The Capital Maintenance Provision Proposal by Manitoba Public Insurance

Manitoba Public Insurance

2019/20 GRA

Consumers' Association of Canada (Manitoba)

Submitted by the Public Interest Law Centre

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This report reviews the appropriateness of the introduction of the concept of a Capital Maintenance Provision (CMP) in the 2019 Manitoba Public Insurance (MPI) General Rate Application (GRA). This report is related to Dr. Wayne Simpson's evidence "The Role of the DCAT and Interest Rate Forecasting in the 2019 MPI GRA" because the CMP is a new complication in the journey to consensus on the setting of MPI's Rate Stabilization Reserve (RSR) range. The introduction of the new concept of a CMP is contrary to the work that has been done to date on this subject.

Relying on a naïve forecast of interest rates, MPI, in its 2019 GRA to the Public Utilities Board (PUB), has applied for a 2.2% overall increase in Basic vehicle premiums. This increase is comprised of a 1.1% decrease based on Accepted Actuarial Practice in Canada (including a 1.2% decrease in the required rate change due to the investment income earned on the Rate Stabilization Reserve (RSR)) and a 3.3% increase for the newly introduced CMP.

The CMP is calculated based on a projected Minimum Capital Test ratio for fiscal year end 2019/20 that remains unchanged from the projected MCT ratio at fiscal year-end 2018/19. The MCT ratio forecasted for the fiscal year end 2018/19 includes the applied for rate change of -1.1%.

There are several issues with the introduction of a Capital Maintenance Provision to the 2019 GRA which are outlined below.

1. **The CMP was never approved by the PUB nor was consensus reached on it by the stakeholders.**

A technical conference was held on March 2, 2018 with the goal of reaching consensus on a Capital Maintenance Provision, as well as seeking consensus on certain matters relating to the interpretation of rate setting in accordance with Accepted Actuarial Practice in Canada. On review of the transcript of this technical conference and the notes distributed it is clear that no consensus was reached and the exchanges did not indicate that MPI would introduce a CMP in the 2019 GRA. In Order 130/17 the PUB expressed some support for the concept of a CMP but did not direct the Corporation to include this in the 2019 GRA. From Page 5 of Order 130/17 the PUB asks that "a technical Conference be held on the issue, and any findings therefrom be incorporated into the 2019 General Rate Application (GRA)." The technical conference did not conclude that a CMP was required in addition to the RSR. Therefore, it was not appropriate to rely on a claim of consensus to introduce a CMP in the 2019 GRA. In response to CAC (MPI) 1-72 the Corporation states "After hearing from PUB advisers and representatives from SGI and the CAC, the Corporation agreed that it was appropriate to include a Capital Maintenance Provision in the 2019 GRA." A full review of the transcript of the technical conference held gives no indication that the Consumers Association of Canada (CAC) supports the use of a CMP.

2. **The CMP has not been vetted by the public.**

When asked in Information Request CAC (MPI) 1-1 what steps had been take to engage with Manitoba consumers/ratepayers on the concept of the capital maintenance provision the Corporation responded that they "did not consult ratepayers/consumers on any of the above noted issues". The Corporation stated reasons for this such as "Anyone wishing to voice support or opposition to the requested rate change can do so through the PUB's online comment tool, in writing, or in person at the public hearing itself. Anyone wishing to test the rate request can apply for standing as an intervener or, presumably, seek to have an existing intervener advance any concerns on their behalf." and that complex issues "are unlikely to garner constructive feedback through a public consultation process." In response to CAC (MPI) 2-25 MPI states "Broader public understanding and/or support for the rate requests, while desirable, does not influence MPI's decision to apply for rates or capital provisions as mandated by the Act."

The introduction of the CMP into the 2019 GRA is a significant change in the requested rate change calculations and theoretical approach to capital by the Corporation. The public deserves to have its voice heard on this significant change. We would argue that the concept is not overly complex and that a lay person would be very clear on it if explained in non-technical language.

