

MPI REBUTTAL EVIDENCE

2018 GENERAL RATE APPLICATION
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**Manitoba
Public Insurance**

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INTRODUCTION

1 This rebuttal evidence responds first to the evidence of Ms. Sherry, *Actuarially*
2 *Indicated Rates for MPI – Investment Return and the RSR* and then to the evidence of
3 Dr. Simpson and Ms. Sherry, *Does the RSR Need to be so Large?* Except for brief
4 general comments at the outset, topics are addressed in the order presented in the
5 expert evidence and the section headings in this document mirror those used in the
6 CAC’s expert evidence, for ease of reference. Silence on any topic in this rebuttal
7 should not be taken as agreement.

1. Rebuttal to the Evidence of Ms. Sherry: Actuarially Indicated Rates for MPI – Investment Return and the RSR

1.1 MPI Comment on the position of the CAC as Reflected in the Evidence of Dr. Simpson and Ms. Sherry

8 The positions of the CAC, as proffered by its expert witnesses, are ones that generally
9 have the effect of undermining the financial condition and long term sustainability of
10 Basic, for the short term gain to ratepayers in the form of a reduction in rates, or
11 rebate of capital. MPI considers this approach to be penny wise, and pound foolish. It
12 is in the best interest of Manitobans to have an insurance model that is sustainable
13 and positioned to deliver long-term rate stability. Manitobans need only look at the
14 high auto insurance premiums in other provinces, to understand how well they are
15 served by Manitoba’s public auto insurance model.

1.2 Response to Ms. Sherry’s Position on “Actuarial Best Practice”

16 In Basic’s current situation is it better to risk asking ratepayers for an RSR rebuilding
17 fee or is it better to use RSR investment income to rebuild the reserve?

1 Ms. Sherry submits that investment income on the RSR should be included in the cash
2 flows to reduce rates, on the basis that they are cash flows to the Corporation. Ms.
3 Sherry argues that Actuarial Standards of Practice allow this treatment. She does not
4 argue that MPI's approach is not a permissible treatment. MPI's approach is consistent
5 with the Actuarial Standards of Practice. MPI's approach makes good business sense in
6 the circumstances of Basic. Ms. Sherry's approach does not make good business sense
7 in the present circumstances of Basic.

8 MPI's position is that only the cash flows related to the policies to be written should be
9 considered in pricing the policies. MPI is already crediting the forecast investment
10 income earned on the *new premiums* associated with policies written in the policy
11 year. MPI addresses the direct link between break even premiums and the policy year
12 investment income in the next section.

13 On the question of whether RSR investment income is a revenue unrelated to policies
14 written in the 2018/19 policy year, Ms. Sherry states the following:

15 *"The Corporation concedes that the investment income earned on the*
16 *RSR is revenue but argues that **this revenue is not related to***
17 ***policies issued in the 2018/19 policy year. This is only partially***
18 ***true.** If the RSR is comprised of premiums paid in prior years then*
19 *some of the policyholders who contributed to it are going to have*
20 *policies in the 2018/19 policy year." [emphasis added]*

21 Ms. Sherry essentially concedes these revenues are unrelated to the policies to be
22 written in this policy year. However, Ms. Sherry's stated position is instead based on
23 (a) the supposition that total equity was collected from Basic policy holders ("**If** the
24 RSR is comprised of premiums paid in prior years..."), and (b) a related argument
25 about fairness and intergenerational equity. Ms. Sherry's effort to tie this issue to
26 intergenerational equity and assert a ratepayers' right to Basic's total equity does not
27 hold when the nature of the RSR is properly understood.

28 The RSR balance is in fact the cumulative result of favorable or unfavorable variances
29 from forecasts used to set rates, including capital transfers from other lines, or RSR
30 rebates and surcharges. Without these additional transfers, the RSR balance is, in a

1 sense, the cumulative “error term” on the complete set of MPI’s past policies, that
2 have been written over many years, and with the actual cost of many of these policies
3 still being finalized. Rates for these policies were set on a break even basis using best
4 estimates, which if done correctly, would mean the only instance where ratepayers
5 have ‘contributed’ funds to the RSR would be when they are charged an RSR
6 rebuilding fee. As will be discussed in greater detail, the capital in the RSR today is
7 almost entirely attributable to transfers from Extension, as in recent years rates have
8 consistently under collected the actual costs of providing insurance¹. Without recent
9 capital transfers, the RSR balance would be near zero.

