STAFF REPORT
OV05043092

CALCULATION OF SALES COST FACTOR

November 27, 2006

1 Purpose of the Sales Cost Factors

Regulated firms are entitled to rates that afford them the opportunity to recover their reasonable costs plus a reasonable profit. Accordingly, the proposed regulations provide detailed formulas for determining the reasonable costs of providing title insurance and escrow services. One component of such costs is sales costs, which generally refers to the costs associated with acquiring business, including commissions, salaries and overhead of sales personnel, advertising, and other activities intended to attract sales.

In the regulations, sales costs are identified as a "sales cost factor" in the denominators of the regulatory formulas. (See §§ 2357.7 (formula for preliminary report charge), 2357.12 (definition of sales cost factor), 2357.13 (formula for policy charge), 2358.5 (formula for full escrow charge), and 2358.6 (formula for subescrow charge).)

Section 2357.12 sets the sales cost factor at 15%. Thus, the formula for the maximum charge builds into premiums a 15% allowance for sales costs, including commissions.

2 Basic Principles

Sales costs throughout the insurance industry, including title insurance, have historically been dominated by commissions – payments made to sales personnel and organizations as a percentage of the premium. The proposed regulations conform to this convention, treating sales costs as a variable expense, expressed as a percentage of the overall premium. Algebraically, this is done by including it as a percentage in the denominator of the formulas.

While in principle a fraction of sales costs (e.g., advertising) is typically thought of as fixed, rather than variable, expenses, the bulk of the costs do vary with premium. By selecting a percentage high enough to cover the reasonable sales costs, both fixed and variable, the proposed regulation will produce sufficient revenue to cover all reasonable costs.

The sales cost factor covers internal and external costs, direct and indirect costs, and all forms of compensation, including salary, commissions, and bonuses.

A data call conducted in 2005 by the Department of Insurance sought to obtain cost data from title insurers and underwritten title companies, including sales costs. The companies' responses proved not to be illuminating. It was apparent that no consistent definition of "sales costs" was observed by the companies, which inconsistently categorized some costs as "sales," as "customer service," or under other categories. And, as discussed below, the sales costs the companies incurred were not, in any case, a fair measure of the reasonable costs for selling title insurance in a competitive market.

3 Reverse Competition and Sales Costs

In general, the regulations rely on the companies' actual expenditures as a measure of the reasonable costs of the various components of the cost of providing title insurance and escrow services. However, the actual levels of sales expenditures in this industry would not be a valid standard to employ because the relevant markets are not competitive and are instead afflicted with reverse-competition that leads to excessive sales expenditures.

The report prepared for the Insurance Commissioner measuring the competitive conditions in the title-insurance markets found among the effects of reverse-competition in title markets inflated costs as companies competed for business by conferring benefits – legal and illegal – on middle-men who steer business to the title companies and who have no economic incentive to keep the cost of the service low. The absence of downward pressure on prices from those who select the vendor of title services is one of the characteristics that distinguishes this market from a competitive market and makes the observed sales costs an incorrect proxy for reasonable sales costs in a competitive market.

4 Alternative Measures of the Reasonable Costs of Selling Title Insurance

Because the observed expenditures for sales in the title industry are not a valid basis for determining what would be the reasonable costs of sales in a competitive market, other yardsticks for those costs have been examined. The staff has considered various other industries that might be thought to be comparable to the title insurance industry such that the reported sales costs of the reference industry are relevant to the reasonable costs for title insurance and related services in a hypothetical price-competitive market.

Industries examined were those that involved the rendition of financial information and services to retail consumers and that reported data in a form that was reliable and sufficiently specific to isolate the sales costs of the comparable products and services.

The staff concluded that the most appropriate such standard is personal-insurance lines in the property-casualty insurance industry. Experience in those lines would be indicative of the necessary costs to sell an insurance product to consumers in a reasonably competitive market. The principal lines of personal insurance are homeowners and the two lines of private passenger automobile insurance, liability and physical damage. Using personal-lines property-casualty insurance is facilitated by the fact that admitted insurers writing this insurance must file their expenses on a nationwide uniform basis with state insurance departments, including the California Department of Insurance.

5 Selection of the Sales Cost Factor

Under statutory accounting for property-casualty insurers, costs associated with sales and customer-service are reported as: commissions and brokerage expenses, the amounts paid on a percent-of-premium basis to sales personnel and organizations; other acquisition, covering advertising and other non-commission costs; field supervision, covering the carrier's supervision of its field sales force; and collections, covering the receipt and processing of premiums.