The use of a CMP was supported by the use of one by Saskatchewan Government Insurance (SGI). This is not valid because SGI does not put through rate changes every year and their methodology has only been reviewed in one rate program (2014). It has not been put through any sort of public review in Saskatchewan, as indicated by Chris McCulloch of SGI during the technical conference. The last rate change in Saskatchewan was effective August 31, 2014 when the government of Saskatchewan approved a 3.4% rate increase by SGI plus a 1.0% increase to the capital amount for a total overall average increase of 4.4%. SGI's rate and capital needs cannot be compared to MPIs because SGI's rates are not reviewed annually and increases taken annually when warranted.

3. **The CMP does not align with Accepted Actuarial Practice in Canada.**

In response to CAC (MPI) 1-78 the Corporation states that it "is not aware of the existence of any industry, gray and peer-reviewed literature regarding the need for and the methodology to establish a Capital Maintenance Provision (CMP) for non-profit, monopoly, public auto insurers, and therefore did not review any. The CMP is simply a tool for maintaining capitalization from year-to-year, based on a standard industry measure of capitalization (i.e. the Minimum Capital Test ratio). Even if such literature existed, the Corporation does not believe it was necessary, in the circumstances, to review it in order to recognize the need for a CMP and to establish the methodology."

This response makes it clear that the use of a CMP is not normal actuarial practice and is not supported by any type of analysis or research in the industry.

4. **The use of an MCT target to set a CMP level is arbitrary and not board approved.**

In response to CAC (MPI) 1-74 the Corporation states that it "does not believe that the use of an MCT ratio equal to the projected ratio is the "ideal" MCT ratio to rate to. In this case, it is simply the MCT ratio at which capitalization is maintained for the 2019/20 fiscal year, the year the rates applied for are written. It is inappropriate to target a capital maintenance provision (CMP) beyond the fiscal year 2019/20, as any rate changes approved in the 2020 GRA could affect the 2020/21 fiscal year."

This response makes the point that the MCT used to calculate the proposed CMP in the 2019 GRA has no basis in actual capital need but is an arbitrary figure used to force through a CMP in this application. The application does not put forth a clear explanation for the use of an MCT ratio that would be appropriate to determine a rate increase.

The Board has shown support for setting the required capital range for the Corporation based on the DCAT analysis. From Board Order 130/17 Page 79 "the Board understands the merits of the MCT for providing a relatively simple, convenient and objective metric of Basic's relative financial strength. Nevertheless, the Board continues to prefer to have the upper threshold determined in a like manner to the lower threshold, thereby directly reflecting Basic's risk profile through scenario testing substantially modeled from Basic's own experience."

The determination of a required rate increase to ensure a constant MCT is contrary to the PUB's preference that the DCAT analysis be used to determine rate need based on the Corporation's risk profile.

5. **The CMP does not align with the Board approved methodology for calculating the amount of capital the Corporation requires nor is it consistent with work to date.**

Board Order 130/17 directive 11.20 states "For fiscal year 2017/18, the lower threshold for the Basic Total Equity will be $180 million, based on the iterative modelling approach over a two-year time horizon at a 1-in-40-year (97.5th percentile) outcome level after routine management / regulatory actions". Board Order 130/17 directive 11.21 states "For fiscal year 2017/18, the upper threshold for Basic Total Equity will be $325 million, based on the iterative modeling of a 1-in-40-year scenario over a two-year time horizon after routine management / regulatory actions."

The proposed CMP does not align with this directive and has not been approved for use by the Board.

