

STATE OF CALIFORNIA  
DEPARTMENT OF INSURANCE  
45 Fremont Street, 21<sup>st</sup> Floor  
San Francisco, California 94105

**SUBCHAPTER 4.75. Homeowners Insurance Rates and Underwriting.  
Article 1. Experience Rating in Residential Property Lines of Insurance**

**INITIAL STATEMENT OF REASONS**

**CDI File No. RH06050472**

**Date: January 31, 2006**

California Insurance Commissioner John Garamendi will hold a public hearing to consider regulations governing the rates, rating plans, rating systems and underwriting rules of California residential property (homeowners) insurance, specifically considering the adoption of Title 10, California Code of Regulations, Chapter 5, Subchapter 4.11, Article 1, Section 2371, *et seq.* The proposed regulation is entitled: **SUBCHAPTER 4.11. Homeowners Insurance Rates and Underwriting. Article 1. Experience Rating in Residential Property Lines of Insurance**

**STATEMENT OF SPECIFIC PURPOSE**

Rate Regulation: The purpose of this regulation is to clarify and make specific the standards relating to what data may be properly relied upon as the bases for a rate change request made pursuant to Cal. Ins. Code § 1861.05 and to make specific the standards upon which an insurer may, through applications of its rating plans, rating systems and underwriting rules, calculate the rates applied to or the premium charged for policies of residential property insurance. These specific standards are designed to ensure that rates are based on actuarially sound data and that the rating plans, rating systems and underwriting rules used by insurers do not result in rates or premiums that are excessive, inadequate, unfairly discriminatory or otherwise in violation of the law. This regulation draws a distinction between the calculation of the base rate and the calculation rates related to premium surcharges based on claims.

A base rate is a numerical amount which represents the total annual premium that the insurer must charge in order to cover expenses and obtain a reasonable rate of return. *Spanish Speaking Citizens' Foundation, Inc. v. Low* (2000) 85 Cal.App.4th 1179, 1186, 103 Cal. Rptr. 2d 75, 80. The calculation of a base rate pursuant to section 1861.05, "requires that an insurer provide a highly technical, formulaic, presentation of its loss, expense and claims data so that the Department can determine whether the base rate is excessive, inadequate or unfairly discriminatory. [(See generally Cal. Code Regs., tit. 10, §§ 2644.1-2644.23.)]" *Donabedian v. Mercury Ins. Co.*, (2004) 116 Cal. App. 4th 968, 992, 11 Cal. Rptr. 3d 45; 50. In general, all reasonable expense and loss cost data may be used in the calculation of the base rate.<sup>1</sup>

The proposed regulation does not address this aspect of insurance ratemaking. What this regulation does address are two distinct aspects of what are commonly known as premium surcharges based on claims. A premium surcharge based on claims is a rate component or rating

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<sup>1</sup> To be sure, in underwriting a homeowners policy of insurance many factors are applied as against the base rate such as location, square footage and type of construction in order to arrive at a dollar amount premium to be paid for the policy of insurance. This regulation does not address those rating and underwriting factors.

or underwriting factor that is applied to the base rate to calculate the final rate or premium.<sup>2</sup>

The first consideration relating to premium surcharges based on claims rates goes to the type of data relied upon in calculating the premium surcharge rate. Like its cousin, the base rate, the calculation of the premium surcharge rate is subject to the strictures of Cal. Ins. Code § 1861.05 and similarly requires the insurer provide a highly technical, formulaic, presentation of its loss, expense and claims data so that the Department can determine whether the premium surcharge rate is excessive, inadequate or unfairly discriminatory. Key to this analysis is ensuring the data used in the calculation of the premium surcharge rate is actuarially sound data. Where the data used in the calculation is not sound the resulting rates will not meet the standard of Proposition 103 as those premium surcharge rates will necessarily be excessive, inadequate or unfairly discriminatory.

The second consideration relating to premium surcharge rates goes to when premium surcharges may be properly applied. In general, premium surcharges based on claims come into play after the policyholder has made a claim against her homeowners insurance policy. To the extent the premium surcharge increases the premium, that rate increase must be actuarially sound. In order for the increased rate to be actuarially sound the claim that triggers the premium surcharge must have an actuarially sound relationship to future risk of loss, otherwise here is no justification for the increase in premium. In other words the claim must in some way increase the future risk of loss commensurate with the increase in premium. Where this relationship does not exist, the premium surcharge rate will necessarily be excessive, inadequate or unfairly discriminatory.

