DECISION

2020 NSUARB 3
M09418

NOVA SCOTIA UTILITY AND REVIEW BOARD

IN THE MATTER OF THE INSURANCE ACT

- and -

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

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

APPLICANT: **SONNET INSURANCE COMPANY**

FINAL SUBMISSIONS: December 17, 2019

DECISION DATE: **January 9, 2020**

DECISION: **Application is approved as modified.**

I INTRODUCTION

[1] Sonnet Insurance Company applied to the Nova Scotia Utility and Review Board to change its rates and risk-classification system for private passenger vehicles. The company proposed rate changes that vary by coverage and result in an overall all-coverages combined increase of 50.1%. In addition to rate changes, the company proposed changes to its territorial differentials and rating variables, and the introduction of a group discount.

[2] Sonnet began to offer automobile insurance in Nova Scotia in 2016. It is a sister company of Economical Mutual Insurance Company and operates primarily on-line or "direct to consumer". Sonnet presently underwrites a relatively small number of policies in Nova Scotia.

[3] Sonnet had included proposed changes to its underwriting rules in the application. After the application was filed, as a result of communications with Board staff, Sonnet removed the underwriting rule changes from this application and made a separate simplified application for their approval (M09489). The Board issued a decision approving those changes on November 25, 2019 (2019 NSUARB 154).

[4] The Board must consider whether the proposed rates and risk-classification changes are just and reasonable and in compliance with the *Insurance Act* (*Act*) and its *Regulations*. The Board is satisfied that Sonnet's application, when modified to conform with the Board's directions, will meet these requirements, and will then approve the proposed changes.

II ANALYSIS

[5] Sonnet applied under the Board's *Rate Filing Requirements for Automobile Insurance – Section 155G Prior Approval* (*Rate Filing Requirements*). Sonnet received and responded to Information Requests (IRs) from Board staff. Board staff prepared a report to the Board with recommendations on the application (Staff Report). Before providing the Staff Report to the Board, Board staff shared it with Sonnet. The company reviewed the report and informed Board staff that it believed the report contained an error regarding the calculations of the complement of credibility. As a result of further review by Board staff, a revised Staff Report was prepared and provided to Sonnet. The company responded that it agreed with the revised Staff Report and the recommendations it contained.

[6] Board staff examined all aspects of the ratemaking procedure to make the recommendations in the Staff Report and suggested that the Board further review certain issues. Board staff consider that Sonnet satisfactorily addressed all other aspects of the ratemaking procedure in its application and IR responses.

[7] The Board examines the following issues in this decision:

- Profit Provision and Target Return on Equity (ROE)
- Complement of Credibility
- Proposed Rate Changes
- Territorial Differentials
- Changes to Rating Variables
- Introduction of Group Discount

Profit Provision and Target Return on Equity (ROE)

[8] To produce its indications, Sonnet used a 12% target for ROE and a 2:1 premium to surplus ratio. This ROE produces a profit provision of 7.5% of premium. Both

selections are at the upper end of the ranges which the Board generally considers reasonable. Over the past several years, the Board has been concerned about the level of profit observed in the industry, as evidenced by the 2012 and 2013 versions of the General Insurance Statistical Agency (GISA) Financial Information Reports. The Board considered that even with the approval of a 12% ROE, companies were earning much higher returns. As a result, the Board began to require the use of a 10% ROE by companies when developing their indications.

[9] The GISA reports for 2014 to 2018 each show a negative ROE for the insurance industry. The Board has considered this is not likely the result of its requiring companies to use the low end of the range for ROE, but rather is due to companies choosing to take less than their indicated rate changes, together with deteriorating experience. The Board has continued to require companies to use a 10% ROE, unless the company can demonstrate that its experience differs from the industry.

[10] Board staff asked Sonnet why it should not be required to use a 10% ROE. The company said that as a mutual insurance company, it is restricted in how it can raise capital, compared to publicly traded insurance companies. For this reason, the Board has allowed Sonnet and its sister company, Economical, to use the 12% ROE in previous applications. The Board sees no reason to depart from this position and will allow Sonnet to continue to use the target 12% ROE in developing its indicated rate changes for this application.

Complement of Credibility

[11] In its last mandatory filing for private passenger vehicles, Sonnet used the prospective net trend as the complement of credibility. This method assumes that the

current rates were adequate when they were set. However, in that application, Sonnet proposed to make no changes to its rates, despite indications for an increase. As a result, Sonnet's current rates were not adequate, and the company said that the prospective net trend approach is not appropriate for this application.

[12] To address this, Sonnet changed its complement of credibility to use the rate change indicated for a larger group (Economical), adjusted to reflect Sonnet's current rates. The company said this is better for several reasons: the complement should account for any gaps in Sonnet's rate inadequacy; as a new and small company, Sonnet's prior indications based on its own data might be unreliable; and, Sonnet believes using Economical indicated rates is more reliable as it anticipates its mix of business will "gravitate" towards the Economical mix.