From Board Order 130/17 page 29: "The Board finds the Corporation's approach, in excluding the expected return on investment assets supporting Basic Total Equity, to be inconsistent with the break-even objective that has been a foundation of Basic rate-setting. The Corporation estimated that including this source of revenue in estimating the Basic overall rate indication reduces its estimate of the Basic overall rate indication from a 2.7% increase to a 1.6% increase, a decline of 1.1 percentage points, based on an assumed Basic capital level in line with the Application's financial forecast. While the Board does consider this approach to be inconsistent with the break-even objective, the Board appreciates the need to protect Basic's capital position against depletion due to the natural growth in Basic's risk profile, i.e., the expectation for Basic claim liabilities (and investment portfolio) to grow over time since the addition of new claims is expected to outpace the settlement and closing of old claims. The Board believes a properly constituted Capital Maintenance Provision, loosely based on that developed by Saskatchewan Auto Fund, can legitimately be considered as a necessary Basic expense cash flow for rate-setting purposes while remaining consistent with the break-even objective."

When reviewing this excerpt it is important to consider that the RSR balance goes from an actual of $211 million in 2017/18 to forecasts of $254 million and $280 million in 2018/19 and 2019/20, respectively, with MPI's proposal. The profit of the Corporation is forecast to be $18 million in 2019/20 based on MPI's proposal (PF.1). MPI's capital position is such that even with no rate increase the forecasted RSR balance at the end of 2019/20 is at 84% ($257/$305) using the method MPI is suggesting and at 102% ($257/$251) using the PUB approved method as a percentage of the top end of the RSR range. This indicates that there is no urgency to implement any sort of capital build provision. These figures are not consistent with a break even objective.

In response to CAC (MPI) 2-20 a) the Corporation states "The forecasted implementation of the Corporation's new investment portfolio has lowered the minimum of the RSR range as of February 28, 2019. However, a Capital Maintenance Provision is required to offset the decline in the MCT ratio from February 28, 2019 to February 29, 2020." and in b) "The Corporation is applying for a 0.1% rate increase with a 2.1% Capital Maintenance Provision. The Corporation believes that the 2.1% Capital Maintenance Provision is fair to rate payers because: i) it represents the increased risk associated with the natural growth of the business as a result of the new policy holders; and ii) it maintains the capital level that protects rate payers from potential rate shock from future unforeseen adverse events." It is difficult to reconcile these assertions with the reality that the DCAT analysis has shown that the risk profile of the Corporation requires a decrease in the RSR range. The RSR range will go up in dollar terms as the size of the Corporation increases. This negates the need for a CMP.

6. **The introduction and basis for a CMP in the 2019 GRA is incomplete.**

In response to CAC (MPI) 1-74 the Corporation states that "The use of a CMP, as calculated in the current rate application, does not result in the need for a rebate in the future. Rebates would be determined based on the upper RSR target and/or the application of a Capital Release provision (presently not in place). Regardless of the capitalization level of Basic, the Corporation still calculates the appropriate CMP for the policyholders in a particular year. The Corporation then determines the need for a build (surcharge) or release (rebate), based on the current level of the MCT, relative to the lower and upper RSR targets. If the MCT ratio were above the upper RSR target range, the Corporation would likely request a rebate. The Corporation is currently developing a Capital Management Plan to, among other things, address this question. However, for the current GRA, the 2018/19 MCT ratio is within the calculated lower and upper RSR target. As a result, the Corporation did not request either a rebate or surcharge."

The CMP was introduced in the 2019 GRA without complete review and analysis of the Corporation's actual capital plan and needs. Neither a Capital Release provision nor a Capital Management plan have been reviewed and analyzed.

Further, the introduction of a CMP to the process is contrary to the work that has occurred in prior years to bring the DCAT and RSR range discussion to the point it is now. The Board has shown support for the use of the DCAT adverse scenarios to set the lower and upper targets for the RSR. The DCAT links the Corporation's risk profile to the amount of capital it should hold to withstand plausible adverse scenarios. In response to CAC (MPI) 2-18 the Corporation states "In short, while the RSR target levels will move over time based on changes to the Company's risk profile and resulting DCAT analysis – the CMP is needed to ensure that the actual capital position does not deteriorate with changes in Basic's risk profile, as measured by the MCT ratio." This suggests that the use of the DCAT to set the RSR range will adjust to any changes in the Corporation's risk profile and, therefore, go up as needed to fit that profile. A CMP is not needed on top of a carefully analyzed DCAT and resulting RSR range.

