

CAPITAL DESTRUCTION AT ICBC CONTINUES

In its September 15, 2017 filing with the BC Utilities Commission (BCUC),¹ ICBC forecast that a 20% increase in Basic rates would be required to keep the Basic capital reserve (equity) above the government's regulatory minimum of 100% of the minimum capital test (MCT) ratio by year-end 2017/18.²

Rather than impose this massive increase on private and commercial vehicle owners, the government chose to retain the Liberal government's 2013 "rate smoothing" directive to the BCUC, and limit the 2017 rate increase to 1.5% over the 4.9% increase for 2016. By comparison, the 2016 indicated requirement was for a 15.5% increase, and the previous government chose to limit the increase to the 4.9% increase, which was essentially imposed on the BCUC in late December 2016.

When minister responsible David Eby announced the 2017 rate increases he hinted that changes in the Basic coverage model are being considered which would reduce the growth in claims costs. The question is whether the changes -- which presumably will include an Alberta style cap on pain and suffering claims as recommended in the Ernst Young report -- will be sufficient to halt, or even reverse, the rapid deterioration in ICBC's critical financial condition, as measured by the size of the capital reserves? This paper helps set the stage for answering this question.

THE PURPOSE OF THE CAPITAL RESERVE

An adequate capital reserve is required to help buffer the impact of annual cost changes on the premium rates paid by policyholders. It should be large enough to guarantee that anticipated claims can be paid. The Saskatchewan Auto Fund provides the following description of the purpose of an adequate capital reserve (which is called the Rate Stabilization Reserve in that province):

¹ http://www.bcuc.com/Documents/Proceedings/2017/DOC_49993_B-1_ICBC-2017-Revenue-Requirements-Application.pdf p. ii.

² The BCUC is responsible for approving the compulsory Basic insurance rate increases, but has no jurisdiction over the Optional rates.

Capital adequacy speaks to the Auto Fund's ability to honour its financial obligations. An adequate balance in the Rate Stabilization Reserve (RSR) gives the Auto Fund a financial resource to draw on when adverse events increase the cost of claims, thereby protecting customers against unpredictable premium increases for their auto insurance. The Auto Fund uses a common property and casualty industry measurement called the Minimum Capital Test (MCT) to monitor the adequacy of the RSR. The MCT is a risk-based capital adequacy formula that assesses risks to assets, policy liabilities and off-balance sheet exposures by applying various factors to determine a ratio of capital available over capital required.³

In the early 2000s, the provincial government formally separated the compulsory Basic monopoly insurance from the Optional coverage, and set the minimum MCT capital ratios at 100% for Basic insurance, and 200% for the Optional program. The Optional ratio was much higher because ICBC would compete with the private insurers for this business, and they were required to have a higher capital reserve.⁴ A high ratio ensured that private insurers would not accuse the government of giving ICBC an unfair advantage in the pricing of the Optional coverage.⁵

BASIC RATES SUBSIDIZED BY CAPITAL DESTRUCTION

Unlike the private insurers, the government does not expect to profit from the sale of the compulsory Basic insurance (in other provinces where the private insurers provide this coverage a profit is expected). No profit is expected in Saskatchewan or Manitoba, the other publicly owned auto insurance jurisdictions.

In recent years, rising claims costs have required significant increases in Basic premiums. But the Liberal government imposed a 'rate smoothing' policy that kept the increase in rates lower than the increase required to match the growth in costs. The resulting operating deficits, combined with the impact of low interest rates⁶, dramatically reduced the Basic capital reserve.

Table 1 shows that from 2010 to 2014 the Basic program's capital ratio fell from 162% to 96%, but was bolstered by the transfer of \$486 million of capital from the highly profitable Optional program. In 2015 and the 15-month 2016/17 fiscal

³ https://www.sgi.sk.ca/pdf/annualreports/SGI_2016_Annual_Full.pdf p. 12.

⁴ The minimum, or supervisory, target for Intact Financial, for example, is 170%.

⁵ See pg. 110-111 in http://www.bcpolicy Perspectives.com/media/attachments/view/doc/article_bc_studies_icbc_2013/pdf

⁶ Changes in Total Comprehensive Income, which is the sum of net income and changes in asset values and pension requirements, increase or decrease the capital reserve (equity).

years the Basic total comprehensive losses totalled \$1.0 billion. Again, the transfer of \$823 million of Optional funding kept the capital ratio just above the regulatory minimum.