[13] Board staff reported that the use of the prospective net trend would result in a significant decrease in the overall indicated rate change. The decrease would be even larger if Sonnet made an adjustment to the average accident dates for the rates. Sonnet's change to using Economical data thus has a significant impact on the rate level need. Sonnet said that there would need to be an adjustment for rate adequacy if the prospective net trend were used and said that using Economical's indicated rates accounts for the lack of an adjustment. While Board staff agreed, Sonnet's approach to using the Economical data complement also presents concerns.

[14] Board staff reported that Sonnet had made no adjustment for the losses observed for Economical and assumed that the loss ratios across all classes and territories are the same for both companies. Board staff suggest this is unlikely. Further, Board staff noted that the Sonnet approach assumed that the Economical data is fully

credible, while Economical has acknowledged it is not. Board staff also noted Sonnet's use of a "premium adjustment ratio" calculation, which Board staff believe overstates the rate level changes needed.

[15] Board staff concluded that using the Economical indications requires a weighting of the data and suggested a blended approach should be used to make appropriate adjustments for credibility. Board staff recommended that the Board require Sonnet to use a complement of credibility that first applies to the adjusted Economical indication. Where the Economical data is not fully credible, Sonnet would assign the remaining balance of credibility to the prospective net trend applied from the average accident date of its current rates (i.e., the rates effective March 7, 2018) adjusted to reflect the rate inadequacy that results from Sonnet not taking the indicated changes in its last application. The use of this complement would result in a decrease in Sonnet's indicated overall rate change from +77.6% to +65.8%. The Board accepts the recommendation of Board staff for the complement of credibility.

Proposed Rate Changes

[16] Using the 12% target ROE and the complement of credibility changes just discussed, Board staff developed indications which it said the Board should use in assessing the reasonableness of the proposed Sonnet rates. Sonnet's proposed overall all-coverages rate increase is 50.1%, which the Board compares to the staff indications of +65.8%.

[17] The Board observes that for all coverages except Bodily Injury, Uninsured Automobile, and Specified Perils, the proposed changes are lower than the staff indications. The company proposed to leave SEF #44 (Family Protection Endorsement)

unchanged, despite an indicated increase. Most coverages will see large increases. Board staff observed that the proposed rates are likely to produce an ROE which is less than the target 12%.

[18] Board staff have recommended that the Board approve the proposed rates, even though the proposed changes are large. The Board has considered that Sonnet's previous application, in which it proposed no changes despite indicated increases, has resulted in a situation where the company must now respond to its rate inadequacy. The Board understands that Sonnet was in the early stages of its business development at the time of the last application; however, the Board notes that now having to seek approval for large increases demonstrates the importance of following the indications more closely. The Board does not want companies to charge rates which are inadequate to support their business. The Board considers that having a range of providers of automobile insurance in Nova Scotia is desirable for consumers. The financial security of those providers is equally desirable. Therefore, the Board accepts the staff recommendation to approve the proposed rates and finds them to be just and reasonable.

Territorial Differentials

[19] When Sonnet made its first application for approval of rates in Nova Scotia, it based its territories and territorial definitions on those which Economical was then using. Economical later made changes to its territorial differentials, but Sonnet did not adopt them in its last application. Sonnet's territorial differentials are no longer aligned with Economical. In this application, Sonnet again relied on the territorial analysis conducted by Economical because that data is more credible and allows the company to determine the differences between rating territories and to establish appropriate differentials.

Sonnet proposed, therefore, to set its differentials equal to those used by Economical and off-balanced the impact of the change as part of its off-balancing the impact of all rating variable changes in order to make the changes revenue-neutral.

[20] Sonnet's proposal will result in the two companies again being aligned for territorial differentials. Board staff have recommended approval of the proposal. The Board accepts the recommendation.

Changes to Rating Variables

[21] Sonnet considered the results of a Generalized Linear Model analysis which Economical provided in its most recent private passenger vehicle application to the Board. To address concerns about profitability and its mix of business, Sonnet used this analysis, as well as its own competitive information to propose changes to several of its rating variables. The Board notes that Sonnet combined the impact of all the changes and off-balanced the total impact in order to make the changes revenue-neutral.

Annual Distance

[22] Since this information is self-reported and unverified, Sonnet saw this variable as an opportunity for fraud, and thus it chose to adopt the Economical differentials, which, given the involvement of brokers, may be less subject to fraud concerns.

Vehicle Age

[23] Sonnet proposed to align its differentials for all coverages with those of Economical. This change will provide more segmentation and give a higher discount for older vehicles. Sonnet also proposed to apply this rating variable to Third Party Liability

and Direct Compensation Property Damage (DCPD) coverages where it is currently not used.

Years Licensed x Driver Gender Interaction

[24] Sonnet stated that it underwrites more policies for inexperienced drivers than Economical does, and these drivers are therefore over-represented in its business. Sonnet's competitive analysis shows that the company is underpriced for drivers licensed for 20 years or less, and especially so for drivers licensed less than 10 years. The opposite applies to drivers licensed 21 years or more. Sonnet and Economical are not currently aligned for this rating variable. Sonnet proposed to align them by using the Economical differentials for Third Party Liability, DCPD and Accident Benefits coverages. Sonnet proposed to leave its other differentials for this variable unchanged.