Disclosure Requirements: The purpose of the disclosure provisions is to foster equity, fairness, and plain dealing in the marketing and sale of policies of residential property insurance in California. The purpose of this regulation is to define, clarify and make specific requirements regarding information to be shared by the insurer with the insured or potential insured about the terms of any contract of residential property insurance sold in California in order to prevent unfair or deceptive acts or practices in the sale of policies of residential property insurance and to avoid unfair methods of competition in the insurance marketplace.

Proposition 103: The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians.(Historical and Statutory Notes, 42A West's Ann. Ins. Code (1993 ed.) foll. § 1861.01, p. 649.) The purpose of this regulation is to facilitate the Commissioner in the performance of his duties as required by law, specifically to ensure that residential property insurance is fair, available and affordable for all Californians.

## **STATEMENT OF SPECIFIC STATUTORY AUTHORITY**

### **Rate Regulation / Cal. Ins. Code Section 1861.05(a)**

In California much of the Commissioner's regulatory authority over property and casualty lines of insurance is found in the McBride-Grunsky Insurance Regulatory Act of 1947

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<sup>2</sup> The Commissioner has determined that when referring to something other than the base rate, the term "rate" as it is used in Cal. Ins. Code section 1861.05 may be synonymous with premium. "A fair reading of Proposition 103 and Calfarm shows that the terms 'rates' and 'premiums' are used interchangeably." *Allstate Ins. Co. v. Gillespie*, (1992) CITE.

(Cal. Ins. Code, § 1850.4 *et seq.*) Proposition 103 was added to the McBride-Grunsky Act becoming effective on November 8, 1989. The stated purpose of the initiatives is to ensure that “insurance is fair, available, and affordable for all Californians” and to protect consumers from “excessive, unjustified and arbitrary rates.” The Insurance Commissioner is duty bound to enforce the provisions of Proposition 103 so as advance it stated purposes. The Commissioner has determined that rates, rating plans and underwriting rules that are not actuarially sound result in “excessive, unjustified and arbitrary rates.”

Cal. Ins. Code § 1861.05(a), an integral component of Proposition 103, provides that no rate “shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter.” As is discussed in detail below, this subsection provides the Commissioner with broad authority to regulate insurance rates in the lines of insurance subject to the McBride-Grunsky Act. Residential property or homeowners insurance lines of insurance are subject to the McBride-Grunsky Act. Since the advent of Proposition 103, the extent of the Commissioner’s authority to regulate rates has been subject to much debate and analysis in the California courts

While there is no express grant of authority in Proposition 103 requiring the Commissioner to promulgate regulations to ensure insurance rates are not excessive, inadequate, unfairly discriminatory or otherwise in violation of the law, the Commissioner's authority to adopt regulations as necessary to facilitate the implementation of Proposition 103 is well established

In *Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal. 3d 805, 824, 258 Cal. Rptr. 161; various insurance companies and trade associations challenged Proposition 103 as unconstitutional being on its face. The California Supreme Court rejected that contention for the most part but it did hold one provision unconstitutional because that provision precluded rate adjustments necessary to avoid confiscation. The Court also held that to avoid an unconstitutional taking the procedures used to examine rates must provide insurers with the opportunity to earn a fair and reasonable rate of return. The Court opined that given these constitutional considerations and the complex nature of insurance ratemaking a regulatory scheme, i.e., the promulgations of regulations, was inevitable. As to those yet to be drafted rate regulations the court stated that the Commissioner "has broad discretion to adopt rules and regulations as necessary to promote the public welfare" (*Id.* at p. 824.) The Court added that in developing rate regulations under Proposition 103 the Commissioner "may exercise such ... powers ... as may fairly be implied" from the initiative. (*Id.* at p. 824.) Thus, even though there is no express statutory rulemaking authority in Proposition 103 the initiative does confer upon the Commissioner broad, albeit implied, authority for the promulgation of rate regulations such as those proposed herein.

In response to *Calfarm*, Commissioner Garamendi adopted rate regulations, establishing ratemaking methodology consistent with *Calfarm* to determine rates in Proposition 103 lines of insurance. Those regulations were, in turn, the subject of *20th Century Ins. Co. v. Garamendi* (1994) 32 Cal. Rptr. 2d 807, 842. In *20<sup>th</sup> Century* the California Supreme Court followed *Calfarm* in upholding the Commissioner’s broad authority under Proposition 103 to promulgate rules regulating insurance rates. In discussing the Commissioner’s implied authority to promulgate rate regulations under Proposition 103 the Court stated:

The Commissioner's powers are not limited to those expressly conferred by statute, but also include " ' ' 'such

additional powers as are necessary for the due and efficient administration of powers expressly granted by statute, or as *may fairly be implied* from the statute granting the powers.' " [Citation.] " (*20th Century Ins. Co. v. Garamendi* (1994) 8 Cal.4th 216, 245, 32 Cal. Rptr. 2d 807, 842. (Italics in original.)

