automobile insurance (the "Application"). The Application proposes an overall average rate level increase of +8.9% to be effective no earlier than 100 days post approval for new business and renewals, rounded to the 1st of the following month.

Facility was established under section 97 of the *Insurance Companies Act* as an unincorporated non-profit association of insurers. Its purpose is to ensure the availability of automobile insurance to all owners and licensed drivers of motor vehicles who would otherwise have difficulty obtaining such insurance. Every automobile insurer licensed to write business in the province is required to become a member of Facility and share in its financial results. As a part of its function to serve the residual market, Facility tries to position itself as a marginal player in the context of the entire automobile insurance market.

Included in this Application is a proposal by Facility to introduce a profit provision in its PPA rates. Facility has indicated that, if this proposal is approved, it intends to include a profit provision in its future rate filings for all other classes of business it writes in the province including, but not limited to, Taxis and Limousines, Commercial Vehicles, Miscellaneous Vehicles and Public Vehicles.

The issue of whether Facility rates in this province should reflect a profit provision has not previously been addressed by the Board as Facility has not applied for its approval.[1] As a result, the current proposal represents a policy change for the Board's consideration.

2. Procedural Matters

The Application was referred to the Board's actuarial consultants, Oliver Wyman Limited ("Oliver Wyman"), for review.

On June 8, 2021 Oliver Wyman filed questions on Facility's actuarial analysis and Facility filed responses on June 17, 2021. Follow-up questions were filed by Oliver Wyman on June 29, 2021 and Facility filed responses on July 9, 2021.

On June 25, 2021 the Board issued Requests for Information on the Application and Facility filed responses on July 19, 2021.

On August 6, 2021 Oliver Wyman filed a report of findings outlining its review of the actuarial justification provided in the Application. Facility filed comments in response to the Oliver Wyman report on August 16, 2021 and Oliver Wyman confirmed it had no follow-up comments on August 17, 2021.

[1] Facility previously filed an application for a profit provision in 2007, however the proposal was withdrawn by Facility prior to the Board's review. See Order Nos. A.I. 3(2007) and A.I. 6(2007) for further details.

A Notice of Application was published in newspapers throughout the province starting September 11, 2021 inviting interested parties wishing to participate in the Application to contact the Board by September 29, 2021. No submissions were received.

3. Review of Application Proposals

In the Application Facility calculated its indicated PPA rate level need by coverage based on an actuarial analysis of its loss experience for the five-year period from 2015 to 2019. This analysis included an investment rate of return on cash flow of 1.44% and also introduced a new consideration, a profit provision, to the rate proposal. Facility reported that its current rate level ought to be increased by an estimated overall average of 10.7% to achieve a return of 6.0% of premium. Despite establishing this indication, Facility proposed an overall average rate level increase of 8.9%. A summary of the indicated and proposed changes by coverage are summarized as follows[2]:

Coverage	**Facility Indication**	**Facility Proposal**
Bodily Injury Tort	+15.5%	+12.0%
Property Damage Tort	+15.5%	+12.0%
Direct Compensation Property Damage	+15.5%	+12.0%
Uninsured Automobile	+11.3%	+11.3%
Underinsured Motorist	+3.5%	+3.5%
Accident Benefits	+8.4%	+8.4%
Collision	-0.7%	0.0%
Comprehensive	-6.3%	0.0%
Specified Perils	+25.9%	0.0%
Total	**+10.7%**	**+8.9%**

Facility noted that its proposed rate level change was less than its indicated need in order to minimize the impact on policyholders of introducing a profit provision in the province.[3] Facility estimated that its proposed overall rate level increase of 8.9% would result in an average written premium of $2,500 per vehicle which represents an average increase of approximately $204 per vehicle.

