

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE**
45 Fremont Street, 21st Floor
San Francisco, California 94105

File No. RH05042749

Date: July 18, 2006

NOTICE OF PROPOSED RULEMAKING

Rate Approval Regulations

SUBJECT OF HEARING

Notice is hereby given that Insurance Commissioner John Garamendi (“Commissioner”) proposes to amend or adopt California Code of Regulations, Title 10, Sections 2642.4, 2642.5, 2642.6, 2642.7, 2643.2, 2643.6, 2643.8, 2644.2, 2644.3, 2644.4, 2644.5, 2644.6, 2644.7, 2644.8, 2644.9, 2644.10, 2644.11, 2644.12, 2644.15, 2644.16, 2644.17, 2644.18, 2644.19, 2644.20, 2644.21, 2644.23, 2644.24, 2644.25, 2644.26, 2644.27, 2644.50, 2646.3, and 2646.4, to implement the rate approval provisions of Proposition 103 and California Insurance Code Section 1861.05.

PUBLIC HEARING

The Commissioner will hold a public hearing to provide all interested persons an opportunity to present statements or arguments, either orally or in writing, with respect to the proposed action at the following date, time, and location:

Wednesday, September 13, 2006 – 10:00 a.m.
California Department of Insurance Hearing Room
45 Fremont Street, 22nd Floor, San Francisco, CA 94105

The facilities to be used for the public hearing are accessible to persons with mobility impairments. Persons with sight or hearing impairments are requested to notify the contact person for this hearing in order to make special arrangements, if necessary.

CONTACT PERSONS

Any questions regarding this notice should be directed to:

Bruce V. Patton, Senior Staff Counsel
California Department of Insurance
Rate Enforcement Bureau
300 Capitol Mall, Suite 1700
Sacramento, CA 95814
Telephone: (916) 492-3560
Facsimile: (916) 324-1883
Pattonb@insurance.ca.gov

The backup contact person for these inquires is Cathleen Chapman (contact information below).

WRITTEN COMMENT PERIOD

Any interested person, or his or her authorized representative, may submit written comments relevant to the proposed regulatory action to the Commissioner via electronic or U.S. mail, personal delivery or facsimile. Comments shall be transmitted by one method only.

The written comment period closes at **5:00 p.m. on September 13, 2006**. Any materials *received* after that time will not be considered. Submit comments to:

Cathleen S. Chapman
Staff Counsel
California Department of Insurance
45 Fremont Street, 21st Floor
San Francisco, CA 94105
Telephone: (415) 538-4458
Facsimile: (415) 904-5490
chapmanc@insurance.ca.gov

ADVOCACY OR WITNESS FEES

Persons or groups representing the interests of consumers may be entitled to reasonable advocacy fees, witness fees, and other reasonable expenses, in accordance with the provisions of California Code of Regulations, Title 10, Subchapter 4.9 in connection with their participation in this matter. Persons interested in inquiring about the appropriate procedures should contact the Office of the Public Advisor at the following address:

California Department of Insurance
Office of the Public Advisor
300 Capitol Mall, 17th Floor
Sacramento, CA 95814
(916) 492-3559

A copy of any written materials submitted to the Public Advisor regarding this rulemaking shall also be submitted to the contact person for this hearing. Please contact the Office of the Public Advisor for further information.

AUTHORITY AND REFERENCE

California Insurance Code Section 1861.05, *Calfarm Ins. Co. v. Deukmejian*, 48 Cal.3d 805 (1989) and *20th Century Ins. Co. v. Garamendi*, 8 Cal. 4th 216 (1994) authorize the Commissioner to regulate in an orderly manner the insurance market in California, to determine that rates that are neither excessive nor inadequate, and to protect the public while implementing Proposition 103. The proposed regulations would implement, interpret or make specific Insurance Code sections 1861.05, and 1861.13.

Because this proposed rulemaking action concerns ratemaking, California Government Code §11340.9(g) applies.