10 Ms. Sherry is critical of MPI’s position that crediting investment income effectively
11 operates as a premature rebate, and that total equity should not be rebated on a
12 forecast basis. She observes that rate setting is inherently prospective. This is true of
13 cash flows related to policies, but misses MPI’s essential points:

- 14 a) The RSR framework contains no capital maintenance/rebuild provisions (unlike
15 other insurers), and the RSR today consists of capital that MPI voluntarily
16 transferred to Basic in order to help place Basic on a sustainable financial
17 footing after a succession of years with deficient rates had eroded capital,
- 18 b) Basic rates contain a zero profit provision, and
- 19 c) When Basic is already undercapitalized and is increasingly reliant on transfers
20 from Extension that cannot be counted on, it is unwise to adopt an
21 interpretation of Actuarial Standards of Practice that would have rates being
22 priced at a loss, with what amounts to a negative profit provision.

23 MPI’s position is that rebates should only occur when there is “money in the bank” to
24 rebate, and that rebuilding fees should only be asked for when there is an actual
25 shortfall. Neither rebates nor rebuilding fees should be based upon forecasts.

¹ 2018 GRA Volume I Overview OV.1.1

1.3 Response to Ms. Sherry's Position on "Intergenerational Equity"

1 Ms. Sherry maintains that MPI's proposal results in intergenerational inequity. This is
2 incorrect both conceptually and in reality.

3 Conceptually, Ms. Sherry relies on the notion that ratepayers have a right to the total
4 equity of Basic, appealing only to MPI's responsibility to Manitobans. To be clear, MPI
5 is responsible to ensure access to compensation benefits, and injured Manitobans are
6 entitled to receive Personal Injury Protection Plan (PIPP) benefits from the day they
7 are born to the day they die. MPI meets its responsibility to ratepayers by providing
8 broad coverage compulsory auto insurance, at cost. The insureds who have paid policy
9 premiums to MPI have also received the benefit of being indemnified for losses. MPI is
10 at risk. Basic's total equity belongs to MPI's shareholder, the Province of Manitoba, per
11 section 14(1) of the MPIC Act².

12 The practical reality is that funds in the RSR today are almost entirely the result of
13 transfers from the extension line of business, as recent variances from forecast have
14 been large and negative³. This situation emerged because past Basic customers were
15 not, as it turned out, paying their fair share, due largely to an overly optimistic
16 interest rate forecast. MPI's willingness to transfer \$176 million from extension over
17 three years has actually avoided current customers paying rebuilding fees to make up
18 for deficient rates of the past⁴.

19 The CAC's expectation that total equity be returned to ratepayers, as promptly as
20 possible, is not reasonable. Policies are priced fairly in the year they are issued, and
21 MPI takes a reciprocal approach to dealing with variances from forecast. MPI does not
22 come back to ratepayers of a specific policy year asking them pay more if experience
23 develops worse than forecast, just as it does not rebate when experience develops
24 better than forecast. The trigger for rebates or rebuilding fees is the degree of
25 capitalization, as laid out in the RSR framework.

