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2 **A.I. 3(2006)**
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5 **IN THE MATTER OF** the *Automobile,*
6 *Insurance Act*, R.S.N.L. 1990, c. A-22, as
7 amended (the “*Act*”)
8

9 **AND**

10
11 **IN THE MATTER OF** an application by
12 Royal and SunAlliance Insurance Company
13 of Canada (the “Applicant”) to implement
14 revised rates for its Private Passenger class
15 of business.
16

17 On September 1, 2005 pursuant to legislative changes enacted on August 1, 2005, the Applicant
18 submitted for the Board’s review and approval, a revised private passenger automobile insurance
19 rating program for use with effect from August 1, 2005.

20
21 **Legislation**
22

23 On August 1, 2005 the Government of Newfoundland and Labrador enacted legislation amending
24 the *Automobile Insurance Act* and the *Insurance Companies Act* in relation to the conduct of
25 participants in the automobile insurance industry and the regulation of rates in the province. Among
26 other things, the changes eliminated the benchmarking system of rate review and approval used by
27 the Board since inception of automobile insurance rate regulation and substituted new rate review
28 requirements.
29

30 Under the revised automobile insurance legislation, rate decreases take effect no sooner than thirty
31 days following filing with the Board. Rate increases are subject to prior approval and in connection
32 therewith, the Board must determine, in accordance with provisions outlined in regulations, if a
33 proposed rate is “too high”. Where such a finding is made the Board is required to prohibit, or vary
34 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 announced 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 October 24, 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 an ROE of 10.8%, an ROI of 4.01% and a Premium to Surplus ratio of 1.5:1. These parameters, as well as the assumptions made by the Applicant in connection with other factors in the rate making process are reflected in the indications and the proposed rate changes shown below:

Royal	Company Indications	Company Proposal
Coverage		
Third Party Liability	15.4%	10.0%
Accident Benefits	-3.0%	-3.0%
Collision	12.6%	10.0%
Comprehensive	-24.4%	-25.0%
Specified Perils	-8.4%	0.0%
Uninsured Motorist	2.4%	0.0%
Total	9.6%	5.7%

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 increases at the greater of 15% or \$75 for each successive renewal.

The Applicant proposes to offer the following discounts:

DISCOUNT	%	COVERAGES
Claims Free	5%	All Coverages and All Classes except Class 05 or 06
Experience	10%	All Coverages and All Classes except Class 05 or 06
Long-Term Policyholder	5%	All Coverages and All Classes except Class 05 or 06
Multi Vehicle	10%	Third Party Liability, Accident Benefits, Uninsured Automobile, All Perils (Collision Portion) and Collision - All Classes except Class 05 or 06
Multi Line	5%	Third Party Liability, All Classes except Class 05 or 06
Student	50%	Third Party Liability and Collision - Class 05 or 06

1 The proposed discounts are consistent with those previously approved. These discounts relate to the
2 risk, are not subjective or arbitrary, and are in accordance with the legislative provisions. In addition
3 the impact of the discounts has been appropriately reflected in the rate filing as reviewed by MOW.
4

5 The Applicant proposes Class of Use definitions that vary from those recently amended in the
6 Statistical Plan of the Superintendent of Insurance. The Class of Use definitions are consistent with
7 those accepted by the Board as reasonable in the Applicant's last rate filing, with the exception of
8 changes to Class 03 to allow limited business use. MOW has reviewed the proposed Class of Use
9 definitions and finds them to be similar to the Superintendent of Insurance's Statistical Plan. MOW
10 has also concluded that the selected class differentials are reasonable.
11

12 **Detailed Analysis**

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14 In its review of rate filings the Board is mandated to prohibit or vary a rate which it determines is
15 "too high". The Board makes this determination following a thorough review of all information
16 submitted by the Applicant and careful consideration of the reports and findings of its expert
17 consultants. In exercising its jurisdiction the Board reviews the base rates for each coverage and a
18 determination is made as to whether or not they are "too high". That is to say, the review is on a
19 coverage by coverage basis. This is consistent with the amended legislation and is in keeping with
20 the historical practice of the Board which was adopted to avoid the cross subsidization of rates
21 between coverages. Allowing the establishment of a rate for one coverage lower than is justified and
22 permitting a rate for another coverage to be higher than is justified by the actuarial and other
23 evidence would result in rates which are not reflective of costs and, depending on the coverage
24 chosen, may cause some insureds to pay more than actuarially justified.
25

26 As identified in the Board's detailed Filing Instructions, the Applicant is required to provide
27 justification of any rate increases. Where the Applicant does not utilize the specific parameters set
28 out in the filing guidelines the Applicant is required to provide the Board with sound reasoning and
29 justification for the deviation. For example, in connection with ROI, the guidelines provide the

Board's acceptable range of factors but state, "*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.*" Similar cautions and directions are provided in connection with the remaining guideline factors and assumptions, where appropriate.

Actuarial

The November 15, 2005 report of the Board's actuarial consultants identified a number of issues and provided rate indications based on alternate assumptions found by MOW to be reasonable and supported by the information contained in the Applicant's filings, or, reasonable on the basis of industry factors.

With respect to assumptions made in the determination of rates, these are matters of actuarial 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. In their place MOW substituted alternate assumptions they felt more appropriate or reflective of market or other conditions as follows:

- Loss Trend – the Applicant utilizes ten years loss data to determine its loss trends for all coverages. The Applicant does not distinguish between past and future loss trends. 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 coverages is more reasonable to reflect more current trend.
- Effects of Reform - the Applicant did include provision for savings arising from the reforms implements through previous legislative changes but only applied the savings to the third party liability bodily injury portion and not the property damage portion. MOW has adjusted for this.