For 2017/18, ICBC forecasts a loss of \$441 million in the Basic program. This prompted the new government to order a further infusion of \$470 million of Optional capital to keep the capital reserve just above the minimum level (line 5 compared to line 6).⁷

TABLE 1 – CHANGE IN BASIC CAPITAL RESERVE and CAPITAL RATIO (\$=million)

	---2010 to 2014---		-----2015-----		-----2016/17-----		-----F2017/18-----		---2010 to F2017/18---		
	\$	MCT	\$	MCT	\$	MCT	\$	MCT	\$	MCT	
1	Start of Year	1,597	162	1,633	136	1,521	117	1,456	103	1,597	162
2	Δ Comp. Income	(450)		(563)		(438)		(441)		(1,892)	
3	End of Year	1,147	96	1,071	83	1,083	76	1,015	69	(295)	(20)
4	From Optional	486		450*		373		(470)		1,779	
5	End Reported	1,633	136	1,521	117	1,456	103	1,485	101	1,485	101
6	Regul. Minimum	1,200	100	1,300	100	1,414	100	1,470	100		
7	Difference	433	36	221	17	42	3	15	1	n/a	
8	Rate Change %	20.0		5.5		4.9		6.4		41.4	

Source: ICBC annual reports, ICBC (updated) 2017/18 to 2019/20 Service Plan, ICBC 2017 Rate Requirement Application. 2016/17 includes 15 months.

Notes: * The \$450 million was a post year-end adjustment, but is included in the 2015 year for clarity. 2016/17 includes 15 months.

From 2010 to the year-end 2017/18 the Basic program will have required about \$1.8 billion in Optional transfers to keep the Basic capital ratio above the government’s regulatory minimum level.

THE SASKATCHEWAN SITUATION

In Saskatchewan the compulsory basic auto insurance is provided by the public Auto Fund, managed by the Saskatchewan Government Insurance (SGI) corporation. Policyholders have a choice between purchasing a tort policy, which allows the

⁷ OIC 326/17 of September 5, 2017.

victim to sue for pain and suffering, or a no-fault policy, which provides much higher coverage limits for injury claims but precludes claims for pain and suffering. Approximately 96% of the Auto Fund policyholders choose the no-fault coverage.

Table 2 shows that basic insurance rates have increased at a comparatively modest cumulative 8.5% from 2010 to 2016, and the Auto Fund has been able to increase the capital reserve ratio from 69% in 2014 to 124% by March 31, 2017. The increase in the capital reserve has been achieved without any funding transfers from SGI’s profitable optional insurance program.

TABLE 2– SASKATCHEWAN AUTO FUND CHANGE IN CAPITAL (\$=million)

		----2010 to 2014----		-----2015/16-----		-----2016/17-----		----2010 to 2016/17---	
		\$	MCT	\$	MCT	\$	MCT	\$	MCT
1	Start of Year	155		218	69	377	99	155	
2	Δ Comp. Income	63		159		188		410	
3	End of Year	218	69	377	99	565	124	565	124
4	Rate Change	8.5		nil		rebalance		8.5	

Source: Saskatchewan Auto Fund annual reports. Capital ratio target of 100% set in 2014, previously 75% to 150%.

From 2010 to 2016/17, the Auto Fund recorded a cumulative \$410 million in total comprehensive income, allowing it to keep rate increases moderate and building a comfortable capital reserve. The basic policyholders in Saskatchewan and Manitoba (which prohibits claims for pain and suffering) enjoy the lowest rates for compulsory auto insurance in Canada.⁸

OPTIONAL CAPITAL RESERVE DEFICIT APPROACHES \$1.0 BILLION

ICBC, unlike the public auto insurers in Saskatchewan and Manitoba, does not publicly report on the Optional program. Its annual reports and service plans discuss operations at the combined (or corporate) level. Basic program specific information can be gleaned from the annual rate application submissions, and related responses to specific questions.