² 2018 GRA CAC (MPI) 2-15

³ 2018 GRA Volume I Overview OV.1.1, and Volume II Investments INV.2.3

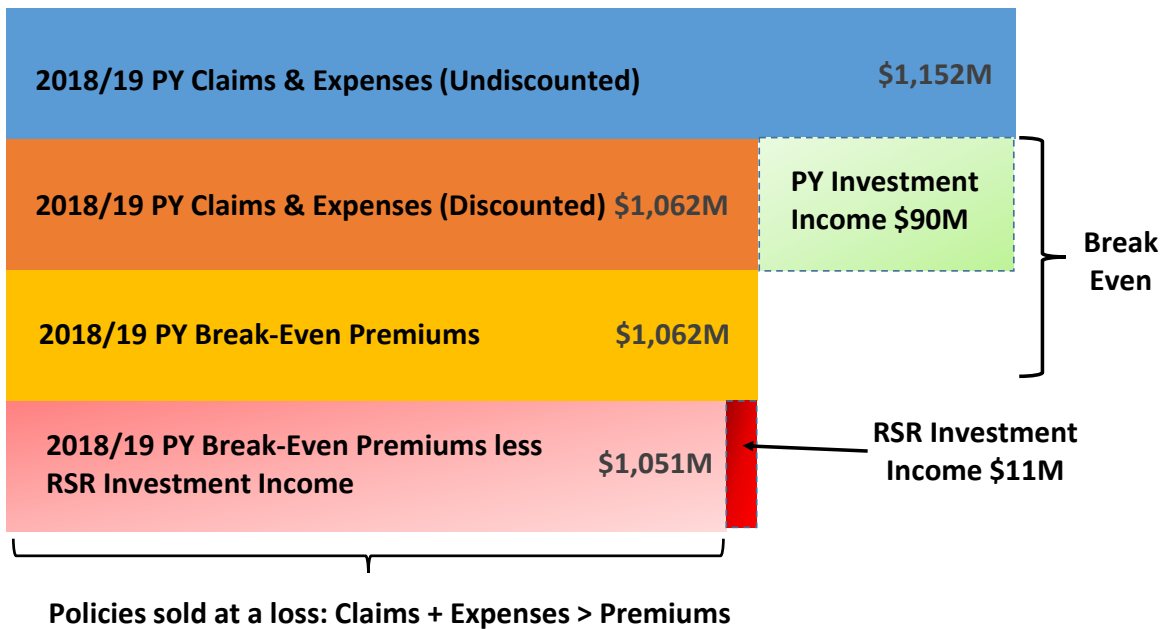
⁴ 2018 GRA PUB (MPI) 2-10

Adequate capitalization is critical to delivering rate stability. Ms. Sherry asserts that MPI does not recognize that rates paid by policy holders will be higher because RSR investment income is not included in the rate indication. To the contrary, not only does MPI recognize this fact, but is the very essence of MPI’s position. Rebating RSR investment income prices the policies being written at a loss, because the investment income on total equity is unrelated to the premiums charged for those policies. This erodes Basic’s capitalization, and put ratepayers at risk of rebuilding fees and rate shock, which can threaten the public’s confidence in the public auto insurance model.

The following graphic depicts MPI’s central points with respect to ratemaking:

- a) That Policy Year investment income (the income earned on new policies written in the policy year) is accounted for in break-even premiums (Green bar segment), and
- b) Including RSR investment income in the rates sets policy premiums at a loss because RSR investment income does not related to the policy written in the current policy year (Red bar segment).

Figure 1: Break Even Rate Calculation for 2018/19 Policy Year (PY) (\$ millions)



1.4 Response to Ms. Sherry's Position on "Confusion between using Investment Income from the RSR and an RSR Rebate"

Ms. Sherry asserts that MPI has confused investment income from the RSR with an RSR rebate, on the premise that RSR investment income is a cash flow that should be factored into ratemaking. As explained above, this premise is false.

Ms. Sherry further asserts that if the RSR were allowed to grow, it would exceed the "level required" to achieve the "stated purpose of the RSR". For the RSR to function to its stated purpose, there must be sufficiently wide **range** over which total equity can fluctuate and absorb the variations from adverse results. If the level of total equity is at the bottom of the range, as it is now, then the RSR cannot serve its intended purpose, as even minor adverse events or rate deficiencies could trigger a rebuilding fee.

In response to PUB (MPI) 1-77, MPI provides a table (reproduced as Figure 2 below) of modelled probabilities that total equity will fall below 37% MCT (or \$239M) in 2021/22, without "management action" (usually referring to rate increases or rebuilding fees). From the starting RSR Balance of \$200 million, which is a very close approximation of the DCAT modelled lower RSR target, there is a 61% chance (1-in-1.6) that total equity will fall below the lower RSR target, triggering a rebuilding fee. This confirms MPI's assertion that a total equity balance at the minimum RSR target, defeats the purpose of the RSR.

Figure 2: Total Equity Decline Probabilities

Line No.	Starting RSR Balance February 28, 2017	4 Year Combined Scenario before Management Action	
		Probability	Total Equity < \$239M (37% MCT) in 2021/22
1	\$181M (29% MCT)	65.84%	1 in 1.5
2	\$200M	61.00%	1 in 1.6
3	\$250M	48.18%	1 in 2.1
4	\$300M	34.99%	1 in 2.9
5	\$350M	23.04%	1 in 4.3
6	\$400M	13.09%	1 in 7.6
7	\$438M (100% MCT)	7.45%	1 in 13.4

1 Ms. Sherry also asserts that RSR investment income is not “approved as part of the
2 RSR”, without citing any reference to a Board order making such a finding. MPI is not
3 aware of such a finding.

