ICBC Insurance Corporation of British Columbia

Chapter 4

Section III

ICBC Capital Requirements

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1 ICBC Capital Requirements

Insurance companies require capital in order to absorb unexpected losses arising from unusual events and factors, and to protect policyholders. ICBC's need for capital is recognized in Special Direction IC2 (see Appendix 4.III.A) which provides that ICBC as a whole must achieve capital available of at least 110% of MCT by December 31, 2014 and maintain that capital available thereafter[1]. For the purpose of determining ICBC's overall capital requirement, the Commission is directed to set Basic insurance rates in a manner that allows the Basic insurance business to achieve capital available of 100% of MCT by December 31, 2014 and to treat ICBC's Optional insurance as having capital available of 170% of MCT.[2]

"MCT" is defined in Special Direction IC2 by reference to the federal *Insurance Companies Act* and guidelines issued by the Office of the Superintendent of Financial Institutions (OSFI)[3]. OSFI is the primary regulator of federally chartered insurers, and has established an overall minimum capital framework for insurers. OSFI uses a risk-based formula called the Minimum Capital Test or "MCT" to determine an insurer's capital available and capital required.

The MCT represents the ratio of capital available to the capital required. Capital available consists of equity, subordinated debt and a recognition of a portion of the excess of the market value of investments over book value.

Capital required consists of the sum of:

- Capital for on-balance sheet assets (For example, government bonds do not attract capital requirements, but corporate bonds do);
- Margins for premiums[4];
- Margins for unpaid claims liabilities;

[1] Special Direction IC2 to the British Columbia Utilities Commission, BC Reg 647/2004 and 678/2004, Section 3(1)(b)
[2] Ibid, Section 3(1)(b)(i) and (ii). ICBC is in fact required to allocate its existing capital as at January
[3] Ibid, Section 1
[4] The greater of 50% of premiums written and 100% of net unearned premium

- Catastrophe reserves;
- Amount for reinsurance ceded to unregistered reinsurers; and
- Capital for off-balance sheet exposures.

For more details of the MCT calculation, refer to OSFI Guideline at www.osfi-bsif.gc.ca/eng/documents/guidance/docs/MCT_Guideline_e.pdf.

OSFI establishes the target minimum capital by assessing the risk associated with assets, policy liabilities, and off-balance sheet exposures. OSFI's industry standard is that property and casualty insurance companies will establish and maintain a target minimum capital level of at least 150% MCT to cope with volatility in markets and economic conditions, and to provide for risks not explicitly addressed in the calculation of policy liabilities or the MCT.

To date, ICBC has been operating on a lower level of capital relative to industry requirements because ICBC has not been subject to regulatory minimum requirements, and because the *Insurance Corporation Act* permits the provincial government to pay to the corporation the amount by which its liabilities exceed its assets[5]. Special Direction IC2 now requires ICBC to achieve by December 31, 2014 and maintain thereafter an overall capital available target of 110% of MCT, and for that purpose, requires Basic insurance rates to include the amount necessary for the Basic insurance business to achieve capital available of 100% of MCT[6]. In addition, Special Direction IC2 requires ICBC to allocate its existing capital as at January 1, 2004 (the beginning of ICBC's 2004 fiscal year) so that Optional insurance has capital equal to 170% of MCT in its 2004 fiscal year[7].

[5] Ibid, Section 28
[6] Ibid, Section 3(1)(c)(iii) and 3(1)(b)(ii)
[7] Ibid, Section 4(1)(c)(i)

The following figure illustrates the capital available, capital required and 100% of MCT amount (minimum capital required) as at December 31, 2004 for the Basic insurance business, after the allocation to the Optional insurance business of the amount required for Optional insurance to achieve 170% of MCT.

Figure 4.III.1 – ICBC Basic Insurance Capital Available/Required/MCT

($ millions)		Basic Insurance
Capital available:		
Retained earnings as at December 31, 2003	$	25.0
Excess of market value over book value of investments		121.5
Adjustment for assets with a capital requirement of 100%		(11.3)
Capital available at December 31, 2003		135.2
Outlook for the year ending December 31, 2004		(19.8)
Capital Available at December 31, 2004	**$**	**115.4**
Capital required:		
Balance sheet assets	$	208.0
Margin for Unpaid claims		336.4
Margin for premiums		66.8
Off balance sheet exposures		0.3
Minimum Capital Required (100% of MCT)	**$**	**611.5**
Projected Capital Deficiency at December 31, 2004		**(496.1)**

At December 31, 2003, the retained earnings for ICBC as a whole were $535.9 million. ICBC has allocated $510.9 million from retained earnings to its Optional insurance business. This amount, together with market value adjustments for investments and adjustments for assets, results in the allocation of capital available sufficient for the Optional insurance business to achieve 170% of MCT, as required by Special Direction IC2.

