

1 **A.I. 10(2006)**

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

8 **AND**

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10 **IN THE MATTER OF** an application by
11 The Personal Insurance Company
12 (the “Applicant”) to implement revised rates
13 for its Private Passenger class of business.
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16 On September 1, 2005, pursuant to legislative changes enacted on August 1, 2005, the Applicant
17 submitted for the Board’s review and approval, a revised private passenger automobile insurance
18 rating program for use with effect from August 1, 2005.

19
20 **Legislation**
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22 On August 1, 2005 the Government of Newfoundland and Labrador enacted legislation amending
23 the *Automobile Insurance Act* and the *Insurance Companies Act* in relation to the conduct of
24 participants in the automobile insurance industry and the regulation of rates in the province. Among
25 other things, the changes eliminated the benchmarking system of rate review and approval used by
26 the Board since inception of automobile insurance rate regulation and substituted new rate review
27 requirements.
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29 Under the revised automobile insurance legislation, rate decreases take effect no sooner than thirty
30 days following filing with the Board. Rate increases are subject to prior approval and in connection
31 therewith, the Board must determine, in accordance with provisions outlined in regulations, if a
32 proposed rate is “too high”. Where such a finding is made the Board is required to prohibit, or vary

the rates.

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

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

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

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

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

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

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

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

Filing Instructions

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

"3.1 CATEGORY - 1

3.1.1 Category 1 - Definition

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

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

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

3.2 CATEGORY 2- GENERAL FILING

3.2.1 Category 2 - Definition

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

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

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

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

The Application

On September 1, 2005 the Applicant submitted to the Board for consideration a detailed filing of private passenger automobile insurance rates. A copy of the filing was forwarded to the Board's actuarial consultants, Mercer Oliver Wyman (MOW) for their review and report. Throughout the ensuing weeks various information requests were issued by MOW to the Applicant and responses received such that it was not until December 2, 2005 that a final filing was considered to have been made and MOW could complete its review and issue its report.

The filing proposed a schedule of rates based on a Return on Equity (ROE) of 15%, a Return on Investment (ROI) of 5.4% and a Premium to Surplus Ratio of 2.25:1. These parameters, as well as the assumptions made by the Applicant in connection with other factors considered in the rate making process, are reflected in the indications and the proposed rate changes shown below:

The Personal	Company Indications	Company Proposal
Coverage		
Third Party Liability	17.4%	-5.0%
Accident Benefits	23.4%	-5.0%
Collision	4.5%	-5.0%
Comprehensive	-18.2%	-5.0%
Specified Perils	-71.3%	-5.0%
Uninsured Motorist	23.4%	-5.0%
Total	11.7%	-5.0%

Where a person who is insured with the Applicant would upon renewal experience an increase as a result of changes flowing from this application, the Applicant proposes to cap rate increase arising as a result of this application at 0% for twelve months.

The Applicant proposes to offer the following discounts:

DISCOUNT	%	COVERAGES
Multi Vehicle	10%	All Coverages and All Operators
Limited Use	50%	Third Party Liability and Collision; Occasional Operators
Multi Occasional	25%	Comprehensive and Specified Perils; Occasional Operators
Anti-Theft	15%	Comprehensive and Specified Perils - All Classes

The Applicant proposes to create new classification variables which are inconsistent with the Class of Use definitions under the Statistical Plan of the Superintendent of Insurance, though it will report its data in accordance with the Statistical Plan Class of Use definitions. The proposed rates are established based on classification differentials determined after a detailed study conducted using a

Generalized Linear Model. MOW found that the analysis was reasonable and resulted in classification variables which are predictive of cost differences. Therefore the new classification variables appropriately reflect the discounts that were eliminated, including Driver Experience, No Claims discounts and Short Commute discounts. In addition to the discounts that remain in the proposal, contained in the table above, the Applicant's filing makes reference to a Group discount. The Applicant's rating algorithm contains a provision for the discount but does not provide further particulars.

Finally, the Applicant proposes a surcharge of 5% applicable to All Coverages and All Operators where the insured vehicle is not owned by the insured but is leased by the insured.