1.5 Response to Ms. Sherry’s position that “Including Investment Income is the public auto insurance norm”

4 Ms. Sherry quotes a portion of an MPI response to an IR to suggest that including
5 investment income is the public auto insurance norm. Ms. Sherry omitted from her
6 quote the relevant contextual facts that MPI had provided in the sentences that
7 followed:

8 *“However, this comparison to MPI is not appropriate without*
9 *consideration to the capital requirements and capital management*
10 *policies of each jurisdiction. Both SGI and ICBC have capital*
11 *maintenance and capital build/release provisions built into their rate*
12 *setting process. MPI cannot establish capital maintenance or capital*
13 *build/release provisions without capital targets.”*

14 As well, Ms. Sherry asserts that the capital of a well-managed insurance company will
15 naturally replenish and draw down over time. What is not said, is those ‘well managed’
16 companies also have a positive profit provision. Basic has a zero profit provision which
17 prices policies at cost, and achieves the break-even mandate. The CAC’s proposal to
18 include income on total equity as an offset to rates would remove the only other
19 source of growth to Basic’s total equity, outside the potential for a favourable variance
20 from forecast. The chance of a favourable variance diminishes when rates are set
21 below cost, by crediting investment income on total equity. Growth in the total equity
22 balance would be relying on luck, and ‘well managed’ companies are not run on luck.

23 Ms. Sherry would be well aware of this as she is the Vice President, Insurance
24 Solutions at Wawanesa Mutual Insurance Company in Winnipeg, a private insurer that
25 sells auto insurance policies.

REBUTTAL TO THE EVIDENCE OF DR. SIMPSON AND MS. SHERRY

2. MPI Comment on the Collaborative Processes

1 MPI has maintained its commitment to the collaborative process with the PUB and
2 parties to the GRA, and considers it a valuable opportunity for stakeholders and MPI to
3 discuss the merits of alternative approaches to relevant matters. However, MPI does
4 not consider the collaborative process to be a venue for the 'pre-approval' of
5 methodologies to be included in DCAT Report, or the GRA more broadly. MPI's Chief
6 Actuary must continue to act in a manner he regards as consistent with his
7 professional obligations, including following the Actuarial Standards of Practice. MPI's
8 management and Board must act in the best interests of the Corporation. MPI wants
9 to identify areas of consensus, if that is possible; however, it is unreasonable to
10 expect that MPI would delegate the management of the Corporation to the
11 collaborative process.

2.1 Response to Dr. Simpson and Ms. Sherry's position on "Use of the MCT to Set the Upper Threshold of the RSR"

12 In their opening paragraph, Dr. Simpson and Ms. Sherry question if "the risks facing
13 the corporation [have] risen that much in one year". In point of fact, they have.
14 Basic's balance sheet is growing, and the MCT test assesses the risk (and associated
15 capital requirement) as a function of balance sheet values and the associated
16 percentage risk factors. While the risk factors have remained unchanged (year over
17 year), the balance sheet values continue to grow. Price inflation, as measured by the
18 CPI, or any general multi-good basket, is not a useful reference point for the risks
19 facing a property and casualty insurer. This point is explored further below.

20 Dr. Simpson and Ms. Sherry question the appropriateness of the MCT test to set the
21 upper RSR threshold, given that MPI is "in a quite distinct position from private

1 property and casualty insurers who operate in a competitive market with the real
2 possibility of bankruptcy”.

3 The narrative proffered by Dr. Simpson and Ms. Sherry is a significant
4 oversimplification. First, the MCT test measures risks faced by P&C insurance
5 companies, and these risks apply to MPI. The 2018 GRA dedicated a section⁵ in the
6 Rate Stabilization Reserve chapter to explaining the risks categories accounted for in
7 the MCT test. These risk categories are:

- 8 1. Insurance Risk
- 9 2. Market Risk
- 10 3. Credit Risk
- 11 4. Operational Risk
- 12 5. (Less) Diversification Credit

13 These risks are real and material, as evidenced by the fact that MPI has measurable
14 values for these risks⁶, which sum to the “capital required” under MCT. These risks
15 exist by virtue of the fact that MPI is a property and casualty insurance company.
16 Whether the insurer operates in a competitive market or as a monopoly is irrelevant.

17 Further, MPI rejects any notion that it should govern itself with less commitment to
18 operating sustainably, and delivering rate stability because its shareholder is the
19 Government of Manitoba. There should be no expectation that taxpayers will bail out
20 Basic in the event of under capitalization, and it is imprudent for MPI operate with any
21 such expectation.

22 Dr. Simpson and Ms. Sherry also question MPI’s assertion that the MCT test better
23 reflects the riskiness of P&C insurers. MPI has been clear: the MCT test is an
24 independent and objective test, developed by Office of the Superintendent of Financial
25 Institutions (OSFI) leveraging the breadth and depth of information available to it
26 about the risks facing P&C insurers. Simply put, OSFI has an informational advantage.