INFORMATIVE DIGEST

Summary of Existing Law

California Insurance Code Section 1861.05, added by Proposition 103 in 1988, requires the Commissioner's approval of most property and casualty insurance rates. Minimal hearing requirements are specified in California Insurance Code Section 1861.08. Consumer participation is authorized by California Insurance Code Section 1861.10.

California Code of Regulations, Title 10, Sections 2641.1 through 2646.5 set forth the processes and policies by which the Commissioner shall review rates. However, given the passage of time, those regulations require revisions. This rulemaking proceeding proposes those revisions.

Policy Statement Overview and Effect of Proposed Action

The Commissioner proposes to make changes to the following sections of Title 10 of the California Code of Regulations. These sections concern the approval of insurance rates.

Section 2642.4 Pure Premium

Existing section 2642.4 defines pure premium. The changes proposed to this section update changed terminology.

2642.5 Rating Period

Existing section 2642.5 defines rating period. The changes proposed to this section recognize that a generic determination for rating period is no longer contemplated.

2642.6 Recorded Period

Existing section 2642.6 defines recorded period. The changes proposed to this section recognize that a generic determination for recorded period is no longer contemplated.

2642.7 Lines of Insurance

Existing section 2642.7 sets forth the lines of insurance. The changes proposed to this section recognize that some lines of insurance have been reclassified by the National Association of Insurance Commissioners ("NAIC") since original adoption of these regulations. Because the lines of insurance are based on the NAIC Annual Statement classifications, the changes are proposed for consistency purposes. Mechanical breakdown and similar coverage is classified as other liability occurrence for purposes of these regulations. Mechanical breakdown is not currently specified, and therefore it arguably could be included in more than one line. Classifying it ensures consistent treatment. The existing regulation allows an insurer to disaggregate certain lines into commodity and specialty. A proposed change also allows the Commissioner to do so. Medical malpractice is deleted as a specialty line because unique issues related to medical malpractice coverage are separately addressed.

Section 2643.2 Rating Basis

Existing section 2643.2 defines rating basis. The changes proposed to this section recognize that a generic determination for rating basis is no longer contemplated.

Section 2643.6 Interjurisdictional Allocations

Existing section 2643.6 addresses interjurisdictional allocations. The changes proposed to this section recognize changed terminology and allow the Commissioner to disaggregate commodity and specialty lines.

Section 2643.8 Factors Calculated by the Commissioner

New section 2643.8 establishes the factors which shall be used for review of rate applications, when these regulations require the periodic updating of specified factors.

Section 2644.2 Maximum Permitted Earned Premium

Section 2644.2 currently defines the maximum permitted earned premium. Changes proposed to this section recognize both fixed and variable investment income, and allow use of the efficiency standard for companies with expenses below the efficiency standard, thus rewarding more efficient companies. Fixed expenses in the numerator and variable expenses in the denominator are replaced with the efficiency standard in the denominator.

Section 2644.3 Minimum Permitted Earned Premium

Section 2644.3 currently defines the minimum permitted earned premium. Changes proposed to this section correspond to the changes to the maximum permitted earned premium described immediately above.

Section 2644.4 Projected Losses

Several changes are proposed to existing section 2644.4.

Current section 2644.4(b) provides that for medical malpractice insurance, where the use of claims-made policies predominates, projected losses are calculated on a report year basis, except where occurrence policies predominate. Because calculating projected losses on a report-year basis is appropriate for all claims-made policies, the regulation has been amended to provide that projected losses shall be calculated on a report-year basis for all claims-made policies.

Although subject to the provisions of Proposition 103 and these regulations, treatment of mechanical breakdown and other policies providing coverage on a multi-year basis is not specifically addressed in the current regulations. Proposed new subsection (c) provides that for policies providing multi-year coverage, such as mechanical breakdown, projected losses shall be calculated using a sound actuarial method.

New subsection (d) provides that for policies providing death, disability and retirement coverage (such as medical malpractice), projected losses shall be calculated using a sound actuarial method.

Similar to changes to other provisions of these regulations, language is proposed to be added to section 2644.4(e) allowing the Commissioner, in addition to an insurer, to disaggregate a line of insurance into commodity and specialty categories.