In *State Farm Mutual Automobile Ins. Co. v. Garamendi, supra*, 32 Cal.4th at pp. 1041-1042 (2004) the California Supreme Court stated, "[A]rticle 10 gives the Commissioner broad authority over insurance rates, and expressly precludes him from approving rates that are 'excessive, inadequate, unfairly discriminatory or otherwise in violation of' chapter 9 of the Insurance Code."

In *RLI Ins. Co. Group v. Superior Court*, (1996) 51 Cal.App.4th 415, 51 Cal. App. 4<sup>th</sup>, in discussing the Commissioner's authority to regulate rates the court of appeal stated:

It is also " "well settled in this state that [administrative] officials may exercise such additional powers as are necessary for the due and efficient administration of powers expressly granted by statute or as *may fairly be implied* from the statute granting the powers." ' ' " *Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal. 3d 805, 824, 258 Cal. Rptr. 161; *RLI Ins. Co. Group v. Superior Court*, (1996) 51 Cal.App.4th 415, 431 51 Cal. App. 4th 415.

In *California State Auto. Assn. Inter-Ins. Bureau v. Garamendi*, (1992) 6 Cal. App. 4th 1409, 8 Cal. Rptr. 2d 366, the court provided, "In light of the broad mandate given by the Legislature to the Commissioner, the courts must necessarily recognize her "broad discretion" to enact specific measures which are consistent with the goals of the statutory scheme.

*Calfarm* and 20<sup>th</sup> Century spawned a long line of case focusing on insurance rate regulation under Proposition 103 too numerous to review here. However, the above cited cases should make it abundantly clear that the Commissioner has authority to promulgate rules of general application pertaining to, as the proposed regulation does, insurance rate regulation.

The goal of every insurance company is to correlate rates for insurance policies as closely as possible with the actual cost of claims. As stated above, section 1861.05 provides, "[n]o rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter." In terms of the numerical rate, considering whether a rate is excessive, inadequate or unfairly discriminatory, the *Calfarm* standard requires rates within a range that can be described as "fair and reasonable" (*CalFarm, supra*, 48 Cal. 3d at pp. 822-823; *20th Century, supra*, 8 Cal. 4th at p. 244), and rates which are "fair and reasonable" are constitutional, i.e., are not confiscatory. ( *CalFarm, supra*, 48 Cal. 3d at p. 816, fn. 5; *20th Century, supra*, 8 Cal. 4th at pp. 244-245.). It follows, of course, that rates calculated using data that is not actuarially sound will in all likelihood produce rates that are "excessive, unjustified and arbitrary" and something other than "fair and reasonable." And it would also follow that surcharge triggers which increase the premium paid by the policyholder must also be actuarially sound less the surcharge premium charged be "excessive, unjustified and arbitrary."

## **Disclosure Requirements / Cal. Ins. Code section 790.10**

Section 790.03 appears in an article entitled "Unfair Practices." The stated purpose of Cal. Ins. Code §§790 *et seq.*, is "to regulate trade practices in the business of insurance . . . by defining, or providing for the determination of, all such practices in this State which constitute unfair methods of competition or unfair or deceptive acts or practices and by prohibiting the trade practices so defined or determined." (§ 790). The proscribed acts are defined as unfair competition or unfair practices, subject to specific administrative action (§ 790.04). The remedies for these administrative infractions are clearly defined in §§ 790.05-790.09. For purposes of administering the "Unfair Practices" article, the Commissioner is authorized under § 790.10 to issue reasonable rules and regulations. The Commissioner has identified an unfair insurance business practice, that practice being, insurer are not informing policy holders and potential policyholders are not being put on notice of the negative ramifications of making a claim. The proposed regulation is designed to prohibit this practice by requiring specific disclosures.

In promulgating this regulation the Commissioner is "providing for the determination" of acts or practiced he believes to be unfair within the meaning of the Unfair Practices Act. It is clear that the act gives the Commissioner express authority to define and make specific those acts or practices he determines "pursuant to the act" to be "unfair." Cal. Ins. Code §790.10 provides the Commissioner with specific, express, statutory authority to issue rules that identify and define specific unfair practices.

