STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 24th Floor
San Francisco, California 94105

INITIAL STATEMENT OF REASONS

STANDARDS FOR REPAIR AND THE USE OF AFTERMARKET PARTS

Date: June 12, 2012 **REG-2011-00024**

INTRODUCTION

Pursuant to California Insurance Code (CIC) Section 790.10, California Department of Insurance ("Department") proposes amendments to Title 10 California Code of Regulations (CCR) Sections 2695.8(f) and (g), entitled "Fair Claims Settlement Practices Regulations."

The original regulations, effective January 13, 1993, were promulgated to provide definitive standards of conduct to insurers and other licensees for compliance with the Insurance Code's unfair claims settlement practices statute, Section 790.03.

The Department promulgated these sections to address repair standards including the use of aftermarket parts in connection with automobile collision claims.

Because additional clarification is necessary to ensure compliance, the Department proposes to amend the provisions these CCR sections to implement, interpret, and make more specific the provisions of CIC Section 790.03.

DESCRIPTION OF THE PUBLIC PROBLEM

The current law with regard to an insurer's standards for adjusting and settling automobile insurance claims and use of aftermarket parts has been substantially unchanged since 1993.

Subdivision (f) governs how insurers are to handle partial losses for automobile insurance claims settled on the basis of a written estimate prepared by or for the insurer. Currently, the insurer must provide a copy of the estimate to the claimant and the estimate must be in an amount which will allow for the repairs to be made in a workmanlike manner. When the claimant contends the cost of repair to a vehicle exceeds the insurer's written estimate, the insurer shall (1) pay the difference between the two written estimates or (2) if requested by claimant, provide the name of at least one shop that will repair the vehicle for the amount of the insurer's estimate, or (3) reasonably adjust the written estimate prepared for the claimant by the body shop of his/her choice and provide a copy of adjusted estimate to the claimant.

Subdivision (g) prohibits an insurer from requiring the use of non-original equipment manufacture ("aftermarket") replacement crash parts in the repair of an automobile unless certain

conditions are met. First, the part must be at least equal to the original equipment manufacturer (OEM) part in terms of kind, quality, safety, fit, and performance. Second, insurers requiring the use of the part shall pay the cost of any modifications to the parts which may become necessary to effect the repair. Third, insurers requiring the use of the part must warrant that such parts are of like kind, quality, safety, fit, and performance as original equipment manufacturer replacement crash parts. Fourth, the part must carry sufficient permanent, non-removable identification so as to identify the manufacturer. Finally, the use of non-original equipment manufacturer replacement crash parts is disclosed in accordance with California Business and Professions Code Section 9875.

The purpose of these longstanding laws is to protect the public from financial and physical harms caused by inferior repairs or defective aftermarket parts and to maintain insurer accountability in the process. Performing repairs in a manner that is not compliant with current repair standards or placing an inferior aftermarket part in a vehicle may result the vehicle's value to depreciate. Also, a part that is not of like kind, quality, safety, fit, and performance may cause injury or even death if it malfunctions.

After several years of evaluating this law and investigating complaints from the consumers and auto repair shops, The Department of Insurance has concluded that disputes regarding the true cost of repairs of damaged vehicles and the applicable repair standard required to comply with the current regulation continue to negatively effect the claims handling process. Additionally, aftermarket parts that are not compliant with the current regulations continue to infiltrate the repair process threatening public safety. The Department is also aware of substantial costs borne by auto repair shops and their customers associated with installing defective or poorly fitting parts required by insurers.

The proposed amendments address these and related issues by clarifying and making more specific an insurer's obligation to provide prompt, fair and equitable settlements that allow for the vehicle to be repaired in a workmanlike manner, particularly when the repair includes using an aftermarket part. The proposed amendments will improve public health and safety by mandating improved repair standards and better fitting parts to be use in vehicle repairs, which will result in safer cars and possibly produce a savings in liability insurance premiums. The added disclosures and reporting safeguards provided by the amendments also increase the transparency in the insurance claims transaction and maintain the insurers' accountability in the process.