⁵ 2018 GRA Volume II RSR.4.5.2.2, MCT Measures Risks that are faced by MPI

⁶ 2018 GRA Volume II RSR.6.2

1 MPI has also stated that an RSR range reflecting both the DCAT methodology, to
2 determine the absolute minimum level of capital, and the balance sheet based MCT
3 methodology, to establish at what level total equity becomes surplus, is preferable to
4 relying on just a single methodology. Factors that make a DCAT and MCT based RSR
5 range preferable include: comparability of capitalization with peers who use MCT,
6 diversity in methodology with an objective measure, and breadth of information
7 considered through inclusion of a balance sheet based measure.

8 Dr. Simpson and Ms. Sherry also refer to a passage from the recent report by Ernst &
9 Young for ICBC, but make no reference to MPI's extensive response to the material
10 cited in CAC (MPI) 2-16. MPI fully addressed the issues in this IR response, and
11 concluded that MPI's circumstances are very different from those of ICBC, which has a
12 145% MCT Target, and that MPI's request for 100% MCT as an upper RSR Target
13 appears to be consistent with Ernst & Young's (E&Y) recommendation.

14 Finally, Dr. Simpson and Ms. Sherry reiterate their case for narrow (1-in-20 and 1-in-
15 100) or wide (1-in-10 and 1-in-200) range RSR thresholds, using alternative
16 percentile levels of risk tolerance. This proposal is not appropriate for two reasons.
17 First, both ranges have minimums that are lower than the absolute minimum level of
18 capital that is already established at the 1-in-40 percentile level, which was arrived at
19 through the collaborative process, and appears to MPI to have been a point of
20 consensus. Second, the range of the RSR, under either option, remains too narrow to
21 capture the variability in operating results. An RSR range that is too narrow does not
22 serve the purpose of protecting ratepayers from volatility, and potential rate shock.
23 MPI's proposed DCAT based upper RSR target estimates the variability in financial
24 results at a selected probability (1-in-40), over a selected time horizon (3 years),
25 without management action⁷. This variability results in a range that very closely
26 corresponds to the 100% MCT target MPI has applied for, and is further evidence that
27 100% MCT is appropriate.

⁷ For the reasons described in 2018 GRA Volume II RSR 2017 DCAT Report, DCAT.6

2.2 Response to Dr. Simpson and Ms. Sherry's position on "Determination of the Base Scenario in the DCAT"

2.2.1 Interest Rates

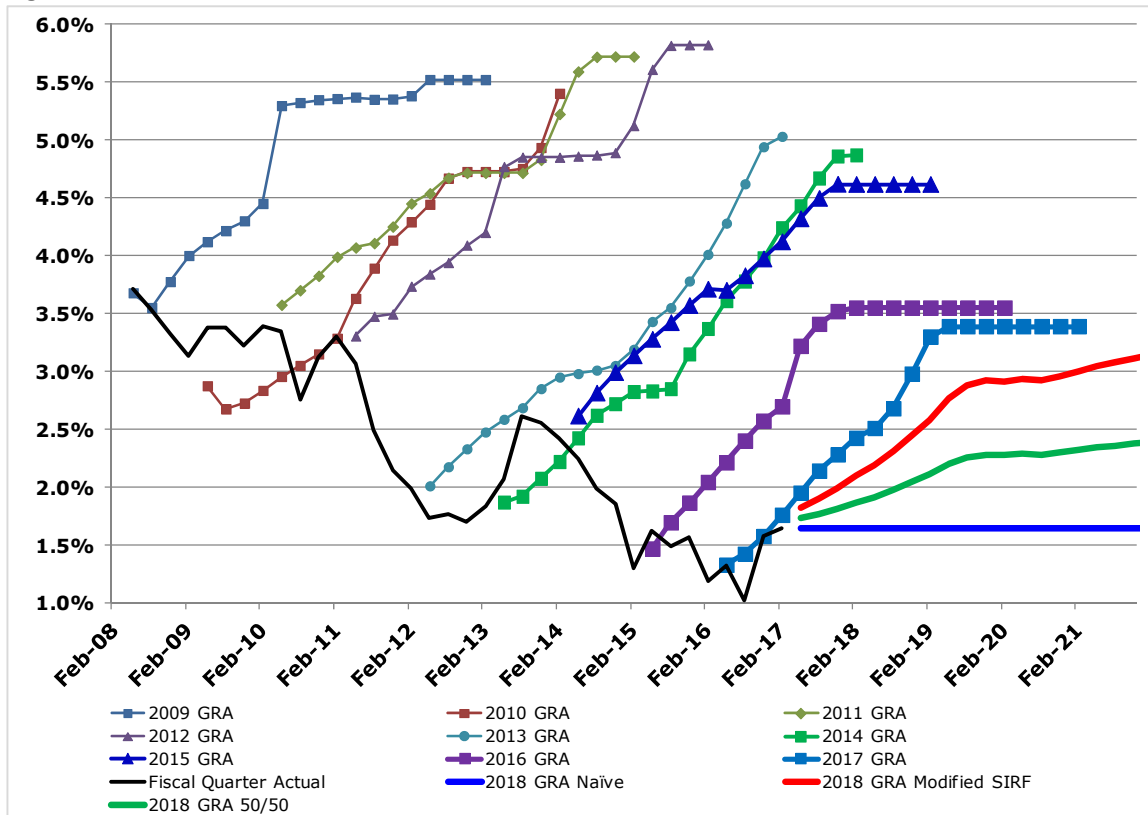
1 Dr. Simpson and Ms. Sherry are critical of the use of the naïve interest rate forecast in
2 the DCAT, and cite a number of recent events in the Bank of Canada's overnight rate,
3 bank forecasts, and the bond market to support the ongoing use of the Standard
4 Interest Rate Forecast (SIRF). However, this criticism is grounded in the selective
5 reliance on two favourable data points among many that suggest the opposite
6 conclusion, and further ignores the evidence MPI has submitted supporting the naïve
7 forecast as a best estimate.