Oliver Wyman reviewed the rate level indications developed by Facility and, in so doing, examined all aspects of Facility's ratemaking process. Oliver Wyman found that the assumptions used by Facility were generally in keeping with the Board's Mandatory Filing Guidelines ("Guidelines") and were reasonable in the circumstances, with the exception of Facility's return on investment assumptions. Oliver Wyman noted that the 1.44% return on investment assumption that Facility used to develop its indications was lower than the average return earned by insurers operating in the province and that using the industry average rate of return would lower the +10.7% overall rate level indication filed by Facility to +6.4%. Oliver Wyman did not opine on the reasonableness of including a profit provision in Facility's rates.[4]

[2] Facility Association Mandatory Filing, Section 4 - Actuarial Support, page 35.
[3] PUB-FA-007.
[4] Oliver Wyman Report, pages 1-2 and pages 7-8.

4. Board Findings

The Board is cognizant that there are a wide range of possible outcomes in any prospective ratemaking exercise. The Board must be satisfied that the proposed rate changes are supported based on the information filed and are just and reasonable in the circumstances. In making this determination the Board considers the professional judgement of the actuaries, as well as the support and explanation for their respective positions. The Board notes that neither Facility nor Oliver Wyman took the position that the other's work was unreasonable or contrary to actuarial standards of practice.

The Board has reviewed the record of the proceeding, including Facility's actuarial memorandum, Oliver Wyman's report and Facility's responses to information requests. The issues to be addressed are: i) whether the Board should allow a profit provision; ii) if allowed, what target profit level should be set; and iii) the return on investment rate assumptions. These issues, along with the Board's findings on each, are discussed in the following sections.

i) Inclusion of Profit Provision

The proposal by Facility to introduce a profit provision in its PPA rates represents a change in approach for Facility as its current rates in the province do not include a profit provision. According to Facility it is not precluded by legislation from seeking approval of a profit provision. Facility also noted that Newfoundland and Labrador was the only jurisdiction in which Facility operates where a profit provision has not been approved for use.[5]

Facility submitted that its unique structure and function within the automobile insurance industry supports the inclusion of a profit provision even though it operates as an unincorporated non-profit association. Facility noted that it is not a licensed insurer and serves only as a conduit to facilitate the sharing of risk. All business placed through Facility is collectively written and supported by automobile insurers who are required to become Facility members as a condition of being licensed to write business in the province. Facility contracts with a few of these members to act as Servicing Carriers who issue and endorse policies, receive premiums and adjust claims on behalf of all members. The members are the counterparty to the insurance contracts written via the Servicing Carriers and are required by law to carry the capital and associated costs to support the Facility business. The results of the insurance written by the Servicing Carriers are not maintained in Facility, but are instead distributed back to members based on market share. Therefore, it is the members who must share in all of Facility's profits or losses. Facility submitted that its rates should include a profit provision to generate an appropriate return for its members given that they are writing and supporting the Facility policies and are in the business of insurance to earn profit.[6]

Facility further submitted that the absence of a profit provision in its rates is resulting in a systemic shortfall and acting as a drain on members' capital. Over the 10-year period from 2011 to 2020 Facility business in the province incurred total operating losses of $12.9 million for PPA and $24.5 million for all classes combined. Facility noted that these losses were passed on to members and would have been even higher if adjusted for other costs directly assumed by members such as

[5] Facility Association Mandatory Filing, Section 4 - Actuarial Support, pages 30-31.
[6] Facility Association Comments on Oliver Wyman Report, pages 2-3.

premium taxes, health levies and deemed cost of capital. Facility submitted the province may start to experience insurance availability issues if a profit provision is not introduced to help reduce losses and cover the costs of its members.[7] Facility stated:

> Insurers choose to do business in a jurisdiction because they can make a fair return on their capital. FA strives to be as small as possible to ensure that the FARM remains a marginal player in the market, and consumers are served by a healthy, competitive market. That is best achieved by a FARM that is self supporting, and not a drain on member's capital, and thus fulfills the role of market availability at the point of rates that cover the costs, including claims, expenses and capital which make that market possible. A systemic shortfall in any of those three areas will have long-term consequences for the health of the entire insurance market in the province.[8]

