DECISION

2018 NSUARB 61
M08533

NOVA SCOTIA UTILITY AND REVIEW BOARD

IN THE MATTER OF THE INSURANCE ACT

- and -

IN THE MATTER OF AN APPLICATION by **PAFCO INSURANCE COMPANY** for approval to modify its rates and risk-classification system for private passenger vehicles

BEFORE: Roberta J. Clarke, Q.C., Member

APPLICANT: **PAFCO INSURANCE COMPANY**

FINAL SUBMISSIONS: March 14, 2018

DECISION DATE: **March 22, 2018**

DECISION: **Application is approved.**

I INTRODUCTION

[1] Pafco Insurance Company (Pafco or Company) filed supporting documents and materials (Application) with the Nova Scotia Utility and Review Board (Board) for approval to modify its rates and risk-classification system for private passenger vehicles (PPV). The Application, dated February 2, 2018, was filed electronically on February 7, 2018, and the original documents were received on February 9, 2018.

[2] Information Requests (IRs) were sent to the Company on February 21, 2018, and responses were received on March 5, 2018.

[3] As a result of a review by Board staff, a staff report dated March 14, 2018, (Staff Report) was prepared. The Staff Report was provided to the Company for review on March 14, 2018. The Company responded on the same day, indicating that it had reviewed the Staff Report and had no comments.

[4] The Board did not deem it necessary to hold an oral hearing on the Application.

II ISSUE

[5] The issue in this Application is whether the proposed rates and changes to the risk-classification system are just and reasonable and in compliance with the *Insurance Act* (*Act*) and its *Regulations*.

III ANALYSIS

[6] The Company sought approval to change its rates and its risk-classification system for PPV. The Application was made in accordance with the Board's *Rate Filing*

Requirements for Automobile Insurance – Section 155G Prior Approval (*Rate Filing Requirements*). The Company's mandatory filing date was February 1, 2018, but the Board had granted a request for an extension to February 8, 2018.

[7] The proposed effective dates are May 1, 2018, for new business and July 1, 2018, for renewal business.

Rate Level Changes

[8] The Company proposed to change its rates and risk-classification system. The proposed change represents an overall rate level increase of 6.0%.

[9] The Company's indications suggested that rates should increase by a significantly higher amount, with the greatest indicated increases being for the components of Third Party Liability coverage, Comprehensive and Specified Perils coverages, and Collision coverage. The Company proposed no change to SEF#44 (Family Protection Endorsement), despite a large indicated decrease.

[10] In considering the Company's Application, Board staff reviewed all aspects of the ratemaking procedure, including the following:

- Loss trends and the effects of reform;
- Loss development;
- Credibility standards and procedure, and complement of credibility;
- Expense provisions, including unallocated loss adjustment expense provisions;
- Premium (rate group drift) trends;
- Experience period and weights;
- Premium to surplus leverage ratio; and
- Target and proposed return on equity (ROE).

[11] Board staff report that the only issue arising from the Application where the Board should consider alternate assumptions from those used by Pafco in developing its

indications was the profit provision and thus, the ROE. All other issues were addressed satisfactorily in the IR process.

Return on Equity

[12] The Company used a target ROE of 12% and a premium to surplus ratio of 1.7:1 to determine the indicated rate level changes. Coupled with its selected investment return on surplus assets, the resulting profit provision, expressed as a percentage of premiums, exceeded 9%.

[13] The Board has, for some years, considered that an ROE in the range of 10-12% is reasonable. This range, using a standard 2:1 premium to surplus ratio, and using the Pafco investment return leads to an allowable range of 6.7-8.1% for profit, expressed as a percentage of premiums. This is lower than Pafco's selection.

[14] In addition, the Board has noted, in several recent decisions, its concern over the level of profit observed in the industry, based on the 2012 and 2013 Financial Information Reports produced by the General Insurance Statistical Agency (GISA). The Board grew concerned that insurers were earning greater profits than the 12% ROE that the Board had ordered. As a result, it ordered companies to lower their target ROE to 10%.

[15] The Board is aware that the 2014-2016 GISA Financial Information Reports show that, for PPV, industry is earning a negative ROE. The Board has considered that this is more likely a result of companies choosing not to apply for their full indicated rate changes, as well as some deteriorating experience, including inclement weather in early 2015, rather than a result of the Board ordering companies to use a 10% target ROE.