The proposed amendments will strengthen and enhance the current law by:

(1) Requiring insurers to pay the additional costs associated with inspecting and testing the aftermarket part. This proposed amendment would also require the insurer to pay for the costs associated with returning the defective part to the manufacturer/distributor and the cost to remove and replace the defective part with a replacement part.

(2) Requiring the current insurer warranty be expressly stated on the insurer's repair estimate

(3) Requiring the insurer to stop specifying the use of the part that is not of like kind, quality, safety, fit, and performance and to notify the collision repair estimating software provider, the part distributer, and the part certifying entity that it is not compliant.

SPECIFIC PURPOSE AND REASONABLE NECESSITY FOR THE REGULATIONS

The specific purpose of the proposed regulations and the rationale for the Commissioner's determination that they are reasonably necessary to carry out the purpose of Section 790.03 are as follows.

Section 2595.8(f)

2695.8(f)(amend):

Section 2695.8(f) requires insurers to prepare an estimate in an amount sufficient to have the repairs completed in a "workmanlike manner," but insurers and auto body repair shops have interpreted these terms differently. Specifically, when a manufacturer, software estimating system, or other accepted repair standard is required to complete a particular repair, the insurer may refuse to include the time or parts necessary to complete the repair in a way that is compliant with the repair standard in the repair estimate. This causes the estimate prepared by the insurer to be insufficient to comply with the statutory requirement.

The proposed amendments define "workmanlike manner" to mean compliant with the standards set forth in 16 CCR Section 3365 governing auto body repair shops.

This section is amended to prohibit an insurer from willfully departing from those standards or the guidelines provided in the estimating software used to generate the estimate. By more specifically defining "workmanlike manner," this change will ensure that insurers are providing fair and equitable settlement of automobile claims as required by the statute.

2695.8(f)(3) (amend):

Section 2659.8(f) also governs how insurers are to handle partial losses for automobile insurance claims settled on the basis of a written estimate prepared by or for the insurer. Currently, the insurer must provide a copy of the estimate to the claimant and the estimate must be in an amount which will allow for the repairs to be made in a workmanlike manner. Additionally, when the claimant contends the cost of repair to a vehicle exceeds the insurer's written estimate, the insurer shall (1) pay the difference between the two written estimates or (2) if requested by claimant, provide the name of at least one shop that will repair the vehicle for the amount of the insurer's estimate, or (3) reasonably adjust the written estimate prepared for the claimant by the body shop of his/her choice and provide a copy of adjusted estimate to the claimant.

The amendment to subsection (3) requires the insurer, if it chooses to reasonably adjust its

written estimate, to provide the claimant and the repair shop with either an edited copy of the claimant's repair shop estimate or a supplemental estimate based on the itemized copy of the claimant's estimate, identifying each individual adjustment made. The amendment also clarifies that the adjustment must be made of the "written estimate prepared by the repair shop of the claimant's choice..." In other words, the written estimate prepared for the claimant is the basis for the adjustment. This amendment is reasonably necessary to allow both the consumer and the auto body repair shop to identify specifically where those adjustments have been made and the adjustments still provide a fair and equitable settlement of automobile claims as required by the statute..

Section 2695.8 (g)

Section 2695.8(g)(2) (amend):

Section 2695.8(g)(2) is amended to require insurer to pay for any additional costs associated with inspecting and testing the aftermarket part. Although the current regulations provide for the insurer to pay the cost of any modifications of the aftermarket part needed to complete the repair, there are additional costs associated with inspecting the part before it placed on the vehicle and testing it once the repair is complete to ensure it is safe and fitting properly. This amendment is necessary to specifically provide for payment of those costs, ensuring insurers are providing fair and equitable settlement of automobile claims as required by the statute.

Section 2695.8(g)(3) (amend):

Section 2695.8(g)(3) is amended to require the insurer warranty currently mandated be expressly written on the estimate of repair generated by the insurer. Prior to the amendment, the insurer was required to provide the warranty but was not obligated to disclose that to the consumer. This express written disclosure will make it clearer to the consumer that the aftermarket part is warranted by the insurer. This amendment is necessary to ensure the insurer is providing the most fair settlement of automobile claims.