Facility noted that an analysis of recent residual market placements suggests that Facility rates are becoming competitive with standard market rates, due in part to Facility's lack of a profit provision. According to Facility approximately 21% of the business placed through the residual market during 2020 was due to the Facility premium being lower than other markets, with the Facility premium being approximately $631 lower on average than the next available standard market carrier. Facility submitted that including a profit provision in its rates would reduce the observed gap with the standard market rates and help ensure a properly functioning market.[9] Facility further noted that its rates should provide appropriate price signals to drivers of the higher risk profile they are intended to represent and assist Facility in delivering on its purpose of minimizing residual market presence.[10]

The Board notes that Newfoundland and Labrador is the only Canadian jurisdiction in which Facility operates that does not allow a profit provision in its rate structure. Legislation in this province does not prohibit the Board from allowing a profit provision to be included in Facility's rates and, as such, the decision on whether to allow a profit provision in Facility's rates is a policy decision for the Board.

Insurers are required by law to have capital reserves to offset their obligation to pay claims and that capital has a cost in the form of the return earned on those investments. The Board recognizes this in the Guidelines, which allow insurers to set rates that include a profit provision of 5% to 6% of premiums. All automobile insurers in the province are required by legislation to be members of Facility and are required to carry the capital and associated costs to support Facility's operations. As Facility's present rate structure does not include a provision for cost of capital its members incur the cost to maintain these capital reserves without the opportunity to recover these costs. The Board believes it is not reasonable to expect member companies to bear these costs, which are real costs. In addition, the lack of recognition of capital costs in Facility's rates could be viewed as a subsidization of Facility risks by the voluntary market, either through rates or shareholder returns, which is also not reasonable or fair. These costs should be borne by those insured through Facility. The inclusion of a profit provision in Facility rates in this province would also be consistent with other jurisdictions in Canada in which Facility operates.

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[7] PUB-FA-006; PUB-FA-010.
[8] PUB-FA-006. FARM refers to Facility Association Residual Market.
[9] Facility Association Comments on Oliver Wyman Report, page 3.
[10] Facility Association Mandatory Filing - Cover Letter - 2021-06-01.

The Board also accepts Facility's submission that inclusion of a profit provision that is consistent with standard market insurers will contribute to the residual market function supporting itself and help position Facility as a marginal player. Facility stated that approximately 21% of the insurance placed with it in 2020 was placed because its rates were lower than those of standard market insurers. According to Facility this indicates its rates have become inappropriately competitive with standard market rates. Facility submitted that including a profit provision in its rate structure will make its rates less competitive relative to standard market rates. The Board agrees that Facility's position as a marginal player in the overall automobile insurance market in the province favours the principle of allowing Facility to include a profit provision in its rates.

The Board finds that, for the reasons set out above, Facility should be permitted to include a profit provision in its rates. The Board's determination on the actual level of profit provision that will be allowed is set out below.

ii) Profit Provision Level

The Guidelines state that all insurers must derive their rate indications based on a target profit provision stated as a percentage of premium, with the same provision for all coverages. The Guideline profit range as a percentage of premium that the Board will generally accept as reasonable in rate filings is 5.0%-6.0%.[11] The Guidelines do not make any specific reference to the level of profit provision deemed to be reasonable for Facility as the residual market provider.

