

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

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INITIAL STATEMENT OF REASONS

California Insurance Commissioner John Garamendi will consider amendment/adoption/deletion of Title 10, Chapter 5, Subchapter 4.9, Article 2 Sections 2642.4 through 2642.7; Article 3 Sections 2643.2, 2643.6 and 2643.8; Article 4 Sections 2644.2 through 2644.12, 2644.15 through 2644.21, 2644.23 through 2644.27 and Article 4.5 Sections 2644.50 and 2646.3 to 2646.4 of the California Code of Regulations (CCR) regarding prior approval of rates and the continued use of rates that are currently in effect.

SPECIFIC PURPOSE OF THE REGULATION

The proposed regulations establish the regulatory scheme both for approving rates and continuing rates already in effect for lines covered by Insurance Code section 1861.01 *et seq.*

NECESSITY

Existing law, Proposition 103 (Insurance Code sections 1861.01 *et seq.*), an initiative approved by the California voters on November 8, 1988, establishes a system of prior-approval rate regulation for property-casualty insurance lines (except those listed in Insurance Code section 1851). In 1991 the Department adopted regulations which provided a formula to determine whether a rate was excessive or inadequate. These regulations were upheld in *20th Century Insurance Company v. Garamendi* (1994) 8 Cal.4th 216 recognizing that the Department's use of a general formula could help reduce the task of reviewing rate applications to a "manageable size". However some components of the formula were left for the enactment of future regulations. The Department's existing regulations also only provide for evaluation of a rate when it is first implemented. Insurance Code section 1861.05 also requires that "no rate shall...remain in effect which is excessive..." Accordingly, these regulations also provide a mechanism for when an insurer has to re-file its rates so that they are not excessive.

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDY, REPORTS, OR DOCUMENTS

The Commissioner did not rely upon any technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation.

REASONABLE ALTERNATIVES TO THE REGULATION AND THE AGENCY'S REASONS FOR REJECTING THOSE ALTERNATIVES

No other alternatives to the regulation (including alternatives to lessen any adverse impact on small business) were presented to or considered by the Commissioner.

REASONABLE ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON SMALL BUSINESS

The Commissioner has determined that the proposed amendment will only affect insurance companies and will therefore not affect or impact small business. Pursuant to Government Code section 11342.610(b)(2), insurers are not small businesses. All reinsurers are necessarily insurers.

EVIDENCE SUPPORTING FINDING OF NO SIGNIFICANT ADVERSE ECONOMIC IMPACT ON ANY BUSINESS

The Commissioner has made an initial determination that adoption of the proposed action will not have a significant, statewide adverse economic impact directly affecting businesses, including the ability of California businesses to compete with businesses in other states.

This proposal primarily updates the existing rate approval regulations in light of changed circumstances and to conform to decisions of the Commissioner in reviewing company-specific rate applications.

In addition, because automobile insurance is generally written based upon the state in which the vehicle is garaged, this action does not affect the ability of California insurers to compete with insurers in other states.

SPECIFIC PURPOSE AND REASONABLE NECESSITY OF REGULATION

The specific purpose of each regulation section and the rationale for the Commissioner's determination that each amendment is reasonably necessary to carry out the purpose for which it is proposed are set forth below.

Section 2642.4 Pure Premium

"[A]llocated loss adjustment" is amended to "defense and cost containment" to conform to changes in the National Association of Insurance Commissioners ("NAIC") accounting terminology and methodology. This is a change without regulatory effect, simply recognizing the current terminology used to describe the expenses formerly referred to as allocated loss adjustment expenses.

2642.5 Rating Period

The language "unless otherwise determined pursuant to section 2646.3" is deleted to reflect the deletion of this generic determination. This section currently provides that, unless otherwise determined, the rating period shall be one year commencing on the effective date of the rates. Since initial promulgation of these regulations, a different rating period has never been established. The proposal retains the existing one year rating period.