7. **The introduction of a CMP in the 2019 GRA would introduce intergenerational inequity.**

With a CMP in place the Corporation is building capital by collecting extra premium from those policyholders in place during the rating year in question. The capital collected is built up until a rebate is required. This creates a separation from those rate payers who contributed the dollars to build the Corporation's capital up and those who would receive the rebate.

In response to CAC (MPI) 2-11 a) MPI argues that "Prudent fiscal management requires MPI build capital in advance of adverse events, so as to protect ratepayers against rebuilding fees, and insulate the province's consolidated financial statements." We would argue that going through the DCAT analysis yearly, determining the true capital need of the Corporation based on adverse scenario analysis, determining the RSR range based on the adverse scenario results and holding capital within the RSR range is prudent fiscal management and that holding capital on top of what is held within the RSR range is improper use of rate payers money.

Conclusion

The recommendations below are based upon the belief that MPI should hold capital within a RSR range determined by a fully vetted DCAT process and charge rates that will keep capital within that range until the next DCAT process determines a new range. This will allow policyholders to have confidence in MPI's continued strong financial position.

Recommendations:

1. The PUB order that the CMP be removed from the 2019 GRA.
2. The DCAT methodology should be used to set the RSR range.
3. The PUB approve a decrease in rates based on the 50/50 interest rate forecast and Accepted Actuarial Practice in Canada, that would include the investment income on the RSR.

Appendix A:

Statement of Qualification and Duties – Dr. Wayne Simpson

Qualifications

Dr. Wayne Simpson has a PhD from the London School of Economics (1977) and is a Full Professor in the Department of Economics at the University of Manitoba, where he has taught since 1979. His areas of academic expertise include labour economics, applied econometrics, applied microeconomics, quantitative methods, and economic and social policy analysis.[1] He has authored or co-authored three books and more than sixty peer-reviewed articles on these and related topics, including two papers on the impact of risk on the behaviour of the firm. He is currently on the editorial board of Canadian Public Policy, Canada's foremost peer-reviewed academic journal for economic and social policy, and served on the executive council of the Canadian Economics Association. He was a 2014 recipient of the McCracken award for the development and analysis of economic statistics from the Canadian Economics Association. Dr. Simpson's expertise in applied microeconomics and econometrics are especially relevant to this hearing on Manitoba Public Insurance ("MPI") rates. Applied microeconomics is the study of the behavior of individual agents (e.g., firms and households) in the market using modern theory and empirical methods. It seeks to apply the analysis to practical problems such as risk management and investment strategies. Applied econometrics uses specific statistical techniques, particularly regression methods, to analyze and predict economic behavior and apply it to practical social problems.

In addition to his academic career, Dr. Simpson has worked at the Bank of Canada, the federal Department of Labour, and the Economic Council of Canada. He has also served as a consultant to the private sector and government, primarily in the areas of labour economics and policy evaluation. In recent years, he has served as an expert advisor to Prairie Research Associates (PRA) Inc. and Human Resources and Skill Development Canada as well as to CAC Manitoba through the Public Interest Law Centre.

Wayne Simpson has provided expert evidence at the Public Utilities Board including at the 2014 Needs for and Alternatives to Review of Manitoba Hydro's Preferred Development Plan, the 2007-2008 and 2016 hearings to determine maximum fees for payday loans and the 2007, 2010, 2013, 2014, 2016 and 2017 Manitoba Public Insurance Rate Applications on the Rate Stabilization Reserve and investment strategy. He also provided written evidence in the 2013 payday loan review.