Facility considers an after-tax return on equity of 12% to be an appropriate profit provision to achieve a reasonable return for its members based on the estimated capital required to support Facility business. However, as required in the Guidelines, Facility calculated its rate level indications based on a percentage of premium approach.[12] Facility presented an overall indication of +10.7% based on a profit provision of 6.0% of premium and proposed an overall average rate level change of +8.9%. Facility estimated that, if approved, the proposed rate change would result in a profit provision of approximately 5.0% of premium.[13] This compares with the average return on premium for Facility in Nova Scotia, New Brunswick and Prince Edward Island of 7.8%.[14] As noted by Oliver Wyman, the inclusion of a 6.0% profit provision has a material impact on Facility's overall rate level indication, increasing the indicated rate level need from +1.5% to +10.7%.[15]

In setting a target profit provision for Facility the Board finds no reason to deviate from the guideline profit range in place for regular market insurers. The Board is satisfied that the guideline profit range as a percentage of premium of 5.0%-6.0% is a reasonable range for a target profit provision to be included in Facility's rate filings.

[11] Mandatory Filing Guidelines, pages 21-22.
[12] Facility Association Mandatory Filing, Section 4 - Actuarial Support, pages 7-8.
[13] Facility Association Mandatory Filing, Appendix A, Tab 8.
[14] Facility Association Mandatory Filing, Section 4 - Actuarial Support, page 31.
[15] Oliver Wyman Report, page 7.

iii) Return on Investment Rate

Facility's existing PPA rates approved by the Board include a pre-tax return on investment rate of 2.8%, based on the Board's guideline rate at the time.[16] In the current filing Facility selected a pre-tax return on investment rate on cash flows of 1.44% based on a methodology it refers to as the Government Bond methodology. Facility noted that this methodology is similar in nature to its risk-free methodology except that it uses various Government of Canada average bond yields with consideration of i) the average investment duration based on Facility's PPA claims payment patterns in the province, and ii) an estimated investment expense.[17]

Facility submitted that its selected return on investment rate of 1.44% is reasonable and consistent with the Guidelines as it reflects the reality of Facility's unique status in the industry as the residual marker provider. Facility noted that it only holds funds required to meet its short-term cash flow needs and that all other funds are transferred to its members to invest in their own investment plans and policies. Hence, it is the members, not Facility, that receive and hold funds for investment purposes. Facility accepts that the return on investments earned by members should be included in the calculation of Facility's rate level indications, but noted that consideration must be given to the circumstances under which the Facility funds are invested when deciding the appropriate return methodology to use.

Facility noted that FA Bulletin F05-031 sets out the requirements with respect to Facility funds transferred to members. This bulletin stipulates that: 1) members may invest Facility funds based on their own investment plans and policies; 2) members must be prepared to return the funds within a timeframe requested by Facility; and 3) funds due to Facility must be maintained separately in the accounting books of members. Facility submitted that it is reasonable to assume that funds transferred to members are invested only in highly liquid low-risk assets due to the on-demand callability and segregated nature of the funds as stipulated in the bulletin. Facility noted that the appropriate return on investment rate to use in the rate analysis should therefore be between the risk-free methodology and the industry methodology, which is why Facility opted to use the Government Bond methodology rate of 1.44%.[18]

Oliver Wyman noted that Facility's selected pre-tax return on investment rate of 1.44% essentially equates to a risk-free rate of return as it only considers government bond rates. In contrast, insurer invested funds typically include a mix of asset classes including stocks. Oliver Wyman noted that Facility excluded the consideration of stocks from its investment return methodology based only on the assumption that Facility funds would not be invested in stocks and that Facility did not monitor or audit how members were investing. Oliver Wyman further noted that the reported average pre-tax investment returns for automobile insurers operating in the province were 2.00%, 3.61%, and 3.48% for 2018, 2019 and 2020, respectively; an average of 3.03%. As such, Oliver Wyman found Facility's selected return on investment rate of 1.44% to be low compared to the returns actually earned by insurers who hold and invest the Facility funds. Oliver Wyman asked Facility to provide its rate level indication assuming a return on investment rate of 3.0% and no

[16] PPA rates as approved in Order Nos. A.I. 28(2018) and A.I. 27(2019).
[17] Facility Association Mandatory Filing, Section 4 - Actuarial Support, page 33.
[18] Facility Association Response to Oliver Wyman Questions - 2021-06-17, pages 10-12.

