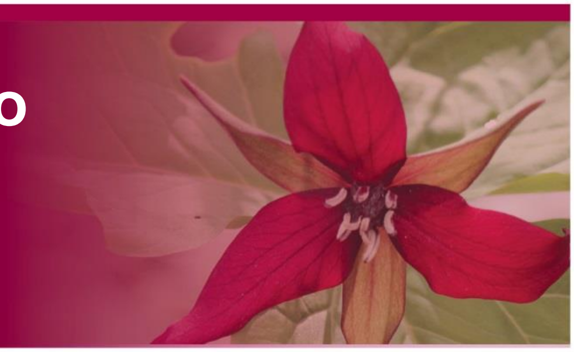
Rate Regulation of Ontario Automobile Insurance

Briefing Note



In order to facilitate greater responsiveness to consumers' needs and enhanced competition in the marketplace, many jurisdictions with automobile insurance regulatory regimes similar to that of Ontario have been moving away from a stringent approach to rate regulation. Ontario continues to have one of the most costly, onerous and restrictive automobile insurance rate filing systems in North America.

In submissions to the Financial Services Commission of Ontario (FSCO) Mandate Review, Insurance Bureau of Canada (IBC) advocated in the strongest possible language, for the government to begin a separate process to assess, overhaul and redesign the current automobile insurance system in Ontario. We have developed a list of potential changes that could serve as short-term measures to improve rate regulation. These suggestions, while helpful to the industry, in no way take away from the urgent need to implement the broader regulatory reform required to modernize rate regulation in Ontario.

IBC welcomes the opportunity to suggest these interim measures, and looks forward to a more comprehensive review.

Background

The Ontario member companies of IBC believe that the Ontario insurance regulatory system should encourage outcomes that:

- Promote competition and encourage product innovation to benefit the consumer;
- Monitor inflation and other cost drivers associated with the automobile insurance product to ensure long-term pricing stability and the assessment of premiums that are both predictive of, and distinguish fairly between, risks; and
- Maintain the prudential integrity of the solvency regulation of insurers.

A great deal of academic research has demonstrated that the current approach to rate regulation of automobile insurance has significant negative effects for consumers, including greater premium volatility, high administrative costs to insurers (and hence, consumers) and regulators, and cross-subsidization of high-risk drivers by low-risk drivers.

By way of example, other jurisdictions such as South Carolina, New Jersey and Massachusetts have each successfully reformed their rate regulation frameworks for automobile insurance to facilitate lower prices by promoting a truly competitive marketplace. A 2012 study authored by Sharon Tennyson for the Insurance Research Council[1] on the impacts of these reforms found that:

> *In each state, insurance premium expenditures have declined relative to previous trends or projections; insurance availability has increased or been maintained at previous levels; . . .*
>
> *As a consequence of reducing government regulation of rates, insurance market sustainability has been enhanced and there are no adverse trends to suggest that post reform outcomes are not sustainable.*

Indeed, in the FSCO Mandate Review Expert Panel's recent Preliminary Position Paper it was noted that:

> *It has been predicted that jurisdictions will continue to move away from this approach [regulation of the pricing of automobile insurance], which has been described as inflexible and unnecessarily costly.*

The unpleasant reality is that Ontario has one of the most restrictive rate regulation systems in North America. The current rate regulation processes that insurers are required to adhere to for filing private passenger rates in Ontario are overly burdensome and discourage companies from proactively amending rates, which means they also discourage rate reductions. These processes limit both competition and innovation, resulting in less choice and higher premiums for consumers.