8 On the first point, the past two quarters are two of only a handful of instances where
9 the SIRF has been directionally correct⁸. Simple visual inspection of Figure INV-46
10 from the GRA, presented as Figure 3 below, confirms the poor historical predictive
11 power of the SIRF. It seems inconsistent for Dr. Simpson and Ms. Sherry to ignore the
12 historical facts in this instance, but emphasize the importance of historical evidence as
13 it relates to the interest rate decline scenario, discussed in the following section.

⁸ Reference 2017 GRA

1

Figure 3 GOC 10 Year Forecasted Rates from 2009 to 2018 GRA and Actual



2

On the second point, the criticism of Dr. Simpson and Ms. Sherry appeals to the authority of forecasters (who have not produced accurate forecasts), but does not substantively address the issue of the naïve forecast being a best estimate, a position which MPI has supported in the GRA⁹. Movements in the actual GOC 10 year bond rates are designed to be captured through a compliance filing for rate setting, reducing to the extent possible, interest rate forecasting risk. On the issue of using the naïve forecast in DCAT, MPI has provided¹⁰ the opinion of Mr. Joe Cheng, MPI's Appointed Actuary, who confirmed that in his experience most DCAT reports rely on a naïve forecast of interest rates, and that such an assumption is rational.

10

⁹ 2018 GRA Volume II Investments INV.2.2.3

¹⁰ 2018 GRA PUB(MPI) 2-17 Attachment A

2.2.2 Inflation

1 Dr. Simpson and Ms. Sherry are critical of the fact that an inflation factor has not been
2 built into rates. MPI's ratemaking model follows Accepted Actuarial Practice, and as
3 explained in the *Rate Setting Framework* chapter of the GRA, is based on Claims,
4 Expense, Investment and Revenue Forecasts. Each of these forecasts considers price
5 inflation in a manner that is appropriate to the specific forecast. Simply building a
6 general inflation factor into rates would be a very coarse assumption, and not
7 reflective of best estimate rate making.

2.2.3 Response to Dr. Simpson and Ms. Sherry's position on "Determination of Interest Rate and Combined Scenarios"

8 The central criticism of Dr. Simpson and Ms. Sherry appears to be what they
9 characterize as the ad hoc nature of the interest rate decline scenario, and the interest
10 rates floor assumption that underpins it. 'Ad hoc' means to do something for a
11 particular purpose, and the interest rate floor assumption is meant to avoid the absurd
12 results of modelling negative nominal interest rates, which are unprecedented in
13 Canadian long term bonds. The interest rate floor assumption is intended to put a
14 reasonable lower bound on the modelled interest rates. The lowest observed monthly
15 yield is used as a reasonable estimate. Any assumed floor lower than what has been
16 historically observed would be an arbitrary assumption.