New subsection (f) provides that for earthquake coverage and for the fire following earthquake exposure, projected losses and defense and cost containment expenses may, if certain conditions are met, be based on complex catastrophe models. This recognizes standard actuarial practice in these unique lines.

Section 2644.5 Catastrophe Adjustment

The existing regulation provides that the Commissioner shall prescribe a catastrophe adjustment in a generic determination. Because the generic determination process is generally proposed for deletion, proposed amendments to this section establish how catastrophe losses shall be averaged, and specifies that there shall be no catastrophe adjustment for private passenger automobile liability coverage.

Section 2644.6 Loss Development

Amendments proposed to this section specify that loss development is based on the dollar-weighted average (rather than the average) of the ratios of losses for the three most recent policy-years or report-years, in addition to the existing reference to accident years. Existing section

2644.4 requires the Commissioner to promulgate reporting intervals for loss development in a generic determination. Because the generic determination process is generally proposed for deletion, the reference to the generic determinations is deleted from this section. Additionally, this section provides that loss development data excludes catastrophes, since including it would distort the results.

Section 2644.7 Loss and Premium Trend

Existing section 2644.7 defines loss trend. The suggested amendment adds a similar definition for premium trend and sets forth the manner in which premium trend factors are developed.

The existing regulation provides that loss trend factors are adopted through the generic determination process. That language is proposed for deletion, since the generic determination process is generally proposed for deletion. Instead, this section now would provide that loss trend factors are developed using company-specific (rather than the current industry-wide) paid loss, closed claim count, and earned exposure data. Where the trend factor within a given line varies significantly, separate trend factors shall be calculated in accordance with that evidence.

Subsection (c) sets forth the credibility standard for various coverages in accordance with standard actuarial practices.

Finally, the section notes that the Commissioner may modify the result of the calculation to reflect factors not reflected in the historical data.

Section 2644.8 Projected Defense and Cost Containment Expenses

Changes proposed to section 2644.8 recognize the change in terminology from allocated loss adjustment to defense and cost containment.

Proposed new subsection (b) allows defense and cost containment expenses to be added to losses for loss development and trend, or they may be developed using ratios of defense and cost containment expenses to losses.

Changes proposed to subsection (c) recognize that it is proposed that the Commissioner, in addition to an insurer, may disaggregate a line of insurance into commodity and specialty.

Section 2644.9 Projected Fixed Expenses

This section is proposed for deletion in keeping with the changes proposed to the efficiency standard.

Section 2644.10 Excluded Expenses

Changes proposed to section 2644.10 set forth the excessive executive compensation amounts in accordance with the amounts established for purposes of insurers' rollback obligations. Because

this is no longer determined through the generic determination process, that reference is also deleted.

To recognize the change in NAIC terminology, "allocated loss adjustment" is changed to "defense and cost containment."

Proposed new language specifies how any disallowance shall be effected.

Section 2644.11 Expense Trend

This section is proposed for deletion as a result of changes proposed to the efficiency standard.

Section 2644.12 Efficiency Standard

Changes proposed to this section clarify that the efficiency standard should be used rather than actual expenses, which rewards more efficient companies.

The efficiency standard is, for the most part, no longer a generic determination under the proposed regulations. As proposed, the Commissioner shall calculate the efficiency standard within 45 days of publication of the necessary source data. The proposed regulation establishes how the efficiency standard is calculated.

Current regulation language sets a separate efficiency standard for insurers selling through employees of the insurer not functioning as agents. Proposed new language changes this terminology to insurers selling insurance on a direct basis.

Language proposed for subsection (c) would allow the Commissioner to establish separate efficiency standards in certain circumstances.

Section 2644.15 Profit Factors

The change proposed to this section recognizes that the applicable federal income tax factor is the underwriting federal income tax factor.