The allocation to the Optional insurance business has resulted in an allocation of the balance of ICBC's retained earnings in the amount of $25 million and capital available in the amount of $135.2 million (both as at December 31, 2003) to the Basic insurance business as required by Special Direction IC2[8]. However, adjustments to the retained earnings applicable to Basic insurance business have been made to reflect the projected 2004 Basic insurance business net loss to arrive at the projected balance of capital available of $115.4 at December 31, 2004.

The required capital available for the Basic insurance business to achieve 100% of MCT is $611.5 million (projected at December 31, 2004). As a result of the allocation of capital available as required by Special Direction IC2, the deficiency in the required capital available for the Basic insurance business to achieve 100% of MCT, projected at December 31, 2004, is approximately $496.1 million.

Recognizing that ICBC historically has not maintained capital at levels approaching industry levels, Special Direction IC2 directs that the deficiency in capital available be gradually built up over a transition period of ten years, ending December 31, 2014. ICBC's approach is to build capital within that period in a manner that protects Basic insurance ratepayers from the volatility that can result from the need to make annual adjustments to the deficiency and the amount of capital required to correct the deficiency. ICBC's goal is smooth, stable and predictable Basic insurance rates.

[8] Ibid, Section 4(1)(c)(ii)

The ten-year timeframe does provide flexibility for ICBC to structure the build-up of capital in a way that recognizes that there will be different factors from year to year which affect capital, either negatively or positively. For example, in the 2005 rate year, there is significant uncertainty that continues to exist with respect to the anticipated changes to the Court Tariff for party-and-party costs and the costs that Basic insurance will incur as a result of those changes.

In order to determine the amount that should be included in 2005 Basic insurance rates on account of the Basic insurance business capital deficiency, ICBC evenly distributed the $496.1 million deficiency over the permitted ten-year period. The amount required to build capital on an even distribution basis would be approximately $50 million per year.

However, an even distribution assumes that the capital deficiency and all factors that may influence smooth, stable and predictable rates remain constant over the ten-year period. Because the capital deficiency and the factors that influence smooth and stable rates will not remain constant, ICBC is required on an annual basis to look at the various known factors that may require either an upward or downward adjustment in the amount of capital that should be included in Basic insurance rates in a particular year.

As noted above, the uncertainty with respect to the Court Tariff for party-and-party costs is a factor of some significance influencing Basic insurance rates. Because ICBC cannot predict the impact of the Court Tariff increase in the 2005 rate year with certainty, it will require some provision for capital in the 2005 Basic insurance rates to address the capital deficiency. ICBC has determined that the appropriate amount to include in the 2005 Basic insurance rates on account of the capital deficiency is $25 million. Accordingly, ICBC has requested Eckler Partners Ltd. to incorporate $25 million on account of capital in the actuarial rate level indication included in this filing.

APPENDIX 4.III.A – Special Direction IC2

PROVINCE OF BRITISH COLUMBIA

ORDER OF THE LIEUTENANT GOVERNOR IN COUNCIL

Order in Council No. 647 *, Approved and Ordered* JUN 3 0 2004

~~Lieutenant Governor~~
Administrator

Executive Council Chambers, Victoria

On the recommendation of the undersigned, the ~~Lieutenant Governor~~ Administrator, by and with the advice and consent of the Executive Council, orders that

(a) Special Direction IC1 to the British Columbia Utilities Commission, B.C. Reg. 321/2003, is repealed, and

(b) the attached Special Direction IC2 to the British Columbia Utilities Commission is made.

Attorney General and Minister Responsible for Treaty Negotiations

Presiding Member of the Executive Council

(This part is for administrative purposes only and is not part of the Order.)