Detailed Analysis

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

The Applicant has proposed a new classification system which has been supported with a detailed technical analysis. Having reviewed the support provided the Board is satisfied that the system is justified and fairly distinguishes between risks. In addition, the Applicant has confirmed that for purpose of statistical reporting, the Applicant's loss and other statistical information required to be reported will be on the basis of the new Class of Use definitions established by the Superintendent of

1 Insurance. The Applicant proposes to surcharge insureds 5% for All Coverages, where the insured
2 does not own the vehicle, but rather leases the same. The Applicant has not provided in the filing
3 any actuarial or other information or evidence to indicate that the level of risk increases simply due
4 to the fact the vehicle is leased rather than owned by the insured.

5
6 The Applicant has indicated in the filing documents the addition of a Group discount to its rating
7 algorithm. MOW notes that the Applicant has not provided associated differential factors detailing
8 the discount level or its impact on rates. In addition, the Board notes that, other than the above
9 noted, the filing makes no further reference to the discount, discount levels or qualification criterion
10 used to determine an insureds' eligibility. Additionally, the Applicant has not provided actuarial
11 information detailing the discount amount or how it has been determined.

12
13 As identified in the Board's detailed Filing Instructions, the Applicant is required to provide
14 justification of any rate increases. Where the Applicant does not utilize the specific parameters set
15 out in the filing guidelines the Applicant is required to provide the Board with sound reasoning and
16 justification for the deviation. For example, in connection with ROI, the guidelines provide the
17 Board's acceptable range of factors but state, "*The Board will consider other return on investment*
18 *assumptions or calculations; however, full rationale for any deviations must be provided, based on*
19 *recently available 2004 financial data.*" Similar cautions and directions are provided in connection
20 with the remaining guideline factors and assumptions, where appropriate.

21
22 Actuarial

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

27
28 With respect to assumptions made in the determination of rates, these are matters of actuarial
29 judgment and are reviewed in the context of reasonableness. MOW reviewed the assumptions made

by the Applicant and expressed the opinion that certain of the assumptions were not fully supported. Where possible MOW substituted alternate assumptions they felt more appropriate or reflective of market or other conditions as follows:

- o Loss Trend – the Applicant utilizes ten years loss data to determine its loss trends for all coverages. It also develops loss trend for third party liability on the basis of combined experience and not separately for bodily injury and property damage. MOW believes that the use of ten year data to develop loss trends for third party liability bodily injury is appropriate but that the use of 5 year data for the property damage component and all other coverage is more reasonable to reflect more current trend.
- o Loss Development – the Applicant uses its own experience to calculate its rate level indications but applies industry loss development factors in place of its own factors to project future loss development. MOW does not have sufficient information to comment on the effect of this approach.
- o Effects of Reforms - the Applicant provides for lower savings arising from the Collateral Sources provision in recent legislative based on information provided by Exactor Insurance Services. The savings were provided as part of the Board's Filing Instructions based on a detailed analysis by MOW. The impact of this variation is approximately 0.3% for Third Party Liability.
- o Credibility Standard/Procedure – the Applicant used a combination of own and industry data to obtain its credibility standard. The Applicant used the industry data unadjusted for the variance between industry and the Applicant's distribution. MOW suggests the use of adjusted industry data where by the net annual trend rate be used for the basis of the compliment of credibility. By making this adjustment the impact on the Applicant's indications is an approximate 14 % reduction.

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

The Personal Coverage	Company Indications	Company Proposal	MOW Indications
Third Party Liability	17.4%	-5.0%	-1.4%
Accident Benefits	23.4%	-5.0%	-1.4%
Collision	4.5%	-5.0%	-7.1%
Comprehensive	-18.2%	-5.0%	-15.8%
Specified Perils	-71.3%	-5.0%	-6.2%
Uninsured Motorist	23.4%	-5.0%	-1.4%
Total	11.7%	-5.0%	-4.0%

The MOW indications are based on the Board's guideline factors for ROE, ROI and Premium to Surplus Ratio.