⁸ Provincial comparisons can be found in http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_40_8_september_2017/pdf

By using both the annual reports, the service plan and the 2017 Basic rate request, it is possible to construct the changes in the Optional capital, as displayed in Table 3.

Unlike the Basic program, ICBC’s Optional program has historically generated significant profits and additions to the capital reserve. In 2010, the government was desperate for new sources of revenue and began to appropriate the “excess” Optional capital.⁹ From 2010 to 2015 approximately \$1.2 billion was transferred from policyholders’ to taxpayers (line 4).

In addition, the government used the Optional program to subsidize the Basic rates, with a projected total of approximately \$1.8 billion being transferred by March 31, 2018 (line 5). All Optional policyholders are Basic policyholders.¹⁰ Therefore, policyholders have consumed their Optional capital reserve savings to enjoy lower than required annual Basic insurance rates.

TABLE 3 – CHANGE IN OPTIONAL CAPITAL RESERVE and CAPITAL RATIO (\$=million)

		----2010 to 2014----		-----2015-----		-----2016/17-----		-----F2017/18-----		---2010 to F2017/18---	
		\$	MCT	\$	MCT	\$	MCT	\$	MCT	\$	MCT
1	Start of Year	2,019	306	1,983	298	1,625	236	990	138	2,019	306
2	Δ Comp. Income	1,502		230		(262)		25		1,495	
3	End of Year	3,521	529	2,213	321	1,363	189	1,015	136	3,514	469
4	To Government	(1,052)		(138)		---		---		(1,190)	
5	To Basic	(486)		(450) *		(373)		(470)		(1,779)	
6	End Reported	1,983	298	1,625	236	990	138	545	73	545	73**
7	Regul. Minimum	1,330	200	1,380	200	1,435	200	1,500			
8	Difference	653	98	245	36	(445)	(62)	(955)		n/a	
9	Rate Change	(12.4)		2.2		2.8		5.1/9.6		(3.3)/1.0	

Source: ICBC annual reports, ICBC (updated) 2017/18 to 2019/20 Service Plan, ICBC 2017 Rate Requirement Application. 2016/17 is 15 months.

Notes: * The \$450 million was a post year-end adjustment, but is included in the 2015 year for clarity.

** Estimated.

⁹ Any capital above the management target of 260%, less the budget for the Transformation program, was appropriated to reduce the government’s borrowing requirement for the taxpayer-supported direct debt.

¹⁰ A recent survey suggests that ICBC enjoys 95% of the Optional market share; see p. 6B-3 in the 2017 Rate Request Application.

The extended 2016/17 (15 month) fiscal year proved a turning point for the profitability of the Optional program. The extended icy conditions in the major population centres during January and February of 2017 resulted in much higher vehicle damage claims (which comprise a higher proportion of Optional claims costs). The poor weather, and some accounting changes at ICBC, pushed the Optional program to a total comprehensive loss of \$262 million for that year. After the transfer of \$373 million to the Basic capital subsidy (line 5), the year-end Optional total capital of \$990 million was approximately \$445 million short of the 200% minimum regulatory requirement (line 8). The forecast of the current year shows that, after the appropriation of the \$470 million, the Optional capital deficit will increase to approximately \$955 million.

SUMMARY

Tables 1 and 2 show the true picture of the annual changes in Basic and Optional capital reserves. It is apparent that the current model is not sustainable. The original policy of the early 2000s of keeping the Optional capital reserve at a minimum of 200% to provide a level playing field with the private insurers was abandoned in 2016, as the government required more Optional program funds to continue the subsidy of the Basic program rates.

ICBC has not provided capital forecasts at the program level beyond the current fiscal year, but the Basic insurance structural deficit of some \$400 million will, if not eliminated, completely consume the remaining Optional capital within 30 months.

The new government has little time to spare to deal with the crisis before a taxpayer bailout of ICBC becomes necessary.

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The writer is a retired senior BC government public servant whose paper describing the BC government's manipulation of the finances of BC Hydro from 2008 to 2014 was published by *BC Studies* in November 2016. *BC Studies* published his paper on the 40-year financial history of ICBC in 2013. He has been an intervener in the BC Utilities Commission's recent reviews of ICBC's rate requests, and is an intervener in the Commission's current review BC Hydro's rate request.