other changes in assumptions and Facility estimated that making this change would reduce its overall rate level indication from +10.7% to +6.4%.[19]

In response to Oliver Wyman, Facility reiterated that it was reasonable to assume its members were investing Facility funds in less risky assets than the funds collected on their regular business given the unique stipulations set out in FA Bulletin F05-031 and the level of expertise held by the members' investment teams. Facility stated that, at a minimum, equity investments should not be considered when selecting an appropriate investment return for Facility and therefore the industry average rate of 3.0% should not be used. Facility further noted that its selected rate of 1.44% was higher than both the 2020 government bond rate of 0.36% and the June 2021 risk-free rate of 0.45%. Facility submitted that it continues to find its proposed overall rate level change of +8.9% based on a selected return on investment rate of 1.44% to be reasonable in the circumstances.[20]

The current Guidelines require insurers to provide the basis of the selected investment return assumption for discounting and compare it with the actual investment returns earned in the recent past as reported in the annual P&C financial statements. As stated in the Guidelines:

> While the expected investment return selected should consider new money rates, the Board anticipates that the selected expected investment return will be close to the actual investment return the insurer earned within the recent past and reflect the mix of all investment assets expected to be held by the insurer. Significant differences must be explained and justified.[21]

Facility has stated that its proposed return on investment rate should be accepted by the Board on the basis that it is reasonable to assume that the funds transferred to its members are invested only in "highly liquid low-risk assets due to the on-demand callability and segregated nature of the funds as stipulated in the bulletin". Facility has provided no information or documentation on the investment portfolios of its members to support this assertion. However, while FA Bulletin F05-031 requires its members to separately account for funds in their accounting records, it also provides for members to be able to invest Facility funds based on their own investment plans and policies. The Board notes a similar concern was raised by the Nova Scotia Utility and Review Board ("NSUARB") in a recent decision issued in relation to an application from Facility for approval of PPA rate changes in that province.[22] In that decision the NSUARB did not accept Facility's proposal to use a risk-free methodology for its return on investment calculation and stated that it would work with Facility to develop and conduct a survey of its member companies regarding the types and mix of investments they use for the Facility assets. The Board believes information on the actual investment mix used by its members for Facility funds, similar to the information proposed to be gathered by the NSUARB, would be useful in assessing whether the methodology and investment return proposed in this application should be accepted.

Based on the above the Board is not persuaded that Facility's proposed return on investment rate of 1.44% should be approved at this time. It is also not clear whether the recent reported average pre-tax investment returns for automobile insurers operating in the province, calculated by Oliver

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[19] Oliver Wyman Report, pages 7-8.

[20] Facility Association Comments on Oliver Wyman Report, pages 3-4.

[21] Mandatory Filing Guidelines, page 22.

[22] 2021 NSUARB 119 M10104 issued October 4, 2021, paras. 46-55.

Wyman to be about 3% over the last three years, is appropriate in the absence of information on the actual investment mix at play for these returns. For this filing the Board is satisfied that the existing pre-tax return on investment rate of 2.8% should remain unchanged. Facility may make another proposal in a subsequent filing for a change in this rate but such a proposal should be better supported in line with the Board's comments set out above.

5. Conclusion

The Board accepts Facility's proposals and assumptions as set out in the Application with the exception of the proposed pre-tax return on investment rate of 1.44%, which the Board has determined should remain unchanged at 2.8%. Facility may file a revised application for proposed PPA rates incorporating the Board's findings in this Decision and Order.

6. Order

IT IS THEREFORE ORDERED THAT:

1. The Application by Facility Association is denied.

2. Facility Association will pay all costs of the Board, including the cost of the actuarial review, arising from this Application.

DATED at St. John's, Newfoundland and Labrador, this 9th day of November, 2021.

DWhalen

Darlene Whalen, P. Eng., FEC
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