Driving Record

[25] Economical uses a rating variable for driving record for Comprehensive and Specified Perils coverages. Sonnet proposed to add the same variable using Economical differentials.

Conviction-Free Discount

[26] Where all regular or frequent operators of the insured vehicle are conviction-free for the past three years, Sonnet currently offers a 15% discount. Sonnet proposed to adopt the Economical differentials, which would increase this discount to 25% for Third Party Liability coverage and 22% for Uninsured Motorist coverage.

Minor Conviction Factors

[27] Sonnet explained that a high number of the risks it has underwritten have at least one minor conviction. The proportion of these risks in the Sonnet portfolio is much

higher than observed for Economical. In order to address this increased risk exposure, Sonnet proposed increasing the differentials for drivers with at least one minor conviction in the past three years by 20%. While the company would still use the same conviction classification as Economical, the new Sonnet differentials would be 20% higher. Sonnet's intention is to provide some deterrent for these risks.

Major and Serious Conviction Factors

[28] Sonnet currently uses differentials that result in the same factors for major and serious convictions as Economical. However, Sonnet underwrites a larger percentage of these risks. Sonnet proposed to increase the differentials for drivers with at least one such conviction by 20% and hopes that this change will deter such risks.

Cancellation for Non-Payment of Premium

[29] Sonnet currently applies a differential that results in a 25% surcharge when a client has had a policy cancelled for non-payment of premium in the past three years. Sonnet said the proportion of risks with this surcharge in its portfolio is about eight times that observed for Economical. The company said that being a direct to consumer underwriter exposes it to considerable risk of fraud and may result in more of these non-payment cancellation risks seeking insurance with Sonnet. To discourage these risks, the company proposed to increase the surcharge by tripling its current 1.250 differential. Board staff stated, however, that Sonnet had not provided any evidence to suggest the resulting 275% surcharge is reasonable.

[30] Board staff advised that Economical has a 100% surcharge for such risks and agreed that an increase in the 25% surcharge Sonnet currently uses is warranted. Board staff recommended that for consistency with the changes in the conviction

differentials, which set the Sonnet differentials 20% higher than Economical's, the Board should reject the proposed 3.750 differential, and instead approve a more appropriate 2.400 differential. Board staff stated that if the recent underwriting rule changes and this new differential do not result in the percentage of risks with non-payment cancellations reducing to a reasonable level, the company would be free to apply for a further increase in the differential in a future filing.

[31] With respect to all the rating variable changes, the Board notes that the nature and delivery of Sonnet's business may contribute to those aspects of its experience which have led to less desirable risks. However, the Board is satisfied that in making these changes as well as the previously approved underwriting changes, Sonnet is addressing the issues. Therefore, the Board approves the changes, subject to the use of the 2.400 differential for the cancellation for non-payment of premium. Sonnet will have to redetermine the off-balancing calculation as a result of this change. The company is to file revised rates within 10 business days of the date of this decision to reflect those changes. Once they are approved by the Board, an order will issue.

Introduction of Group Discount

[32] Sonnet proposed to introduce a Group Discount of 7% for groups consisting of a mix of occupations: professionals, alumni, employer groups, credit unions and labour unions. All these groups meet the definition of eligible group in the *Regulations* and represent a permitted risk-classification factor. Sonnet hopes that offering this discount will attract better risks, but did not provide any actuarial analysis to show the discount level is appropriate. Instead, Sonnet noted that several of its competitors offer a group discount at similar levels. The Board wants to ensure that, given the on-line nature of

Sonnet's business, the group discount will be limited to eligible persons. Board staff advised that Sonnet provided an explanation of how it will verify group membership. The Board accepts the recommendation of Board staff to approve the proposed group discount.

III SUMMARY

[33] The Board finds that the application follows the *Act* and *Regulations*, as well as the *Rate Filing Requirements*.

[34] The Board finds the proposed rates and changes to the risk-classification system, with the changes directed in Paragraph [31], will be just and reasonable, and approves the changes effective January 23, 2020, for new business and March 1, 2020, for renewal business.

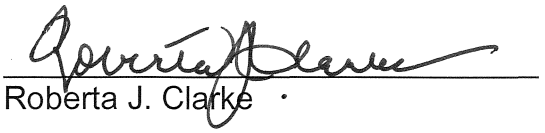
[35] The financial information supplied by Sonnet satisfies the Board, under Section 155I(1)(c) of the *Act,* that the proposed changes are unlikely to impair the solvency of the company.

[36] This application qualifies to set a new mandatory filing date under the *Mandatory Filing of Automobile Insurance Rates Regulations*. The new mandatory filing date for Sonnet for private passenger vehicles is September 1, 2021.

[37] Board staff reviewed Sonnet's Automobile Insurance Manual filed with the Board. Board staff did not find any instances where the Manual contravened the *Act* and *Regulations*. Sonnet must file an electronic version of its updated Manual, within 30 days of the issuance of the order in this matter.

[38] After Sonnet files revised rates in accordance with the directions in Paragraph [31] and they are approved by the Board, an order will issue accordingly.

DATED at Halifax, Nova Scotia, this 9th day of January, 2020.



Roberta J. Clarke