

SHOULD THE GOVERNMENT RETURN THE \$1.2 BILLION APPROPRIATED FROM ICBC POLICYHOLDERS?**Stabilizing ICBC's Finances and Rebuilding Its's Capital Reserves**

In response to the serious financial crisis at ICBC, minister responsible David Eby has announced a series of planned actions to stem the operating losses. These include capping the pain and suffering portion of minor injury claims, increasing the no-fault accident benefits to recognize current reality, expanding traffic enforcement through higher financial penalties for using electronic devices and expanding the use of intersection cameras.

Also, the government just concluded a public consultation on ICBC Basic rates on the premise that the current balance between low and high-risk drivers was unfair to the good drivers.¹ Some 34,000 responses were received to an online questionnaire; unsurprisingly, most agreed that bad drivers should pay more.²

It is highly likely that most of the respondents would have agreed to a question as to whether the government should return the \$1.19 billion in Optional capital that was appropriated between 2010 and 2015, but this option was not included in the questionnaire.

This paper will review how the return of the Optional capital would help to rebuild the Optional capital reserve to restore the level playing field with private insurers. Information on the rationale for a capital reserve and the calculation of an adequate reserve level can be found in Appendix A.

Capital Destruction

An adequate capital reserve is a requirement for any insurer to protect claimants and avoid rate shock in the advent of an adverse financial event. But the previous provincial government deliberately depleted ICBC's once-healthy reserves to reduce the government's direct borrowing requirements and to subsidize Basic premiums.

Table 1 shows that between 2010 and 2015 the government appropriated approximately \$1.19 billion of Optional policyholders' capital, and from 2012 to 2017/18 a further

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http://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary_icbc_rate_design_8_march_2018_copy/pdf/commentary_icbc_rate_design_8_march_2018_copy.pdf

² <https://globalnews.ca/news/4143022/icbc-bad-driver-survey/>

\$1.88 billion of Optional net income and capital was transferred to the Basic program to keep the MCT ratio above the funding targets.

TABLE 1 – OPTIONAL TRANSFERS AND RESULTING MCT RATIO (\$=million)

	To Prov.	To Basic	Total	Estimated MCT Ratio
2010	575.7	--	575.7	Optional@312 Basic@153
2011	101.4	--	101.4	Optional@317 Basic@115
2012	--	372.6	372.6	Optional@313 Basic@137
2013	237.0	113.2	350.2	Optional@304 Basic@149
2014	138.8	--	138.8	Optional@298 Basic@136
2015/16	138.1	450.0	588.1	Optional@226 Basic@ 99
2016/17	--	373.0	373.0	Optional@132 Basic@103
2017/18	--	569.0	569.0	Optional@ 39 Basic@ 47
2018/19	--	--	--	Optional@ 30 Basic@ 9
Total	1,191.0	1,877.8	3,068.8	

Source: Transfers from 2010 to 2014 from ICBC annual reports; 2015/16 and 2016/17 from BCUC, ICBC 2017 Rate Request, IR 1, RM 1-4, Attachment; 2017/18 as per OICs 614/16 and 326/17.

Note: The Basic MCT ratios until 2016/17 provided in various documents related to Basic rate requests at BC Utilities Commission reviews. All Optional MCT ratios are my estimates, as are the MCT ratios for 2017/18 and 2018/19.

The government ignored the 250%/260% Optional management target after 2014 as Optional capital was depleted at a faster pace to prop-up the Basic capital. The new NDP government continued the pattern in late August when it directed ICBC to transfer a further \$470 million of the diminished Optional reserve to support a 6.4% Basic rate increase for 2017.

ICBC's Growing Capital Shortfall

ICBC's February 2018 service plan financial forecast shows the combined capital reserve (equity) falling from \$2.45 billion on 31 March 2017 to just \$560 million by 31 March 2021.³ This is after an annualized \$1.0 billion reduction in costs resulting from planned changes to the Basic program.

Using the MCT management targets in place in 2017 for the Basic (145%) and Optional (250%) programs,⁴ I estimate that the forecasted 2017/18 capital reserve would be approximately \$3.38 billion below the amount deemed adequate. The adequacy gap grows to approximately \$5.63 billion by 2021/22.

³ <http://www.icbc.com/about-icbc/company-info/Documents/Service-plan-2018-2021.pdf>

⁴ The Basic target was established by the BC Utilities Commission and the Optional target was determined by the ICBC board of directors. The Ernst Young report of 2017 states that the Optional management target is 250%.

Table 1 shows the shortfall to the existing management targets. Except for the Basic for 2014 to 2016/17, these are my estimates as ICBC did not separate the capital reserve by the compulsory Basic or the near-monopoly Optional program.