[16] The Board has asked companies to explain if their individual experience is different from industry in order to determine whether they should be permitted to use a target ROE greater than 10% in their indications.

[17] The Board observes that, for Pafco, the use of the 1.7:1 premium to surplus ratio, the 12% target ROE, and the lower investment return on surplus assets, appear to combine to inflate the profit provision. The Board also notes that in the last Pafco application, the Board approved the methodology used by the Company to establish its investment return assumption. In addition, the premium to surplus ratio is consistent with that used by Pafco's sister companies, Allstate Insurance Company of Canada (Allstate) and Pembridge Insurance Company (Pembridge) in recent applications.

[18] In the Allstate and Pembridge applications, and in the last Pafco application, each company was directed by the Board to use an ROE of 10%. In this Application, when asked why the Company should not be required to use the 10% ROE, Pafco said:

> Pafco does not believe that a 10% level of return on equity is commensurate with the business that it writes. As the Board in previous communications has reported a range of 10-12% as a reasonable return on equity; we believe Pafco should fall at the higher end of the range.
>
> Return on equity should be targeted on a company by company basis with a due level of consideration toward the risk undertaken in the portfolio of insureds in order to reasonably reflect the "risk/reward" proposition.
>
> By enforcing the lowest targeted "reasonable level of return" on companies that inherently write riskier business, this proposition is violated. Higher risks should carry a higher margin both to reflect the inherent volatility in the portfolio of insureds, as well as to level the playing field with insurers who write standard, less-risky business. Without such compensation, there is considerable strain on non-standard insurers that may expose the industry to a necessary expansion in the residual market; Pafco believes that this would be counter to the mandate that the Board strives for.
>
> [Response to IR-1, Q. 1]

[19] The Board observes that Pafco had made similar submissions in its last PPV application. The Board then considered that additional risk is already reflected in the experience used by the Company to determine its indicated rates, as well as the lower

premium to surplus ratio and lower investment return. Thus, the Board concluded that Pafco's non-standard business did not warrant a higher ROE.

[20] In this Application, the Board observes that the Company has generally enjoyed good ROE results in recent years, up to 2016.

[21] Board staff asked the Company to provide indications using all Pafco assumptions, except with a 10% target ROE. These indications result in an overall all coverages increase that is about 10% lower than the original indicated increase, and still significantly higher than the proposed increase. The resulting profit provision is close to the top of the range which the Board considers reasonable.

[22] Board staff recommended that the Pafco assumptions with a 10% ROE be used as the appropriate target against which to assess whether the proposed changes will result in just and reasonable rates.

[23] These assumptions then become what is referred to in the Staff Report as the Staff indications. Except for SEF#44 coverage, the proposed changes are directionally the same as the Staff indications, although significantly less, resulting in lower proposed rates. Given the amount of the premium for SEF#44 coverage, where a large decrease is indicated, and the fact that the premium is already considerably less than the industry average for this coverage, Board staff did not recommend the Company be required to amend its proposal to make no change in the rate for SEF#44 coverage.

[24] The proposed changes will result in an ROE that is well below the low end of the Board's range; the same is true of the profit provision. Pafco explained its willingness to accept the lower return:

> Keeping its competitive position in mind, Pafco's plan is to gradually take the full increase over a succession of filings in order to minimize disruptions to our customers. We hope

> that the segment changes we are making at this time would improve our indications in the future. If our experience continues to deteriorate, we will re-evaluate our options.
>
> [Response to IR-1, Q. 5]

[25] The Board has noted, earlier in this Decision, its concern about companies choosing not to take their full indicated changes which appears to result in negative ROE, as observed in the industry in recent years. The Board notes that Pafco has not had a history with the Board of taking a small change in the face of large indications, and therefore, it does not consider it should force a larger change at this time. Therefore, in the circumstances of this Application, the Board accepts the recommendation of Board staff to approve the proposed rates. The Board wishes to make it clear, however, that should the Company continue to seek significantly lower than indicated rates in its next PPV application, the Board may determine that a larger increase, closer to the indications, is warranted.

Territorial Differentials

[26] Pafco conducted an analysis of its territorial differentials, and proposed changes for most of its territories, based on the indications. The proposed changes reflect some deviations from the indications, either to improve the Company's competitiveness, or to help target a specific market.