2642.6 Recorded Period

The language "unless otherwise determined pursuant to section 2646.3" is deleted to reflect the proposed deletion of this generic determination. This section currently provides that, unless otherwise determined, the recorded period shall be the most recent three years for which reliable data are available. Since initial promulgation of these regulations, a different recorded period has never been established. The proposal retains the existing three-year recorded period.

2642.7 Lines of Insurance

The lines of insurance generally correspond to the lines set forth in the Annual Statements insurers are required to file with Insurance Commissioners throughout the country. To conform to the NAIC Annual Statement lines, products liability is added to the existing lines of insurance and glass is deleted. Mechanical breakdown and similar insurance is classified as "other liability occurrence." Currently mechanical breakdown is not specifically described and it arguably could be considered to be included in more than one line. This change will specify how mechanical breakdown is treated under these regulations. In response to workshop comments, the Commissioner is named, in addition to insurers under the current regulation, as those who may disaggregate any of the lines of insurance. This section also specifies that medical malpractice coverage is not a specialty line. Medical malpractice coverage is separately addressed as proposed in section 2644.4 of these regulations.

Section 2643.2 Rating Basis

The sentence with the language "in accordance with section 2646.3" is deleted to reflect the proposed deletion of this generic determination. Since initial promulgation the rating basis has been on the basis of premium charged per exposure and a different rating basis has never been established.

Section 2643.6 Interjurisdictional Allocations

As set forth for section 2642.4, "allocated loss adjustment" is amended to "defense and cost containment" to conform to changes in the NAIC accounting terminology and methodology. For the same reason, "unallocated loss adjustment" is amended to "adjusting and other." Consistent with the amendment to Section 2642.7, as suggested in workshop comments, the Commissioner may disaggregate any of the lines of insurance as well as insurers.

Section 2643.8 Factors Calculated by Commissioner

In the Commissioner's review of rate applications, this section requires calculations of certain factors by the Commissioner. These factors are the trend for the complement of credibility under section 2644.7, the efficiency standard under section 2644.12, leverage factors and surplus under section 2644.17 and reserve ratios under section 2644.21. All of these calculations are reasonably necessary for the formula to be able to calculate a minimum and maximum permitted earned premium to determine whether a rate is excessive or inadequate. If these factors have been published at least 45 days before the receipt of a rate application they may be used by the

insurer. Otherwise the prior set of numbers published by the Commissioner shall be used. If the Commissioner fails to publish the numbers required by these regulations, the application shall be reviewed performing the calculations in the manner set forth in these regulations and applied to the rate application. This section clarifies which factors shall be used in review of rate applications so insurers are on notice regarding that fact.

Section 2644.2 Maximum Permitted Earned Premium

Changes proposed to this section 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. Investment income is divided in to fixed and variable components.

Section 2644.3 Minimum Permitted Earned Premium

Changes proposed to this section correspond to the technical changes proposed to section 2644.2 detailed above but the calculation results in the minimum (as opposed to the maximum premium that can be collected so that a rate is not excessive) permitted earned premium that can be charged for a rate so that it is not inadequate.

Section 2644.4 Projected Losses

Changes proposed to this section allow use of a report year basis for calculating projected losses for all claims made policies. Comments made at technical workshops supported such a change and are useful to increase the accuracy of projected losses. There is no need to limit this to medical malpractice insurance, as provided by the prior language, since other coverages are also available on a claims made basis and should be treated similarly. Projected losses for policies providing multi-year coverage, such as mechanical breakdown, may be calculated on a policy-year basis, allowing accurate measurement of losses for such coverage. For policies providing death, disability and retirement coverage, projected losses shall be calculated using a sound actuarial method which results in a more accurate projection of losses and recognizes the unique nature of this coverage. Language added to subsection (e) recognizes the change previously discussed allowing the Commissioner to elect to disaggregate a line of insurance into commodity and specialty, as suggested in a workshop comment.

New subsection (f) allows modeling to project losses and defense and cost containment expenses for earthquake and fire following earthquake losses, if specified conditions are met. This takes into account the state of the art in earthquake modeling, which has developed since the regulations were initially promulgated.