Table 1 – Estimated Capital Shortfall—Exiting Targets(\$=million)

	BASIC @145%	OPTIONAL@250%	COMBINED
FY2014	107	(308)	(201)
FY2015	800	(350)	450
FY2016/17	595	885	1,480
FY2017/18	1,475	1,900	3,375
FY2018/19	2,325	2,200	4,525
FY2019/20	2,555	2,500	5,055
FY2021/22	2,830	2,800	5,630

Source: Derived from 2016/17 equity from ICBC’s annual report and 2017/18 to 2021/22 from February 2018 service plan.

The Basic program capital reserve slipped below the 145% management target level in 2014. The transfers from the Optional program from 2015/16 to 2017/18 were designed to keep the MCT ratio above the 100% regulatory minimum.

Table 2 shows a large reduction in the capital shortfall for the Basic and Optional programs if the MCT minimum MCT targets were set at 80% for the compulsory Basic program, and 150% for the near-monopoly Optional program.⁵ The combined capital shortfall by 2021/22 would be approximately \$2.7 billion, compared to \$5.6 billion with the higher targets.

Table 2 – Estimated Capital Shortfall—Lower Targets(\$=million)

	BASIC @80%	OPTIONAL@150%	COMBINED
FY2014	(673)	(978)	(1,651)
Fy2015	(39)	(1,040)	(1,079)
FY2016/17	(330)	135	(465)
FY2017/18	500	1,000	1,500
FY2018/19	1,220	1,200	2,420
FY2019/20	1,320	1,400	2,720
FY2021/22	1,400	1,700	3,100

Source: Derived from 2016/17 equity from ICBC’s annual report and 2017/18 to 2021/22 from February 2018 service plan.

If the government returned the \$1.19 billion to the Optional reserve the 2021/22 shortfall would be significantly reduced if the management target MCT ratio was set at 150%.

⁵ The argument that the minimum regulatory targets are too conservative is presented in http://www.bcpolicy Perspectives.com/media/attachments/view/doc/occasional_paper_no_49_21_december_2017/pdf/occasional_paper_no_49_21_december_2017.pdf

The Conflict Between Adequate Reserves and Affordable Rates

In late February 2018, a week after ICBC released its disastrous \$1.39 billion total comprehensive loss forecast for 2017/18, the government abandoned the effort to keep the Basic capital above the minimum target ratio. Announcing a four-year suspension of the 100% MCT minimum requirement,⁶ Minister Eby said that the first goal “is to make sure ICBC stops hemorrhaging money....”and that he expects it will take several years to restore healthy reserves.⁷

Including anticipated savings from the announced reduction in Basic coverage, ICBC’s three-year forecast shows a small combined net profit by 2021/22. However, the forecast shows the capital reserve remaining at dangerously low levels for the forecast period. It would appear the government is unwilling to add a temporary surcharge to the rates to rebuild adequate reserves to ensure financial stability.

Mr. Eby hinted at this trade-off when questioned by Justine Hunter of the *Globe and Mail*; “The nice-to-have, at the end, is a corporation that is financially stable on a go-forward basis that has enough capital in its reserves to cover outstanding liabilities, that is revenue positive and is delivering affordable rates and good benefits....”⁸

The Optional Capital Reserve Gap

ICBC competes with private insurers for the Optional auto insurance market. The private insurers must adhere to the OSFI capital requirements, and many of the larger insurers operate with MCT ratios in the 170% to 200% range.⁹

If the government directs ICBC to operate with little or no capital reserve, it can expect the private insurers to object to the lower rates that ICBC can charge for its Optional product.

Should the Government Return the Appropriated Optional Capital?

In 2010, the government changed the Insurance Corporation Act to allow it to appropriate “excess” Optional capital.¹⁰ The government’s operating debt was increasing because of the economic recession, and the large accumulated capital reserve was viewed as money payable to the taxpayer to reduce the borrowing requirements for operations.¹¹ The *Vancouver Sun* was highly critical of what it termed a “stealth tax,”

⁶ For the rate-setting years from 2018 to 2021.

⁷ <https://www.theglobeandmail.com/news/british-columbia/bc-suspends-icbcs-capital-reserve-minimum-raising-prospect-of-bailout/article38142639/>

⁸ Ibid.

⁹ Intact Financial, the largest private auto insurer in Canada, reported an MCT of 205% for 31 December 2017; https://s1.q4cdn.com/321139868/files/doc_financials/annual/2017/IFC-2017-AR_en.pdf p. 53.