Sections 2695.8(g)(6) (add):

Section 2695.8(g)(6) mandates that the insurer cease requiring the use of a part and to notify the collision repair estimating software provider or other estimating entity it contracts with, of the defect safety issue, or noncompliant aspect of the part if the insurer has knowledge a part is not of like kind, quality, safety, fit and performance. This amendment is necessary to help ensure that defective, unsafe, or noncompliant parts are removed from the marketing and distribution chain and to protect consumers from the financial and physical harm that could result from a non-compliant aftermarket parts.

Section 2695.8(g)(7) (add):

Section 2695.8(g)(7) mandates that the insurer cease requiring the use of a part and to notify the distributor of the specific part of the defect, safety issue or other noncompliant aspect of the part

if the insurer has knowledge a part is defective, unsafe, or otherwise noncompliant. This amendment is necessary to help ensure that defective, unsafe, or noncompliant parts are removed from the marketing and distribution chain and to protect consumers from the financial and physical harm that could result from a non-compliant aftermarket parts.

Section 2695.8(g)(8) (add):

Section 2695.8(g)(8) mandates that, if the insurer specifies the use of a certified aftermarket part, the insurer cease requiring the use of that certified part and to notify the certifying entity of the defect, safety issue or other noncompliant aspect of the part if the insurer has knowledge a part is defective, unsafe, or otherwise noncompliant. This amendment is necessary to help ensure that defective, unsafe, or noncompliant parts are removed from the marketing and distribution chain and to protect consumers from the financial and physical harm that could result from a non-compliant aftermarket parts.

Section 2695.8(g)(9) (add):

Section 2695.8(g)(9) mandates that the insurers specifying the use of aftermarket parts the insurer has knowledge is defective, unsafe, or otherwise noncompliant, pay the costs associated with returning the part and to remove and replace the part with a safe or compliant parts. This amendment is necessary to help ensure that consumers do not bear any costs resulting from the insurer specifying the use to an aftermarket part that is not of like kind, quality, safety, fit and performance and the time it take to provide the compliant parts necessary to effectuate a workmanlike repair. This amendment is necessary to specifically provide for payment of those costs, ensuring insurers are providing fair and equitable settlement of automobile claims as required by the statute.

Notes:

Authority and Reference (amend):

The Note section currently cites section 790.03(c) and 790.03(h)(3) as references for the current regulations. The proposed amendment has the effect of consolidating those two sections to a single reference to section 790.03. This amendment is necessary to ensure that the regulation clearly references all subdivisions of 790.03.

IDENTIFICATION OF STUDIES

The Commissioner has relied upon the Economic Impact Assessment prepared pursuant to Government Code Section 11346.3(b) in proposing the proposed regulations. A copy of the Economic Impact Assessment is included in the rulemaking record. There are no other technical, theoretical, and empirical studies, or similar documents relied upon in proposing the adoption of the proposed regulations.

SPECIFIC TECHNOLOGIES OR EQUIPMENT

Amendment of these regulations would not mandate the use of specific technologies or equipment.

REASONABLE ALTERNATIVES TO THE PROPOSED REGULATIONS

The Commissioner must determine that no reasonable alternative considered by the agency or that has otherwise been identified and brought to the attention of the Department of Insurance would be more effective in carrying out the purpose for which the regulations are proposed, would be as effective and less burdensome to affected private persons than the proposed regulations, or would be more cost-effective to affected private persons and equally effective in implementing the statutory policy or other provision of law.

The Commissioner has considered and rejected the following reasonable alternatives to the proposed regulations:

Alternative #1. Retain the status quo. CDI has considered not adopting the amendments to the current regulations and allowing the existing regulations to remain in place. Some suggest leaving things as they are would be less burdensome and more cost-effective for insurers than the proposed regulations, and equally effective or more effective in carrying out the purpose of the proposed regulations because the provisions of Insurance Code Section 790.03 are clear and there is currently no impediment to full compliance with the statute.