Section 2644.16 Rate of Return

The current regulation provides that the Commissioner shall determine the maximum and minimum permitted after-tax rate of return through the generic determination process. These proposed regulations generally eliminate that process. Therefore, the changes proposed to this section establish the maximum permitted after-tax rate of return at 11%. The minimum after-tax rate of return which an insurer may select is -7%, a number the Commissioner finds is high enough to prevent undue risk of insolvency and to prevent injury to competition through predatory pricing.

Section 2644.17 Leverage Factor and Surplus

The current regulation provides that the leverage factor is the ratio of net written premiums to surplus. Under the proposed regulation, leverage factor is the ratio of earned premiums to the average of year-beginning and year-end surplus. This change was made in response to workshop comments indicating that because the leverage factor as it operates in the permitted earned premium formulas is a gross leverage factor, references to net are potentially confusing. The regulation language is proposed for amendment in response to this comment.

The current regulations provide that the Commissioner will establish leverage factors through the generic determination process. Since the generic determination process is, for the most part, being eliminated, this section provides that total national industry surplus is allocated to lines of business in proportion to the national industry-wide unearned premium, loss, and loss adjustment expense reserves. The calculation shall be made within 45 days of publication of the necessary source data.

Section 2644.18 Federal Income Tax Factors

Existing section 2644.18 establishes a federal income tax factor in connection with review of rate applications. Proposed section 2644.18 recognizes an underwriting federal income tax factor, currently 35%. It also recognizes an investment federal income tax factor, which is calculated as described in the proposed regulations and takes into account different categories of investments.

Section 2644.19 Investment Income Factors

Existing section 2644.19 defines investment income factor as the projected yield multiplied by the sum of the reserves ratio plus the surplus ratio. Proposed section 2644.19 recognizes a fixed investment income factor and a variable investment income factor, as defined in the proposed regulation.

Section 2644.20 Projected Yield

Existing section 2644.20 describes projected yield. The proposed section provides a much more detailed measure of projected yield and uses the insurer's actual portfolio and yields currently available on securities in the United States capital markets.

Section 2644.21 Reserves Ratio

Existing section 2644.21 defines reserves ratio as the average of the last two years loss reserves plus loss adjustment expense reserves plus unearned premium reserves divided by the earned premium for the most recent year for which data are available. Proposed section 2644.21 recognizes both an unearned premium reserves ratio and a loss reserves ratio. One industry-wide unearned premium reserves ratio and one loss reserves ratio for each line is recognized. The source data for these numbers is set forth, as is the time period for performing the calculations. Earthquake, other lines of business subject to catastrophes, mass torts, and other unusual events are treated separately.

Section 2644.23 Credibility Adjustment

Section 2644.23 provides that to the extent data lack credibility, a credibility adjustment shall be made. The existing section provides that the adjustment shall be made to projected losses, projected allocated loss adjustment expenses, projected loss development, and projected allocated loss adjustment expenses development. That language is proposed for deletion. Also proposed for deletion is language providing that the credibility adjustment shall consist of adding to the insurer's data sufficient additional data to provide a total sample size sufficient to meet the applicable credibility criterion established by the Commissioner.

The existing regulation provides that the Commissioner shall specify credibility criteria and appropriate sources of substitute data through the generic determination process. The proposed regulation, in accordance with standard actuarial practice, actually sets forth the standard for full and partial credibility.

The proposed regulation establishes substitute data when the loss and defense and cost containment expense data are less than fully credible. The complementary loss and defense and cost containment expense is defined in proposed new language.

The formula is adjusted in accordance with changes proposed to the efficiency standard.

Proposed new language defines the complement trend and the annual net trend.

As proposed, if the credibility weight is less than 25%, the applicant or Commissioner may use an alternative complementary loss and defense and cost containment expense if it is actuarially sound and reasonable in the circumstances.

Section 2644.24 Trended Current Rate Level Earned Premium

The proposed new section defines trended current rate level earned premium.