Authority under which Order is made:

Act and section:- *Insurance Corporation Act*, R.S.B.C. 1996, c. 228, section 47
Utilities Commission Act, R.S.B.C. 1996, c. 473, section 3

Other (specify):- oic 806/2003

June 11, 2004

res:b 755 /2004/7

SPECIAL DIRECTION IC2 TO THE BRITISH COLUMBIA UTILITIES COMMISSION

Contents

Definitions

1 In this Special Direction:

"Act" means the *Insurance Corporation Act*;

"capital available" means capital available as that term is defined in

(a) the regulations and guidelines made under section 515 (2) of the *Insurance Companies Act* (Canada), and

(b) the Guidelines for Minimum Capital Test (MCT) for Federally Regulated Property and Casuality Insurance Companies number A-1 dated July, 2003 issued by the Office of Superintendent of Financial Institutions;

"MCT" means MCT as that term is defined in

(a) the regulations and guidelines made under under section 515 (2) of the *Insurance Companies Act* (Canada), and

(b) the Guidelines for Minimum Capital Test (MCT) for Federally Regulated Property and Casuality Insurance Companies number A-1 dated July, 2003 issued by the Office of Superintendent of Financial Institutions.

Application

2 This Special Direction is issued to the commission under section 47 of the Act and section 3 of the *Utilities Commission Act.*

Directions relating to the corporation generally

3 (1) With respect to the exercise of its powers and functions under the Act in relation to the corporation generally, the commission must do the following:

(a) set, for 2004, a net income target for the corporation generally, in the amount of $36 million;

(b) require the corporation to achieve, by December 31, 2014, and to maintain, after that date, capital available equal to at least 110% of MCT;

(c) subject to paragraph (e), for each year for which it fixes universal compulsory automobile insurance rates, fix those rates on the basis of accepted actuarial practice so that those rates allow the corporation to collect sufficient revenue,

(i) for 2004, to achieve the net income target set for that year under paragraph (a),

(ii) for each following year for which rates are set, to pay the following:

(A) the costs that are to be incurred by the corporation in that year for road safety programs under section 7 (i) of the Act, including, without limitation, payments by the corporation to any level of government with respect to road safety;

(B) the costs that are to be incurred by the corporation in that year for vehicle licensing, driver licensing and other services and activities of the corporation under section 7 (g) and (h) of the Act that are to be undertaken in that year in accordance with the agreement, as amended from time to time, entitled "Service Agreement between The Ministry of Public Safety and Solicitor General and the Insurance Corporation of British Columbia" and dated as of September 1, 2003;

(C) the payments that the corporation is to make in that year under the agreement entitled "Memorandum of Understanding between B.C. Provincial Government and ICBC" and executed in February, 2003;

(D) the remuneration that the corporation is to pay in that year to persons appointed as agents by the corporation under section 16 of the *Insurance (Motor Vehicle) Act* for collecting government fees, fines and other amounts payable by the corporation to the government and for collecting premiums, fees, debts and other revenue on behalf of the corporation;

(E) the payments that the corporation is to make in that year under the agreement entitled "Traffic and Road Safety Law Enforcement Funding Memorandum of Understanding" made between the corporation and the government as represented by the Minister of Public Safety and Solicitory General and dated December 2, 2003, and

(iii) for 2004 and each following year for which rates are set, to achieve or maintain, as the case may be, the capital available required by the capital available target established for that year under paragraph (b);

(d) subject to subsection (2) of this section, ensure that universal compulsory automobile insurance rates are not based on age, gender or marital status;

(e) ensure that increases or decreases in universal compulsory automobile insurance rates are phased in in such a way that those rates remain relatively stable and predictable.

(2) The commission may approve universal compulsory automobile insurance rates that provide discounts to or are otherwise preferential for

(a) persons who are at least 65 years of age, or

(b) persons with disabilities.

(3) In regulating and fixing rates for the corporation, the commission must treat any premiums levied under section 34 (1.1) (e) of the *Insurance (Motor Vehicle) Act*

as revenue for the corporation's universal compulsory automobile insurance business.