Reasons for rejecting Alternative #1: While it may be somewhat less burdensome or more cost-effective for insurers in some respects to not adopt the proposed regulations, it is more burdensome overall not to do so, since consumers would not be better protected and body shops would still not be paid for some of the costs being passed on to them by insurers. Non-OEM parts have high defect rates, according to some in the body shop industry. It has been stated that certified aftermarket parts fit only 56% of the time and non-certified parts are worse, with a history of fitting just 29% of the time. The body shop industry also contends there are problems with reporting defects, and shops apparently get penalized for reporting defects, so underreporting occurs. However, CDI has no independent verification that shops are penalized for reporting defects in aftermarket parts. Aftermarket parts supplier have rebutted this notion, citing a return rate of just 2%.

While the market share of OEM parts has been decreasing over the years, the market share of aftermarket parts has been increasing. The Mitchell data for repairable vehicles in California illustrate this trend. The percentage of aftermarket parts measured in both dollars and units has consistently increased in the seven years between 2005 and 2012. Relying on just the metric of percentage of parts stated in dollars can overstate growth where there has been inflationary parts pricing, according to a Mitchell spokesman. The market share of OEM parts shows a decline in dollar terms from 81% to 70%, but in terms of units, the decline was more modest from 84% to 78% since OEM's have expanded their discounting/part price matching programs. Nonetheless, the Mitchell data show a rise in dollar terms from 10% to 15% for the market share of

aftermarket parts, and in terms of units, an increase from 6% to 10%. If the status quo is maintained, there may be more non-compliant parts used in the repair process. Maintaining the status quo and doing nothing will allow a negative trend to continue.

Even though the status quo might be less expensive than the proposed regulation in the short run, it would not remedy the problems addressed by the proposed changes to sections 2695.8(g)(6)-(9). The amendments to those five sections are necessary to help ensure that parts that are not of like kind, quality, safety, fit and performance are removed from the marketing and distribution chain and to protect consumers from the financial and physical harm that could result from the use of non compliant aftermarket parts.

Alternative #2. Implement regulations similar to SB 1460 instead of the proposed amendments. A bill introduced by California Senator Leland Yee, SB 1460, would require an automotive repair dealer or insurer who uses or directs the use of replacement crash parts to (a) follow specified procedures when using replacement crash parts, (b) notify the automobile owner regarding the use of specific categories of crash parts in making the repairs, and (c) provide disclosures as to the warranty for those parts.

Reasons for rejecting Alternative #2: CDI determined that SB 1460 would result in less consumer protection, rather than more. While, in the short run, it may be somewhat less burdensome or more cost-effective for insurers in some respects to not adopt the proposed regulations, it is more burdensome overall. As in Alternative #1, consumers would not be better protected. Compared to CDI's proposed amendments to the regulation, this bill will not as effectively address the higher defect rates of aftermarket parts versus OEM parts and will not improve the quality of crash parts and repairs.

SB 1460 creates a new and unprecedented legal presumption that "certified, new non-OEM crash parts" are sufficient to return the vehicle to its pre-loss condition using an arbitrary, largely unknown certification process – an unqualified standard that may harm consumers. There are no assurances in this bill that these certifiers are mandated to actually inspect and test these parts prior to certification and, therefore, no assurance is given that these parts are any safer than a non-certified part.

ADVERSE IMPACT ON SMALL BUSINESS

The Commissioner has determined that the proposed amendments will affect small businesses to the extent that it affects auto body repair shops. The Commissioner has identified no reasonable alternatives to the presently proposed regulations, nor have any such alternatives otherwise been identified and brought to the attention of the Department, that would lessen any adverse impact on small businesses.

The Commissioner has determined that the proposed regulations will affect insurance companies. Insurance companies are not small businesses pursuant to California Government Code Section 11342.610(b)(2).

PRENOTICE DISCUSSIONS

The Commissioner conducted a prenotice public discussion of the proposed regulations on November 16, 2011 pursuant to Government Code Section 11346.45. Interested and affected parties were given an opportunity to present statements or comments with respect to the proposed amendments.