Section 2644.25 Reinsurance

This is a proposed new section. It recognizes that, except for earthquake and medical malpractice facultative reinsurance with attachment points above \$1 million, ratemaking is reviewed on a direct basis without consideration of reinsurance costs. When reinsurance is considered, the manner in which those costs are reflected in the ratemaking formula is set forth. Reinsurance costs are only allowed if the reinsurance agreement was entered into in good faith in an arms-length transaction not between affiliates and at fair market value. There must be an acceptable transfer of risk, the reinsurer must be an authorized reinsurer, the reinsurance must comply with all applicable statutory accounting principles, and a copy of the reinsurance agreements must be submitted with the rate application. In response to workshop comments, the regulation provides that other risk financing mechanisms are considered in the same manner as reinsurance.

In specified circumstances, a petition for hearing regarding reinsurance costs will be granted.

Changes to the efficiency standard are reflected in the proposed regulation.

Section 2644.26 Reinsurance Recoverables

Proposed new section 2644.26 defines reinsurance recoverables.

Section 2644.27 Variance Request

Variances are currently described in section 2646.4(c). In the proposed regulations, the variance provisions are found in section 2644.27.

Section 2644.27(a) is currently found at section 2646.4(b)(2).

Section 2644.27(b) is a new provision specifying the form which an insurer shall use to request a variance (Form CA-RA9). A copy of the proposed form is attached to the regulation text for comment. The form requesting a variance shall identify the variance requested, identify the extent of the variance and the rate component affected, quantify the rate impact, and set forth the justification for the variance. This information is necessary to allow the Commissioner to evaluate the variance request.

Section 2644.27(c) is also a new provision, requiring that variance requests be filed either with the rate application or after the rate application is filed but before a final determination is made on the rate application. Specific public notice of a requested variance is required so that interested members of the public are alerted to the variance request and provided with sufficient opportunity to request a hearing in connection with the rate application if they desire to do so.

Section 2644.27(d) provides that a variance request shall be deemed approved 60 days after public notice unless a hearing is requested or set. This language tracks the language of California Insurance Code Section 1861.05(c).

Section 2644.27(e) makes explicit the fact that the variance request is determined in conjunction with the related rate application.

Section 2644.27(f) sets forth the valid bases for requesting a variance.

The first variance tracks the variance currently found in section 2646.4(c)(1).

The second variance tracks that currently found in section 2646.4(c)(2).

The third variance is similar to the variance currently found in section 2646.4(c)(3). However, as proposed, the variance affects the efficiency standard, not the rate of return.

The fourth variance is similar to the variance currently provided in section 2646.4(c)(3)(B) in that it affects return on equity. However, the proposed variance allows a higher or lower return

on equity due to higher or lower financial investment in underserved communities. The existing regulation recognizes service to underserved markets (rather than financial investment in those markets).

The fifth variance is similar to the variance currently provided in section 2646.4(c)(4). However, under the proposed variance, an insurer need only write 90% of its business in one line. Additionally, the proposal recognizes a variance for an insurer writing 90% of its business in California.

The variance set forth in proposed section 2644.27(f)(6) is currently found in section 2646.4(c)(5).

The variance set forth in proposed section 2644.27(f)(7) is currently found in section 2646.4(c)(7).

The variance set forth in proposed section 2644.27(f)(8) is currently found in section 2646.4(c)(8).

The variance proposed in section 2644.27(f)(9) recognizes situations where the loss development formula may not produce an actuarially sound result.

The variance proposed in section 2644.27(f)(10) recognizes situations where the trend formula may not produce an actuarially sound result. Existing section 2646.4(c)(6) recognizes situations where the insurer should be permitted to employ a different loss trend.

Section 2644.27(f)(11) recognizes a variance where the maximum permitted earned premium would be confiscatory as applied. Because of the nature of this variance, a public hearing is required.

Existing section 2646.4(d) is proposed for deletion, since it affects insurers' rollback obligations.

Section 2644.50 Refiling of Approved Rates

California Insurance Code Section 1861.05(a) provides that a rate may not remain in effect if it no longer complies with the applicable statutory standards. Under proposed new section 2644.50, in certain circumstances, the Commissioner may require an insurer to make a rate filing to ensure that the insurer's rates continue to comply with applicable law. Language proposed in this section also clarifies that nothing in the section shall be construed to specify how often an insurer may file a rate application.