The authority for those portions of the regulation that relate to requirements that the insurer inform the policyholders of the insurers of how claims history is used by the insurer in making rates and otherwise is Cal. Ins Code § 790.10

The Commissioner has promulgated regulations under the authority conferred upon him in Cal. Ins. Code §790.10. Most notably, to establish means to prevent unfair insurance claims practices, the Insurance Commissioner promulgated the Fair Claims Settlement Practices Regulations (§ 2695.1 *et seq.*) under Cal. Ins Code § 790.10

Specifically, as to disclosure, the Commissioner promulgated California Code of Regulations § 2695.4, under the rulemaking authority found in Cal. Ins. Code § 790.10. This section provides in relevant part: "Every insurer shall disclose to a first party claimant or beneficiary, all benefits, coverage, time limits or other provisions of any insurance policy issued by that insurer that may apply to the claim presented by the claimant. . . ." (§ 2695.4, subd. (a).)

The proposed regulation would require certain, specific disclosures as to relating the negative impact policyholders will suffer upon the making of a homeowners insurance claim. This is necessary as the Commissioner has determined the proposed disclosures are, more time than not, not being made.

The Commissioner's express authority to promulgate regulations such as those proposed here has been recognized by the California courts. (See e.g.: *Spray, Gould & Bowers v. Associated Internat. Ins. Co.*, 71 Cal. App. 4th 1260, 84 Cal. Rptr. 2d 552, 1999; *California Serv. Station Etc. Assn. v. American Home Assur. Co.*, 62 Cal. App. 4th 1166, 73 Cal. Rptr. 2d 182, 1998 *need a third one.*)

### **Note: The Commissioner's Authority Over "Underwriting"**

In California "an underwriting rule is properly characterized as a rule followed or

adopted by an insurer or a rating organization which either (1) *limits* the conditions under which a policy will be issued or (2) *impacts* the rates that will be charged for that policy." (*Smith v. State Farm Mutual Automobile Ins. Co. (2001) 93 Cal.App.4th 700, 726 [113 Cal. Rptr. 2d 399]*)

Per the *Smith* case, the term underwriting is sometimes used to denote eligibility for insurance. At other times the term is used to mean the process by which the amount of premium to be paid for a policy of insurance is determined. The Commissioner considers the interpretation in the *Smith* case to be the legal authority in California however, this regulation does not intend to and should not, in application, have any impact whatsoever on insurer eligibility

## **PROPOSED REGULATION BY SUBSECTION**

The following are statements of specific purpose and effect of each subsection of the proposed regulation including the rationale for the determination that each subdivision is reasonably necessary to carry out the purpose for which it is proposed. The proposed regulation is designed to address residential property insurance availability and unfairly discriminatory rating and underwriting in California.

### **Proposed California Code of Regulations section 2371.1 “Purpose” – Adopt**

The proposed subsection provides the purposes of the regulation. The purpose of the subsection is to make clear and specific what the regulation is intended to address and accomplish. The language is therefore reasonably necessary to make clear to impacted entities and the public the reasons for the Commissioner’s action and is reasonably necessary to effectuate that purpose.

### **Proposed California Code of Regulations section 2371.2 “Definitions” – Adopt**

The proposed subsection sets forth definitions for the terms used substantively throughout the regulation. The purpose is to clarify and make specific the meaning of various terms used in the substantive portions of the regulation throughout the regulation. The language is reasonably necessary to effectuate that purpose.

### **Proposed California Code of Regulations section 2371.3 Limitations on Surcharges – Adopt**

This proposed subsection goes directly to rates and rating. The proposed section makes clear to impacted person and entities certain limitations on the imposition of rate surcharges in residential property lines of insurance. The regulation is designed to eliminate the imposition of surcharges (that is, factors applied against the base rate to increase the premium paid) where those surcharges are not based on actuarially sound criteria. This language is substantive. It is necessary that this language or language substantially be included in the regulation to effectuate the purpose of the regulation.

### **Proposed California Code of Regulations section 2371.4 “Limitations on Loss Data” – Adopt**

Insurance ratemaking is the estimation of future costs associated with the transfer of risk

from a consumer to the insurance company. While rates are based on past experience, ratemaking is prospective; rates are established as estimates of future costs. The data used to estimate future costs must be actuarially sound. Rates based on data that is not predictive of future loss are not actuarially sound and necessarily unfairly discriminatory. Proposition 103 requires that rates (be they base rates, surcharges, or discounts) must be approved by the Commissioner prior to use.

The first paragraph in the proposed subsection goes directly to the calculation of surcharge rates based on claim, that is, the amount of the surcharge (a numerical value) that will be applied against the base rate. The Commissioner cannot approve a rate where the supporting data is not actuarially sound, that is, where the data does not reasonably relate to future risk. The paragraph provides that data relating to certain claims may not be used as the bases for calculating premium surcharge rates as the types of losses specifically enumerated do not have a reasonable relationship to future risk. The Commissioner has determined that rates based on loss data as described in the first paragraph are not actuarially sound as those losses do not have a reasonable relationship to future risk. The language is necessary to make clear the standards to be applied to data used to support rates during the prior approval process and is therefore reasonably necessary to effectuate that purpose.