- Credibility Standard/Procedure – The Applicant used a credibility standard of 4,330 claims for third party liability, 1,084 for property damage coverages and 2,707 for accident benefits. MOW uses 3,246 claims for the bodily injury portion of third party liability, 1,082 for property damage coverages and 2,164 for accident benefits. This is consistent with past practice of the Board and the Board’s consultant. Also, the Applicant did not determine the credibility level for third party liability on the sub coverages separately.

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:

Royal	Company Indications	Company Proposal	MOW Indications
Coverage			
Third Party Liability	15.4%	10.0%	6.7%
Accident Benefits	-3.0%	-3.0%	-9.6%
Collision	12.6%	10.0%	4.8%
Comprehensive	-24.4%	-25.0%	-31.1%
Specified Perils	-8.4%	0.0%	-9.4%
Uninsured Motorist	2.4%	0.0%	-2.6%
Total	9.6%	5.7%	1.6%

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 Applicant’s proposals reflect a Premium to Surplus Ratio of 1.5 rather than the 2.25 set out in the filing guidelines. The Applicant did not provide any professional opinion or supporting financial information as sought by the filing guidelines and requests for information. The only support provided for this alternate assumption is a statement of the overall Premium to Surplus Ratio reported on the Applicant’s P&C 1 returns filed with the Superintendent of Insurance for 2003 and 2004. No documentation was provided to show that this information was relevant to the within application to set automobile insurance rates for 2005-2006 in the Province.

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

1 and responses were exchanged with the Applicant. NERA's report, dated March 13, 2006, details
2 the pertinent aspects of these exchanges and summarizes the position stated by the Applicant in
3 support of the requested ROE and ROI and NERA's consideration thereof.

4
5 NERA's final report findings are as follows:

6
7 ROE – *"R&SA has not provided sufficient evidence to support its request for an ROE higher than set*
8 *out in the guidelines."*

9
10 ROI – *"R&SA requested ROI of 4.01% is reasonable."*
11

12 A copy of the MOW report and the NERA report was forwarded to the Applicant for comment. The
13 Applicant did not submit a response to the Board.

14
15 **Findings**
16

17 The Board has reviewed the application, the supporting material, responses to information requests,
18 consultants' reports and all other information relevant to this rate filing. The Board finds the
19 proposed Class of Use definitions are acceptable as they are for the most part in line with the recent
20 changes implemented by the Superintendent of Insurance and the Board's previously approved
21 definitions. As well the associated differentials were found by MOW to be reasonable. The
22 Applicant's proposed discount program is consistent with those previously approved and is
23 consistent with the legislative provisions.

24
25 Based on the review of the available information in connection with this rate filing the Board is not
26 satisfied that some of the other elements of the Applicant's rate proposals are reasonably supported
27 by the available information. In connection with the actuarial analysis, the Board has reviewed the
28 assumptions provided by the Applicant and the alternate assumptions provided by the Board's
29 actuarial consultants, MOW, in respect of loss trend, effects of reform, and credibility standard.
30 While the Board and MOW sought clarification and support for the proposals the Applicant did not

1 fully support its position on each of the elements of the rate proposal. The Applicant was provided
2 with a copy of the MOW report and was given an opportunity to further comment on and challenge
3 the rationale used by MOW. The detailed and comprehensive analysis offered by MOW in its report
4 was not subsequently challenged by the Applicant. The Board finds the alternate assumptions of
5 MOW are fully supported and accepts them as reasonable. The Board therefore will require the
6 Applicant to reflect these alternate assumptions in its rate filing.

7
8 In connection with the cost of capital analysis the Board notes that the filing guideline factors for
9 ROE, ROI and Premium to Surplus Ratio were based on the recent order of the Board issued
10 following a comprehensive hearing with expert testimony. Proposals incorporating alternate factors
11 for ROE, ROI and Premium to Surplus Ratio are approved when fully supported. In the context of
12 the supporting materials the Board makes the following determinations in relation to these factors.

- 13
14 • In connection with the Applicant's proposed ROE of 10.8%, the Board finds that the
15 Applicant has not fully supported the proposal. The Applicant did not provide either
16 financial information or expert opinion supporting the proposed ROE. NERA determined
17 that insufficient evidence was provided to support an ROE higher than 10%. The Board
18 finds that the Applicant has not provided sound rationale or additional compelling evidence
19 to support the use of an ROE other than 10%.

- 20
21 • In connection with the Applicant's proposed ROI of 4.01%, the Applicant has provided
22 substantial information with respect to the requested ROI including an investment policy
23 statement, average duration of investments, and investment portfolio. NERA after a full
24 review of the available information including a weighted average yield for insurers operating
25 in Newfoundland and Labrador, found that the requested ROI of 4.01% was reasonable in
26 the circumstances. Based on all the available information, the Board accepts the proposed
27 ROI as reasonable.

- 28
29 • Contrary to the comprehensive information provided with respect to the ROI the Applicant

provided little information in support of the Premium to Surplus Ratio. The filing guidelines set out a 2.25 to 1 ratio as reasonable. The Applicant proposes a ratio of 1.5 to 1 on the basis of two overall historical ratios which were not shown to be relevant to this rate setting process. The Board will not accept the proposed Premium to Surplus Ratio and will instead require the use of 2.25 to 1 as reasonable and appropriate in the circumstances.

Costs

As set out in the Filing Instructions, pursuant to section 57 of the *Automobile Insurance Act* and section 90 of the *Public Utilities Act*, the Applicant will be required to pay the costs of the Board 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%, a Premium to Surplus Ratio of 2.25 to 1, the assumptions of MOW with respect to Loss Trend, Effects of Reform and Credibility Standard/Procedure.
3. The Applicant shall submit for the 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.
4. The proposed Class of Use definitions are accepted for use.
5. The proposed discount program is approved.

- 1 6. 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