Section 2646.3 Generic Determinations

Existing section 2646.3 defines generic determination as a finding the Commissioner is required or authorized by these regulations to make, which is intended to apply to the rate applications of several or all insurers. The section also sets forth the procedures applicable to generic determinations. For the most part, the proposed regulations eliminate the need for generic

determinations. However, the proposed regulations recognize that generic determinations may be adopted for leverage and reserves ratios, should the Commissioner decide to modify the formula values.

Section 2646.4 Hearing on Individual Insurers' Rates

Existing section 2646.4 sets forth various procedural requirements applicable to a hearing on an individual insurer's rates. Minor technical changes are proposed to existing section 2646.4(b) to conform to other changes proposed in these regulations and discussed elsewhere in this Informative Digest. No changes are proposed to section 2646.4(a).

Existing section 2646.4(c) sets forth the valid bases for requesting a variance. As previously described, the variances are now included in section 2644.27. And as previously described, existing section 2646.4(d) is proposed for deletion since it affects insurers' rollback obligations.

Existing section 2646.4(e) is renumbered as section 2646.4(c).

DISCLOSURES REGARDING THE PROPOSED ACTION

The Commissioner has made the following initial determinations:

Mandate on local agencies and school districts: None.

Cost or savings to any state agency: None.

Cost to any local agency or school district which must be reimbursed in accordance with California Government Code sections 17500 through 17630: None.

Other nondiscretionary cost or savings imposed on local agencies: None.

Cost or savings in federal funding to the state: None.

Significant, statewide adverse economic impact directly affecting business including the ability of California businesses to compete with businesses in other states: None.

Cost impacts on a representative private person or businesses: The Commissioner is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

Adoption of these regulations will not:

- (1) create or eliminate jobs within California
- (2) create new businesses or eliminate existing businesses within California; or
- (3) affect the expansion of businesses currently doing business within California.

Significant effect on housing costs: None.

Small Business Determination

The matters proposed herein will affect insurance companies and, therefore, will not affect small business. (California Government Code section 11342.610(b)(2).)

ALTERNATIVES

In accordance with California Government Code section 11346.5(a)(13), 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 purpose for which the action is proposed or would be as effective as and less burdensome to affected private persons than the proposed action.

The Commissioner invites interested persons to present statements or arguments with respect to alternatives to the proposed action at the scheduled hearing or during the written comment period.

TEXT OF AMENDMENT AND STATEMENT OF REASONS

The Commissioner has prepared an initial statement of reasons that sets forth the reasons for the proposed action. The Commissioner also has available all the information upon which this proposed action is based as well as the express terms of the proposed action. Upon request, the proposed text and initial statement of reasons will be made available for inspection and copying. Requests for the initial statement of reasons or questions regarding this proceeding should be directed to the contact person listed above.

The file for this proceeding, which includes a copy of the proposed amendment, the statement of reasons, the information upon which the proposed action is based, and any supplemental information contained in the rulemaking file, is available for inspection and copying **by prior appointment** at 45 Fremont Street, 21st Floor, San Francisco, California 94105, between the hours of 9:00 a.m. and 4:30 p.m., Monday through Friday. Written requests for the rulemaking file or questions regarding this proceeding should be directed to the contact person listed above.

AVAILABILITY OF MODIFIED TEXT OF AMENDMENT

In response to public comment, the Commissioner may determine that changes to the proposal are appropriate. If those changes are sufficiently related to the original text that the public had adequate notice of the proposal, as amended, copies of the amended text will be sent to all persons who testified or presented comments at the public hearing or submitted written comments during the comment period, and to anyone who requested information regarding the proposal. Thereafter, the Commissioner will accept written comments, arguments, evidence and testimony concerning the changes only, for a period of at least 15 days prior to adoption.

At least 45-days notice will be given if the changes are not sufficiently related to the original text that the public was adequately placed on notice that the change could result from the originally proposed regulatory action.