Wayne Simpson relies on his expertise in applied econometrics, applied microeconomics, and social policy application and analysis in this proceeding. Dr. Simpson's curriculum vitae was

1 His professional expertise in applied microeconomics and applied econometrics provides a foundationfor the analysis of issues related to the management of risk by firms and to the assessment of risk using modern economic and statistical techniques. His expertise also provides a framework to assess the contributions of equities, bonds and interest rates to investment risk.

filed with the Manitoba Branch of the Consumers' Association of Canada's application to intervene in this proceeding.

Duties

The following duties were assigned to Dr. Simpson in the MPI General Rate Application. The Public Interest Law Centre retained Dr. Simpson's services to assist the Manitoba Branch of the Consumers' Association of Canada with its participation in the Public Utilities Board review of MPI's Application on issues related to ratemaking and interest rates.
Dr. Simpson's duties include:

- Reviewing the application;
- Preparing first round information requests;
- Reviewing responses to first round information requests and preparing second round information requests;
- Preparing memos to client and legal counsel;
- Preparing written evidence; and
- Preparing for and attending the hearing.

Dr. Simpson's retainer letter also includes that his duty in providing assistance and giving evidence is to help the Public Utilities Board. This duty overrides any obligation to CAC Manitoba.

Appendix B:

Statement of Qualification and Duties – Ms. Andrea Sherry

Qualifications

Andrea Sherry received her Bachelor of Commerce (Honors) in December 1990 from the University of Manitoba with a major in Actuarial mathematics. She became a Fellow of the Casualty Actuarial Society and Fellow of the Canadian Institute of Actuaries in 2000. She became a Fellow Chartered Insurance Professional and received her Canadian Risk Management designation in 2005. She became a Certified Management Accountant in 2008 and is now a Chartered Professional Accountant, Certified Management Accountant.

Andrea Sherry is currently Vice President, Insurance Solutions at The Wawanesa Mutual Insurance Company in Winnipeg. In her current role, she is responsible for the company's actuarial pricing, product development and maintenance, as well as head office personal lines underwriting. Prior roles include work in solvency and capital, enterprise risk management and investments. She has had appointed actuary and valuation actuary roles prior to joining Wawanesa. She has worked on Dynamic Capital Adequacy Testing and internal models to satisfy the regulatory requirements in the United Kingdom (where internal models to determine capital adequacy are used by larger companies). She has also been involved in the preparation of an Own Risk Solvency Assessment.

Andrea has worked in the Property & Casualty insurance industry for over 25 years and will rely on all of the expertise she has gained, with particular emphasis on her expertise in actuarial work and investments.

Ms. Sherry's curriculum vitae was filed with the Manitoba Branch of the Consumers' Association of Canada's application to intervene in this proceeding.

Duties

The following duties were assigned to Ms. Sherry in the MPI General Rate Application. The Public Interest Law Centre retained Ms. Sherry's services to assist the Manitoba Branch of the Consumers' Association of Canada with its participation in the Public Utilities Board review of MPI's Application on issues related to actuarial ratemaking.

Ms. Sherry's duties include:

- Assist in Interim Vehicle Hire Rates and Technical Conferences;
- Review of overall indication (actuarial report including long tail experience, claims forecast, actuarial rate indication calculation);
- Review of rates and methodology of Driver Safety Rating;
- Review of rates and methodology of Vehicles for Hire;
- Critical Review of Capital Maintenance Provision;
- Review for reasonableness and industry comparison of Asset Liability Management study;
- Develop first round Information Requests;

- Review RSR/DCAT submission;
- Review of first round Information Request responses;
- Develop second round Information Requests;
- Review second round Information Request responses; and
- Hearing preparation.

Ms. Sherry's retainer letter includes that she is to provide evidence that:

- is fair, objective and non-partisan;
- is related only to matters that are within her area of expertise; and
- to provide such additional assistance as the Public Utilities Board may reasonably require to determine an issue.