The second paragraph sets forth specifics the circumstances under which specific data types may be used to support premium surcharge rates. The language is necessary to make clear the standards to be applied to data used to support rates during the prior approval process and is therefore reasonably necessary to effectuate that purpose.

The third paragraph sets forth specific types of data that may not be used to support premium surcharge rates. The language is necessary to make clear the standards to be applied to data used to support rates during the prior approval process and is therefore reasonably necessary to effectuate that purpose.

The fourth paragraph is intended to make sure data used to calculate rates is applied only once in the ratemaking process. The goal of this section is to make clear to impacted entities that loss data used to support base rates may not be used again to support surcharges. The intent is to avoid “double dipping” that is, the use of the same data twice. The Commissioner has determined that “double dipping” is not an actuarially sound ratemaking procedure.

While, as of late, more insurers are applying surcharges based on claims history, the use of surcharges based on historical losses (otherwise known as “experience rating”) is relatively new in homeowners lines of insurance having been adapted from commercial lines where it has been in use for many years. Also, while the application of surcharges is becoming more prevalent many companies have not chosen to go that route but are factoring in all actuarially sound loss data in the calculation of the base rate. The fourth paragraph is designed to make it clear that where insurers are using loss data as the basis for surcharge rates, the same data may not be used to develop base rates. The language is necessary to make clear the standards to be applied to data used to support rates during the prior approval process and is therefore reasonably necessary to effectuate that purpose.

### **Proposed California Code of Regulations section 2371.5 – Adopt**

The purpose of the proposed subsection is to make clear to impacted entities and the public certain requirements relating to information that must be communicated to potential insureds at the point of sale and to annually notice policyholders regarding information relating

to premium surcharges. The Commissioner believes that well informed consumers make better consumers. The Commissioner also believes that insurers should be responsible for making sure the policyholder is informed of all pertinent information relating to coverages and claims and policyholders should be made aware of the consequences of making a claim before taking such an action. The purpose of the subsection to see to it insurance consumers are informed about the products they purchase.

### **IDENTIFICATION OF STUDIES AND REPORTS**

CDI did not rely upon any specific technical, theoretical and/or empirical study, report or similar document in drafting the proposed regulation. The Commissioner has determined that issues and questions relating to the use of surcharges in the prior approval context are best addressed by a rule of general application. The Commissioner has likewise determined that issues and questions relating to consumer complaints relating to the policyholders lack of prior knowledge of the impact on premium of the making of a claim are best addressed by a rule of general application.

To the extent that any specific technical, theoretical and/or empirical study, report or similar document is reviewed or relied upon during the rulemaking process, such study or report or similar document will be made part of the rulemaking file.

### **SPECIFIC TECHNOLOGIES OR EQUIPMENT**

Adoption of the proposed regulation would not mandate the use of specific technologies or equipment.

### **CONSIDERATION OF ALTERNATIVES**

The Commissioner must determine that no reasonable alternative considered by the Commissioner or that has otherwise been identified and brought to the attention of the Commissioner would be more effective in carrying out the purposes for which the regulations are proposed or would be as effective as and less burdensome to affected private persons than the proposed action. The Commissioner, however, invites public comment on alternatives to the regulation.

As to the portion of the proposed regulation relating to surcharges no viable alternative was presented to the Commissioner prior to the drafting of this regulation. The Commissioner has not determined other alternatives may be available to address the issues that are the focus of the surcharge portion of the proposed regulation.

As to the disclosure portion of the regulation no viable alternative was presented to the Commissioner prior to the drafting of this regulation. The Commissioner has not determined other alternatives may be available to address the issues that are the focus of the disclosure portion of the proposed regulation.

Performance standards were not considered in relation to the rate portion of this regulation because rates are required to be approved prior to use and the application of after the fact performance standards would not further the purposes of Proposition 103.

Performance standards were considered in relation to the disclosure portion of the proposed regulation with the objective identified was fairness in the sale of residential property

insurance. However, no specific performance standard was proposed that would be more efficient than the disclosure provisions contained in the proposed regulation. The Commissioner has not determined that performance standards might not represent a viable alternative to the disclosure requirements.

The Commissioner continues to study alternatives.

### **IMPACT ON SMALL BUSINESS**

The Commissioner has determined that the proposed regulations do not affect small businesses.

Date: January 31, 2006

JOHN GARAMENDI  
Insurance Commissioner

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