Cost of Capital

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

"Return on Equity"

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

Return on Investments

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

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

The Applicant suggests that the proposed ROE of 15% is appropriate on the basis of a recent decision in New Brunswick, in light of the fact that it is operating at a relatively lean capital level and its ability to offer lower rates. This Board does not find the New Brunswick decision persuasive given that it contemplates a review of the circumstances in each case and does not set out particulars in relation to the Applicant in this Province. In addition, as set out by NERA the Applicant does not provide support for the theory that it is operating at a lean capital level. As well the Board does not accept the proposition that the ability to offer lower rates justifies a higher ROE.

NERA's final report findings are as follows:

ROE – *"The Personal has not provided sufficient evidence to support its request for an ROE higher than set out in the guidelines."*

ROI – *"The Personal's requested ROI of 5.4% is consistent with the guidelines of the Board."*

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

2
3 **Findings**
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5 The Board has reviewed the application, the supporting material, responses to information requests,
6 consultants' reports and all other information relevant to this rate filing. The new classification
7 variables replace the Class of Use definitions and a number of previously approved discounts. This
8 new approach and the associated differentials were supported with detailed technical analysis which
9 was found by MOW to be reasonable and predictive of cost differences. With the exception of the
10 introduction of the Group discount and the Leased Vehicle surcharge the proposals were fully
11 justified and are considered to be reasonable. In the case of the Group discount the Applicant has
12 not provided any particulars of eligibility criterion or the level of discount without which the Board
13 cannot approve the proposed discount. In the case of the Leased Vehicle surcharge the Applicant
14 has similarly not provided supporting actuarial analysis to confirm that the level of risk is materially
15 changed as between an owner operated vehicle and one that has been leased. In the absence of
16 compelling evidence to substantiate the variance in risk level, the Board must view this surcharge as
17 being arbitrary and contrary to the legislated provisions governing rates.

18
19 Based on the review of the available information in connection with this rate filing the Board is not
20 satisfied that some of the actuarial assumptions in the Applicant's rate proposals are reasonably
21 supported by the available information. The Board has reviewed the assumptions provided by the
22 Applicant and the alternate assumptions provided by the Board's actuarial consultants, MOW, in
23 respect of Loss Trend, Effects of Reform, and Credibility Standard/Procedure. While the Board and
24 MOW sought clarification and support for the proposals, the Applicant did not provide the necessary
25 support for each of the elements of the rate proposal. The Board notes that the Applicant was
26 provided with a copy of the MOW report and was given an opportunity to further comment on and
27 challenge the rationale used by MOW. The Board finds that the detailed and comprehensive
28 analysis offered by MOW in its report is persuasive. The Board accepts the MOW assumptions as
29 reasonable and will require the Applicant to reflect these alternate assumptions in its rate filing.

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

- 6
7 • In connection with the Applicant's proposed ROE of 15%, the Board finds that the Applicant
8 has not fully supported the proposal. The Applicant did not provide sufficient financial
9 information or expert opinion to support the proposed ROE. NERA determined that
10 insufficient evidence was provided to support an ROE higher than 10%. The Board finds
11 that the Applicant has not provided sound rationale or additional compelling evidence to
12 support the use of an ROE other than 10%.
- 13
14 • The Applicant's proposed ROI of 5.4% is consistent with the filing guidelines and is
15 supported in the circumstances.
- 16
17 • The Applicant's proposed Premium to Surplus Ratio of 2.25 to 1 is consistent with the filing
18 guidelines and is supported in the circumstances.

19 **Costs**

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

IT IS THEREFORE ORDERED THAT:

1. The proposed rates are prohibited.
2. The Applicant shall file with the Board revised rate indications reflecting the findings of the Board which specifically include an ROE of 10%, an ROI of 5.4%, a Premium to Surplus Ratio of 2.25 to 1, and the alternate assumptions of MOW with respect to Loss Trend, Effect of Reforms and Credibility Standard/Procedure.
3. The Applicant shall submit for approval of the Board a revised rate proposal, setting out the effective dates, which for each coverage shall be no more than the indications filed with the Board in accordance with this Order.
4. The proposed classification variable and discount program are approved for rate making purposes except that the proposed Group discount and the Leased Vehicle surcharge are prohibited.
5. The Applicant shall pay all the expenses of the Board arising from this 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