Section 2644.5 Catastrophe Adjustment

This section sets forth the time period over which an insurer shall average losses that typically do not occur every year and, if they do, vary significantly in the amount of the loss. Previously the regulation specified the Commissioner would issue a generic determination specifying the time periods to be used but this is deleted. Minimum time periods are specified for homeowners and

private passenger automobile property damage, no adjustment shall be made for private passenger automobile liability. An insurer lacking sufficient years of data shall supplement its own data with specified data from the Insurance Services Office. The catastrophe adjustment shall recognize changes in the insurer's mix of business.

Section 2644.6 Loss Development

This section provides that loss development shall be based on the dollar-weighted average ratios of losses which provide more specificity on how the loss development would be calculated. Furthermore, this section adds policy-year and report-years as appropriate reporting intervals, in addition to accident-year, which is widely recognized as allowing for more accurate loss development when used appropriately. It deletes the reference to section 2646.3, since this generic determination is proposed for deletion. It specifies that loss development shall exclude catastrophe data.

Section 2644.7 Loss and Premium Trend

Changes proposed to this section add premium trend to trend. It deletes the references to section 2643.3 since this generic determination is proposed for deletion. Provides that loss and premium trend shall be developed using the insurer's own data, previously industry wide data was specified. Workshop comments supported such a change as resulting in more accurate projections. This section specifies the method by which premium and loss trend factors shall be developed. Catastrophes are excluded. If the trend factor within a given line varies significantly by subline or other specified factors, a separate trend factor shall be calculated. This section clarifies when credibility must be calculated by form or coverage and is for the entire period. It clarifies complements of credibility for non-fast track coverages. For homeowners and private passenger automobile the standard for calculating full credibility is specified, as is partial credibility and the complement of credibility. It provides a manner by which the Commissioner may take into account factors not reflected in the historical data.

Section 2644.8 Projected Defense and Cost Containment Expenses

Proposed changes to this section reflect the change in terminology from "allocated loss adjustment" to "defense and cost containment," discussed above. These expenses are subject to a catastrophe adjustment. For liability coverages, these expenses may be added to losses or may be developed using ratios of defense and cost containment expenses to losses as recommended in the Department's workshops. Also as discussed above, in response to workshop comments, a proposed change allows the Commissioner, as well as the insurer, to disaggregate a line of insurance into commodity and specialty.

Section 2644.9 Projected Fixed Expenses

This section is proposed for deletion in accordance with the changes proposed to section 2644.12 which allows insurers the efficiency standard expenses.

Section 2644.10 Excluded Expenses

This section adopts, for prior approval purposes, the excessive executive compensation figures promulgated in connection with the Proposition 103 rollback refunds. It adopts the current terminology of defense and cost containment in place of allocated loss adjustment. It specifies how excluded expenses shall be calculated under the formula.

Section 2644.11 Expense Trend

This section is proposed for deletion in accordance with the changes proposed to section 2644.12 which allows insurers the efficiency standard expenses.

Section 2644.12 Efficiency Standard

Changes proposed to this section specify the time (45 days) and manner in which the Commissioner will calculate the efficiency standard. It retains the tri-modal efficiency standard, but changes "employees of the insurer not functioning as agents" to "employees of the insurer selling insurance on a direct basis." A generic determination is allowed in specified circumstances. The efficiency standard is the arithmetic average of the latest three years for which data are available. It is weighted by California earned premium. The section clarifies that data shall be taken from the NAIC database and specifies which data shall be included in the calculation, as suggested by workshop comments. Subsection (a) is deleted in connection with changes to the efficiency standard described elsewhere in this document.

Section 2644.15 Profit Factors

Changes proposed to this section clarify that that the applicable income tax factor is the underwriting federal income tax factor.

Section 2644.16 Rate of Return

The maximum rate of return is specified at 11%. Like the other components specified in these regulations a rate of return figure is necessary in the rate making formula to complete the calculation for the minimum and maximum permitted earned premium. This determination of 11% was based upon a number of factors. As *Calfarm Ins. Co. v. Deukmejian*, 48 Cal.3d 805 at pp. 822-823 notes: "The range of fair and reasonable rates is defined in light of the insurer's legitimate interest in financial integrity and the insured's legitimate interest in freedom from exploitation." In other words the insurers' interest must be balanced with the insureds'.