[27] Board staff said that Pafco had supported its proposed differentials, and recommended the Board approve them. The Board accepts the recommendation.

Other Changes

Class Differentials

[28] The Company reviewed its differentials for certain rating classes. Considering competitive concerns and target markets, Pafco proposed decreases to principal operator Classes 01 and 03 and inexperienced operator Class 10 (male licensed 0-2 years). It also proposed increases to inexperienced principal operator Classes 13 (male licensed for 7 or 8 years) and 19 (female licensed for 5-8 years).

[29] The proposed changes followed the direction of the indications, but with varying magnitude.

[30] Board staff recommended the approval of the proposed changes to Class differentials, and the Board accepts the recommendation.

Driving Record Differentials

[31] Pafco proposed increases to Driving Records 03, 04, 05, and 06, which are the better Driving Records. It took into consideration competitive concerns, and its desire to target certain segments of the market. While the indications suggested there should be decreases for Driving Records 00, 01 and 02, the Company chose to leave them unchanged at present to avoid "…larger dislocation for customers who are already getting large rate increases" (Response to IR-1, Q.8).

[32] Board staff stated that Pafco had supported the proposed changes to the Driving Record differentials, and recommended the Board approve them. The Board accepts this recommendation.

Farmer's Discount

[33] Pafco proposed to remove its Farmer's Discount. It has just removed this in New Brunswick, and wishes to harmonize its discounts in Nova Scotia. The Company said that it is not seeking to cover non-standard farmers or fishermen. Currently it insures only a very small number of policyholders with this discount, and therefore, the overall impact will be negligible.

[34] In the circumstances, the Board accepts the recommendation of Board staff to approve the removal of this discount.

Rating Rules

[35] The Company proposed several changes to its underwriting or rating rules, some of which are clarifications or reorganization of rules. None of them have an impact on premiums. They are:

- Addition of the new Race and Speed Rule to the "Risks to be Referred Section" of the Manual;
- Addition of a rule that the Company will not write or will terminate a contract where any driver or applicant/policyholder is abusive to an employee within the Allstate Canada Group;
- Increases in the vehicle values to accommodate underwriting higher value vehicles;
- Change to the Payment Default wording to align Pafco with Pembridge, without a change to the administrative charge; and
- Change to the eligibility criteria for "New to Canada" drivers. Where no prior insurance exists, the driving record will be based on the years licensed in Canada or the United States only, rather than wherever the driver was licensed. Applicants will be required to provide a three-year driving record report from their prior province or state. A new rule will be added to the Driving Record definition to align Pafco with Pembridge. Pafco said that existing insureds will be grandfathered under the current rules.

[36] Board staff said that Pafco had provided appropriate support for the proposed changes, and recommended that the Board approve them. The Board accepts the recommendation and approves the Rating Rule changes as proposed.

Automobile Insurance Manual Review

[37] Board staff have reviewed the Automobile Insurance Manual on file. One potential violation of the *Regulations* was identified, which the Company advised was a typographical error, which was subsequently revised. Otherwise, Board staff found no instances where the Company is in violation of the *Regulations*. The Company proposed no changes to its Automobile Insurance Manual other than those necessary to effect the changes noted in this Decision.

IV FINDINGS

[38] The Board finds that the Application complies with the *Act* and *Regulations*, as well as the *Rate Filing Requirements*.

[39] The financial information submitted by the Company satisfies the Board, pursuant to Section 155I(1)(c) of the *Act,* that the proposed changes are unlikely to impair the solvency of the Company.

[40] The Board finds the proposed rates are just and reasonable.

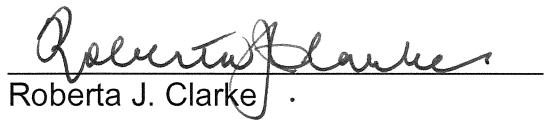
[41] The Application included full actuarial indications and the required territorial analysis; therefore, it qualifies to set the new mandatory filing date for PPV for the Company to February 1, 2020.

[42] The Board approves the effective dates of May 1, 2018, for new business and July 1, 2018, for renewal business.

[43] The Company is required to file an electronic version of its updated Automobile Insurance Manual within 30 days of the issuance of the Order in this matter.

[44] An Order will issue accordingly.

DATED at Halifax, Nova Scotia, this 22nd day of March, 2018.



Roberta J. Clarke