A 2012 PricewaterhouseCoopers (PWC) report identified that the current process for regulating rates in Ontario is:

> *. . . onerous on all parties, it introduces systemic risk in the market and . . . the time required to review an application (3 to 6 months) is out of proportion with the amount of time the same rate will be in force. Moreover, the process by which FSCO establishes reform and trend factors for use in rate applications is completely lacking in transparency, prompting mistrust that the factors are a true reflection of industry experience. Because of the slowness and uncertainties associated with the rate regulation system, insurers hold the view that participating in the rate approval process – particularly at a time when cost stability is in doubt – can put them at risk of having to charge inadequate premiums for an extended period of time.*

As discussed in IBC's submissions to the FSCO Mandate Review, IBC supported the recommendation for a new regulator that could adopt a principle- and risk-based approach to regulation and that would clearly benefit the consumer. However, even within the existing regulatory regime, IBC believes there are a number of relatively simple changes that could be implemented quickly in order to bring improvements to the rate regulation process. IBC would caution that, as has been the history of automobile insurance regulation in Ontario, continual "tweaking" of the existing system is not a long-

[1] The Long-Term Effects of Rate Regulatory Reforms in Automobile Insurance Markets, Sharon Tennyson, 2012

term solution and with the pending redesign of a new financial services regulator for Ontario, there also needs to be an assessment of the regulatory regime and a commitment to implement broader regulatory reform that supports a dynamic and innovative market to best serve the interests of consumers.

It is important to note that all of the changes recommended below could be made under the existing Insurance Act (the Act) and regulations. Section 416 of the Act provides that the Minister may issue policy statements on matters related to risk classification systems and automobile insurance rates so FSCO guidelines could also be amended to accommodate these changes. This can be done on a short-term basis while consideration is given to a complete overhaul of the existing system to create better choice and savings for consumers.

Recommendations

IBC recommends that the government make the following interim changes to the current rate regulation system in the following order of priority:

- Reduce restrictions on rate filing processes for private passenger automobile insurance:
  - → Enable insurers to decrease or increase rates using a "file-and-use" process, which facilitates the ability of insurers to adjust pricing quickly, within an acceptable range (both at the portfolio level and separately at the individual policy level), in response to competitive pressures, to provide product innovation and also to reflect inflationary trends.
  - → If this cannot be achieved in the short-run then, at a minimum, the current restrictions in the simplified rate filing process should be removed to allow either for small rate increases or increased rate segmentation within the current process, as well as to allow for up to 100% recovery from prior rate reductions.
- Remove the restrictions on the use of territory for rating purposes.
- Allow companies to rely more on their own benchmarks.
- Reduce the restrictions on filings for the introduction of new innovative products such as usage-based insurance or telematics.
- Reduce the number of information requirements for all filings.
- Allow insurers more flexibility in the use of capping.

Further details on each of these recommendations can be found in the appendix below.

APPENDIX

Reduce restrictions on rate filing processes for private passenger vehicles. This can be accomplished by doing one or more of the following:

1. Enable insurers to decrease or increase rates using a "file-and-use" process.

In the current system, for private passenger vehicles, insurers need to receive prior approval from FSCO for all filings, including rate reductions, before taking rates to market. This can lead to significant delays in getting new rates and products to consumers.

- Under a file-and-use system, insurers are required to file the proposed rating or underwriting changes with supporting justifications. After a defined period, the filing is deemed approved for use.
- Introducing a file-and-use initiative will lead to a reduced time to market for rate and product innovation. It will also increase the incentive for insurers to file, leading to more frequent filings, less chance of one-off price shocks and ultimately facilitate more effective competition.
- This process is currently in place for non-private-passenger filing categories in Ontario and in other jurisdictions.
- In order to ease this transition, in the short term a "flex rating" band could be included in the initial implementation, whereby file-and-use would apply only when filings fall within a particular rate range.

2. Remove restrictions from the simplified filing process, allow for small rate increases within the process and allow for up to 100% recovery from prior reductions.