Directions relating to the corporation's optional automobile insurance business

4 (1) With respect to the exercise of its powers and functions under the Act in relation to the corporation's optional automobile insurance business, the commission

(a) must, for 2004, set a net income target of $0 for the corporation's optional automobile insurance business,

(b) must, for each year after 2004, set a combined ratio target for the corporation equal to the ratio of A to B where

A means the sum of

(i) the incurred losses for the automobile insurance line of business of insurers, other than the corporation, authorized to engage in automobile insurance average over the preceding 5 years, and

(ii) the incurred underwriting expenses for that line of business of those insurers over the preceding 5 years, and

B means the earned premiums for that line of business of those insurers over the preceding 5 years,

(c) must require the corporation to achieve, by December 31, 2010, and to maintain, after that date, capital available in relation to the corporation's optional automobile insurance business equal to at least 200% of MCT,

(d) must require the corporation to do the following, effective the beginning of the corporation's 2004 fiscal year:

(i) allocate to the corporation's optional automobile insurance business the corporation's retained earnings to the extent necessary to allow the corporation to achieve capital available in relation to the corporation's optional automobile insurance business equal to 170% of MCT;

(ii) allocate the balance of the corporation's retained earnings to the corporation's universal compulsory insurance business;

(iii) advise the commission of those allocations,

(e) subject to paragraph (f), must not fix optional insurance rates, and

(f) if the corporation commits or is about to commit an act, or pursues or is about to pursue a course of conduct, that, in the opinion of the commission, is or will prevent the corporation from meeting the targets set by the commission under this section, may, by order, direct the corporation to

(i) cease or refrain from committing the act or pursuing the course of conduct, or

(ii) perform acts that the commission believes are necessary to remedy the situation.

(2) In determining, under section 12 of the *Utilities Commission Act*, whether disclosure of information with respect to the corporation's optional automobile insurance business is necessary for the administration of the *Utilities Commission Act* as it applies to the corporation, the commission must consider the effect of

disclosure of the information on the corporation's ability to compete in the optional automobile insurance market on a basis similar to its competitors and the harm to the corporation's competitive position that may result from the disclosure of the information.

PROVINCE OF BRITISH COLUMBIA

ORDER OF THE LIEUTENANT GOVERNOR IN COUNCIL

Order in Council No. 678 *, Approved and Ordered* JUL - 6 2004

Lieutenant Governor

Executive Council Chambers, Victoria

On the recommendation of the undersigned, the Lieutenant Governor, by and with the advice and consent of the Executive Council, orders that Special Direction IC2 to the British Columbia Utilities Commission, B.C. Reg. 307/2004, is amended as set out in the Schedule.

Attorney General and
Minister Responsible for Treaty Negotiations

Presiding Member of the Executive Council

(This part is for administrative purposes only and is not part of the Order.)

Authority under which Order is made:

Act and section:- *Insurance Corporation Act*, R.S.B.C. 1996, c. 228, section 47

Other (specify):- *Utilities Commission Act*, R.S.B.C. 1996, c. 473, s. 3; oic 647/2004

July 5, 2004 914 /2004/7

SCHEDULE

1 ***Section 3 of Special Direction IC2 to the British Columbia Utilities Commission, B.C. Reg. 307/2004, is amended***

(a) by repealing subsection (1) (b) and substituting the following:

(b) require the corporation to achieve, by December 31, 2014, and to maintain, after that date, capital available equal to at least 110% of MCT, and, for that purpose,

(i) the commission must, in determining capital available in relation to the corporation generally, treat the corporation's optional automobile insurance business capital available as being equal to 170% of MCT, and

(ii) the commission must set rates for the corporation's universal compulsory automobile insurance business in a way that will allow the corporation to achieve, by December 31, 2014, and to maintain after that date, capital available in relation to its universal compulsory insurance business equal to at least 100% of MCT;, and

(b) in subsection (1) (c) (iii), by striking out "2004" ***and substituting*** "2005".

2 ***Section 4 (1) is repealed and the following substituted:***

(1) With respect to the exercise of its powers and functions under the Act in relation to the corporation's optional automobile insurance business, the commission

(a) must, for 2004, set a net income target of $0 for the corporation's optional automobile insurance business,

(b) must require the corporation to achieve by December 31, 2010 and to maintain, after that date, capital available in relation to the corporation's optional automobile insurance business equal to at least 200% of MCT,

(c) must require the corporation to do the following:

(i) as at the beginning of the corporation's 2004 fiscal year, allocate to the corporation's optional automobile insurance business that portion of the corporation's retained earnings for its 2003 fiscal year that is necessary to allow the corporation to achieve, in its 2004 fiscal year, capital available in relation to the corporation's optional automobile insurance business equal to 170% of MCT;

(ii) as at the beginning of the corporation's 2004 fiscal year, allocate the balance of the corporation's retained earnings for its 2003 fiscal year to the corporation's universal compulsory insurance business;

(iii) advise the commission of those allocations, and

(d) must not fix rates applicable to optional insurance.