However, these categories reflect costs that are reported with commission in property-casualty reporting but that either do not apply to title insurance or are accounted for in the proposed regulations separately from the sales component. For example, in both homeowners and private passenger auto insurance, agents are required to perform certain underwriting functions not applicable to the sales charge here. That underwriting can be a major component of the cost to the agent or broker of making the sale, particularly in homeowners, where the agent or broker may be required to visit the house for a physical inspection. Of course, no such inspections are performed by sales personnel in title insurance, and, were they performed, their cost would be reported separately as underwriting expense, not as sales. (See §§ 2356.8 (reporting of title company's search, examination, and underwriting costs in Tables T103, T104, T109), 2356.9 (reporting of underwritten title company's search, examination, and underwriting costs in Tables UTC03, UTC04, UTC09), 2357.3 (defining total search, examination, and underwriting cost in terms of the tables), 2357.4 (defining the projected search, examination, and underwriting costs as a projection based on the total search, examination, and underwriting cost), 2357.7 (formula for preliminary report charge, including the search, examination, and underwriting component separate from the sales component).)

Similarly, statutory accounting implicitly includes within commissions and brokerage costs field claims-adjustment the portion of claims adjustment performed by agents and brokers. Again, to the extent claims adjustment is being performed on title insurance by UTCs, the costs are reported separately from sales costs. (See §§ 2356.8 (reporting of title company's claims-adjustment costs in Table T104), 2356.9 (reporting of UTC's claims-adjustment costs in Table UTC04), 2357.3 (defining total loss and loss adjustment factor in terms of the tables), 2357.4 (carrying that quantity forward as the projected loss component), 2357.13 (formula for policy charge, including the loss and loss adjustment component).)

Likewise, agents and brokers frequently issue the policy and perform policy-maintenance functions in homeowners and auto insurance that is recognized in the proposed regulations separately from sales costs. (See §§ 2356.8 (reporting of title company's policy-issuance and maintenance costs in Tables T103, T104, T109), 2356.9 (reporting of UTC's policy-issuance and maintenance costs in Tables UTC03, UTC04, UTC09), 2357.3 (defining preliminary report issuance and maintenance and policy issuance and maintenance costs in terms of the tables), 2357.4 (defining the projected policy issuance and maintenance component as a projection based on the total issuance and maintenance costs), 2357.13 (formula for policy charge, including the policy issuance and maintenance component separate from the sales component).)

Each of these functions, when performed by agents and brokers in homeowners and auto insurance, are paid for in sums reported by the property-casualty insurers as commission and brokerage. Each of these functions, whether performed by the underwriter or the UTC, would be paid for in sums reported under the proposed regulations separately from sales costs. It therefore follows that a simple importation of the personal-lines insurance commissions into the proposed regulations would effectively double-count costs significantly.

The following table shows the percent of premium reported going to commission and brokerage and to other acquisition, field supervision, and collections in 2004 and 2005 in the three principal lines of personal insurance, as reported on a national basis and aggregated in the 2005 and 2006 editions of *Best's Aggregates and Averages*.

		2004	**2005**	**Average**
Homeowners	Commissions	13.0%	13.5%	13.2%
	OA, FS, Collections	7.1%	7.3%	7.2%
	Total Sales Cost	20.1%	20.8%	20.5%
Private Passenger Auto Liability	Commissions	8.6%	9.1%	8.9%
	OA, FS, Collections	6.6%	7.1%	6.9%
	Total Sales Cost	15.2%	16.2%	15.7%
Private Passenger Auto Physical Damage	Commissions	8.7%	8.9%	8.8%
	OA, FS, Collections	6.8%	7.2%	7.0%
	Total Sales Cost	15.5%	16.1%	15.8%
Average Sales Costs, 3 lines		16.9%	17.7%	17.3%
Average Sales Costs, 2 auto lines		15.4%	16.2%	15.8%

As the table shows, in the three lines an average 17.3% of premium went to the specified functions; in the two auto lines (excluding homeowners, with the more extensive underwriting function), the two-year average was 15.8%.

In the final analysis, the proposed regulations adopt a sales cost factor of 15%. This quantity is derived from the experience of homeowners and auto insurers (17.3% for all three lines, 15.8% for the two auto lines), adjusted downward about one or two percentage points to reflect the separate recognition of underwriting, claims, and policy-maintenance functions in the proposed regulations. Given the degree of precision possible with available data, this modest adjustment is conservative and leaves companies sufficient revenue to recover their legitimate sales costs.