- Under the existing simplified filing, insurers are permitted to use a simpler, less onerous process when certain conditions are met.
- In practice, these conditions are quite restrictive and significantly limit the usefulness of this process.
- For example, the process can be used only where there is a rate decrease. There are many limits on how specific coverages can be affected, even if the overall change results in a reduced premium for the customer. In addition, no change to algorithms or territories is permissible under the current simplified filing process.
- Removing or relaxing some of the restrictions above could ensure that the simplified process becomes more usable by the industry, again resulting in savings being passed on to consumers sooner.
- In Alberta, the simplified filing process also permits small rate increases each year under certain conditions. This could be considered in Ontario.

- The current process only permits 50% recovery from prior reductions. This reduces the likelihood of insurers opting to pass potential savings on to consumers, as there is no guarantee the insurer will be able to increase rates if the market changes. Therefore we recommend that a 100% recovery be permitted.

3. Remove the restrictions on the use of territory for rating purposes.

- Currently, insurers are restricted to rating on 10 territories in Toronto and 55 across Ontario. Further, these territories have to be contiguous, i.e., the territory cannot be split into two non-adjacent areas.
- Current restrictions result in abrupt price differentials between neighbouring territories – where only 55 territories are permitted, the difference between each territory is likely to be greater.
- Further, the restrictions on territories result in unfair cross-subsidization, whereby consumers living in the least risky part of a territory are subsidizing those in the more high-risk areas.
- IBC therefore recommends that rate regulations permit more territories in Toronto and across Ontario, and that the contiguity restriction be removed. In addition, territorial definitions should be allowed to vary by coverage and, ideally, the ultimate number of territories should be determined by each insurer.
- Insurers should also be allowed to forgo rating territories if they choose and rate using postal codes to help them better align premium to risk.

4. Allow companies to rely more heavily on their own benchmarks.

- Use of FSCO's benchmarks creates risk for the entire industry as it does not recognize that companies have their own unique business models.
- FSCO should focus on monitoring outcomes and ensuring that filings result in fair rates for consumers rather than questioning methodologies selected by actuaries, who are already bound by high standards of practice.
- If FSCO benchmarks are not accurate, there could be price shocks forcing all insurers to file for new rates at the same time.

5. Reduce the list of information requirements for all filings.

- The existing process requires significant resources from companies and FSCO.
- The current full filings can average up to 600 pages, take two months to prepare and cost a significant amount.
- One example is that insurers must provide full rate manuals as part of the filing, which is onerous and does not add any benefit to FSCO.

- As a result of these onerous requirements, the ability of insurers to innovate is hindered, leaving consumers with less competition and choice.

6. Reduce the restrictions on filings for the introduction of new innovative products such as usage-based insurance (UBI) or telematics.

- In Ontario, the process to obtain approval to introduce a new innovative product such as a UBI program, for example, is particularly long and onerous. In addition, FSCO has issued many restrictions on what will and will not be approved. For example, the UBI premium must in all cases be lower than the non-UBI premium, which clearly undermines the ability to match premium to risk.
- There are global examples, (i.e., within the U.K.), where more flexible offerings have been successful in the marketplace and have benefited the consumer.
- The current regulatory approach and the regime in place stifle innovation, which ultimately hurts the consumer. Therefore, IBC recommends that the restrictions on filings for introducing new products are reduced. In addition, once approved, quick and simple processes need to be in place to allow insurers to continue to make ongoing adjustments to these new and innovative programs, such as UBI.

7. Allow companies more flexibility in the use of capping.

- Capping enables insurers to reduce the immediate impact of a rate change on their existing customers. It is particularly useful when certain segments of the book are seeing significant rate changes.
- Currently, capping is only allowed in limited circumstances and only for two years. The rules should be broadened where a company can demonstrate the impact and the value to its customers; as well, the time period should be expanded to four years.
- IBC recommends that insurers be allowed to use capping in more situations and also that caps be permitted at the lower end too, allowing insurers to moderate rate reductions as well as rate increases.
- This would reduce price shocks for customers, spreading rate changes over a number of years, and reduce volatility associated with the current regulatory regime.