¹⁰ This was the first time in ICBC’s history that the government appropriated ICBC funds; in the late 2000s the government had ordered ICBC to provide customer rebates: see http://www.bcpolicy Perspectives.com/media/attachments/view/doc/article_bc_studies_icbc_2013/pdf/article_bc_studies_icbc_2013.pdf

¹¹ While the transfer reduced the government’s direct borrowing requirement, it did not change the government’s net liability position as the “excess” capital asset offset a greater borrowing requirement.

especially as the accumulated Optional profits resulted from over-charging good drivers so that the private insurers could compete for their business.¹² Mike Farnworth of the opposition NDP (and now minister of public safety) declared the taking an “unprecedented cash grab” and said that ICBC should be allowed to return the surplus to policyholders as a rebate.¹³

Now, some seven years and \$1.2 billion later, the provincial government is enjoying healthy revenues and budget surpluses, and the government “trumpeted” that the operating debt would be eliminated by 31 March 2018.¹⁴

The government should return the appropriated capital to partially rebuild the Optional capital reserve. The reserve funds were appropriated when ICBC’s finances were healthy and the government faced growing debt. Now the situation is reversed. Using the 150% minimum from Table 2, a return of the \$1.2 billion Optional capital would produce an Optional reserve ratio of 100% MCT by 2021/22.

Summary

The government and ICBC have forecast stabilized ICBC’s finances by 2019/18, meaning that the operating losses will end. However, based on the February 2018 service plan, there is no plan to rebuild the Basic and capital reserves within the four-year forecast period.

If the government returned the \$1.2 billion capital taken from 2010 to 2015 the Optional reserves would be greatly strengthened. The government could expect much less criticism from private insurers for underpricing the Optional product.

The Basic reserves should be rebuilt through both a premium surcharge, and the government funding ICBC for programs and social policy costs (such as the 25% seniors’ discount for Basic insurance).¹⁵

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The writer is a retired senior BC government public servant whose paper describing the BC government’s manipulation of the finances of BC Hydro from 2008 to 2014 was published by *BC Studies* in November 2016. *BC Studies* published his paper on the 40-year financial history of ICBC in 2013. He has been an intervener in the BC Utilities Commission’s recent reviews of both ICBC’s and BC Hydro’s rate requests.

¹²*Vancouver Sun*, Editorial, 10 March 2010.

¹³ <https://www.leg.bc.ca/documents-data/debate-transcripts/39th-parliament/2nd-session/20100304pm-Hansard-v10n11#3172> p. 3172.

¹⁴ <http://vancouversun.com/opinion/columnists/vaughn-palmer-so-far-so-good-on-debt-with-carole-james-at-the-helm>

¹⁵ <http://www.bcpolicyperspectives.com/blog/posts/fixing-icbcs-finances-four-changes-the-government>

APPENDIX A

Why Is a Capital Reserve Necessary?

A capital reserve “mitigates the risk of insolvency and protects the interests of ratepayers, and claimants. It ensures that Basic insurance is sufficiently capitalized to provide reasonable comfort that it will be able to meet its policyholder obligations.”¹⁶ An adequate reserve should protect policyholders from rate shocks due to unexpected variances from forecasted results and due to events and losses arising from non-recurring events or factors.

All federally-regulated property and casualty insurers are required to maintain an adequate capital reserve, as measured by the Office of the Superintendent of Financial Institutions’ Minimum Capital Test (MCT) formula. In 2003 the BC government adopted the MCT method for calculating the capital ratios for the Basic and Optional programs, and within a couple of years set the Basic minimum at 100%, and the Optional at 200%. In 2006, the BC Utilities Commission set the Basic “management” target at 130%, while the ICBC board of directors set 260% as the Optional operational target.¹⁷

In 2010 the financially-strapped provincial government amended ICBC’s legislation to permit the taking of all Optional capital in excess of the amount required to meet the 260% management target. From 2010 to 2015 the government appropriated \$1.19 billion from the highly profitable Optional program to reduce the government’s direct debt borrowing requirements.

The government’s rationale of the appropriation was that the Optional program was designed to make a profit, although the transfer of “excess” capital is different than a shareholder dividend. Finance Minister Colin Hansen defended the taking of the capital: “It is entirely appropriate that the provincial government representing the shareholder, which is the taxpayers of British Columbia, ask for those dollars to be transferred into the consolidated revenue so that we can reduce what would otherwise be borrowing requirements of the province.”¹⁸

¹⁶ Manitoba Public Utilities Board <http://www.pubmanitoba.ca/v1/proceedings-decisions/orders/pubs/2017%20orders/130-17.pdf> p. 78.

¹⁷ In 2013 this was raised to 145% to reflect the higher risk of the Basic rate suppression policy.

¹⁸ <https://www.leg.bc.ca/documents-data/debate-transcripts/39th-parliament/2nd-session/20100304pm-Hansard-v10n11#3172> p. 3172.

What Size of Capital Cushion is Adequate?

In my paper “ICBC’s Capital Reserve Limits Are Too High”¹⁹ I summarized the considerations that are involved in determining an adequate capital reserve level.

The 2003 government adopted the federal Office of the Superintendent of Financial Institutions Minimum Capital Test (MCT) formula for calculating the capital reserve risk-weighted ratio. Through cabinet order the minimum Basic MCT ratio was set at 100%, while the minimum Optional ratio was set at 200%.

The BC Utilities Commission determined that a Basic management target of 145% was required (ICBC has recommended 150%), while the ICBC board of directors decided that the Optional management target should be 250%. Using the OSFI formula the annual actual capital reserve can be expressed as an MCT ratio, or the MCT targets can be expressed as the actual capital funding required. The funding amount required will vary depending on the size and mix of assets and liabilities.

APPENDIX B

The Capital Reserve Forecast

ICBC does not separate its service plan forecast between the compulsory Basic and the Optional programs. The writer has estimated the Basic and Optional capital reserves and the MCT ratio for the 2017/18 to 2021/22 period. Table B.1 shows the combined capital reserve and the MCT ratios, with the 2017/18 to 2021/22 information from the February 2018 service plan.

Table B.1 – Change in Combined Capital (\$=million)

	\$	MCT%	1% MCT
2012	3,247	200	16.2
2013	3,643	204	17.8
2014	3,616	193	18.3
2015	3,146	157	20.0
2016/17	2,446	112	21.8
2017/18	1,050	34	30.9
2018/19	440		
2019/20	450		
2020/21	560		

Source: Derived from ICBC annual reports, with estimates for 2017/18 to 2019/20 derived from ICBC’s February 2018 Service Plan.

¹⁹

http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_49_21_december_2017/pdf/occasional_paper_no_49_21_december_2017.pdf

Tables B.2 and B.3 show the actual capital and MCT ratios for 2012 to 2016/17, and the writers estimates for the 2017/18 to 2021/22 years.

Table B.2 – Change in Basic Capital (\$=million)

	\$	MCT	1% MCT
2012	1,427	137	10.4
2013	1,716	149	11.5
2014	1,633	136	12.0
2015	1,071	83	12.9
2016/17	1,456	103	14.1
2017/18f	700	47	15.0
2018/19f	140	9	17.0
2019/20f	200	10	19.0
2020/21f	360	16	22.0

Source: Derived from ICBC annual reports (2016/17 is 15 months), with estimates for 2017/18 to 2021/22 derived from BCUC, ICBC 2017 RRA, IR 1, RM 1.6; see

http://www.bcuc.com/Documents/Proceedings/2017/DOC_50367_B-2_ICBC-Responses-to-IR-1.pdf

Notes:

- (1) Includes a \$450 million transfer in January 2016, \$201 million of Optional operating and \$172 million of capital transferred during the year.
- (2) Includes \$99 million form Optional transferred after the close of 2016/17, and \$470 million transferred as part of the Basic rate requirements application for calculating the 2017 Basic rate increase.
- (3) The \$/1% MCT are my estimate as ICBC did not provide this detail.

Table B.3 – Change in Optional Capital (\$=million)

	\$	MCT	1% MCT
2012	1,820	313	5.8
2013	1,927	304	6.3
2014	1,983	298	6.65
2015	2,075	300	6.9
2016/17	990	132	7.5
2017/18f	350	39	9.0
2018/19f	300	30	10.0
2019/20f	250	23	11.0
2020/21f	200	17	12.0

Source: Derived from ICBC annual reports, with estimates for 2017/18 to 2021/22 derived from BCUC, ICBC 2017 RRA, IR 1, RM 1.6; see

http://www.bcuc.com/Documents/Proceedings/2017/DOC_50367_B-2_ICBC-Responses-to-IR-1.pdf

Notes:

- (1) Includes a \$450 million transfer in January 2016, \$201 million of Optional operating and \$172 million of capital transferred during the year.

- (2) Includes \$99 million from Optional transferred after the close of 2016/17, and \$470 million transferred as part of the Basic rate requirements application for calculating the 2017 Basic rate increase.
- (3) The \$/1% MCT are my estimate as ICBC did not provide this detail.

Calculating the Shortfall

The shortfall between the capital management targets and the forecasted actual capital for the 2017/18 to 2021/22 fiscal years shown in tables 1 and 2 in the main report were derived from this information.

For example, the 2017/18 Basic insurance capital shortfall of \$1,475 million at 145% is the \$15 million/1% MCT X 145 = \$2,175 requirement less the estimated actual year-end capital of \$700 million. The shortfall is \$1,475 million.

Changing the requirement to 80% (Table 2) is calculated at \$15 million/1% MCT X 80 = \$1,200 requirement less the actual \$700 million. The shortfall is \$500 million.

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