The historical average for returns on investments in enterprises having corresponding risks to those for insurers, supports an even lower rate of return than the one selected in these regulations and required under the standard articulated in *Power Comm'n v. Hope Gas Co. (1944) 320 U.S. 591*. The higher number further bolsters the "capital attraction" standard articulated in *Hope*.

Lastly, the Commissioner recently issued his decision in the Safeco earthquake prior approval decision, Case number PA 04041210, taking evidence and making a determination about reasonable rates of return. The 11% while slightly higher than the return determined in that case was also relied on in coming to the 11% figure.

Section 2644.17 Leverage Factor and Surplus

Changes to this section specify that the leverage factor is the ratio of earned (not net written) premiums to the average of the year-beginning and year-end surplus. Because the generic determination for leverage factors is proposed for deletion, the reference to section 2646.3 is deleted. Instead, this section sets forth the leverage factors and an allocation method. For each line of business, the leverage factor shall be the national premium divided by the allocated surplus, multiplied by a specified ratio. The leverage factor for earthquake is set at 1.0. For other lines of business subject to catastrophes, mass torts, and other unusual events, the Commissioner may modify the leverage factors. The calculation shall be performed within 45 days of publication of the necessary source data. Separate leverage factors shall be established for claims-made and occurrence policies for medical malpractice, other liability, and product liability.

Section 2644.18 Federal Income Tax Factors

Changes proposed to this section recognize an underwriting federal income tax factor and an investment federal income tax factor. The existing language is deleted as inconsistent with the proposed language. The prospective federal income tax rate on underwriting is set at 35%. The investment federal income tax factor takes into account different categories of investments. The prospective federal income tax rate applicable for taxable bonds, mortgage loans, real estate, cash and short-term investments and on investment expenses is 35%. For capital gains it is 34.1%. For tax-exempt bond interest it is 5.25%. For stock dividends it is 14.175%. For investment income on other invested assets, the weighted average shall be used.

Section 2644.19 Investment Income Factors

The existing investment income factor is proposed for deletion. Instead, a fixed investment income factor and a variable investment factor are proposed. Both factors are defined in the proposed regulation.

Section 2644.20 Projected Yield

Projected yield is redefined in order to come up with a more accurate forecast of future investment earnings. Substantial input came from participants to the workshop who directed the Department to the record in Massachusetts that was developed for private passenger automobile rates and much of the method chosen comes from that.

Section 2644.21 Reserves Ratio

The existing description of "reserves ratio" is deleted. The proposed new language recognizes both the unearned premium reserves ratio and the loss reserves ratio. One industry-wide unearned premium reserves ratio and one loss reserves ratio for each line of business is recognized. The source data for these numbers is set forth, as is the time period for the Commissioner to perform the calculations once the source data becomes available. The loss reserves ratio for earthquake is set at 1.0. For other lines of business subject to catastrophes,

mass torts and other unusual events, the Commissioner is required to modify the industry-wide numbers where they do not provide a reliable estimate of the reserve ratios.

Section 2644.23 Credibility Adjustment

Proposed changes to this section set forth the credibility criteria. When certain data is not fully credible, alternate calculations are set forth.

Section 2644.24 Trended Current Rate Level of Earned Premium

This new section defines trended current rate level earned premium.

Section 2644.25 Reinsurance

This section provides that, except for earthquake and medical malpractice facultative reinsurance with attachment points above \$1 million, ratemaking is reviewed on a direct basis without consideration for reinsurance costs. For earthquake and medical malpractice, the manner in which reinsurance costs are reflected in the ratemaking formula is set forth. The formula is adjusted in accordance with changes to the efficiency standard.

To ensure that premiums charged to policyholders comply with the statutory requirement that no rate shall be excessive, inadequate, unfairly discriminatory, or otherwise in violation the law, reinsurance costs shall only be allowed if the reinsurance agreement was entered into in good faith in an arms-length transaction not between affiliates and at fair market value for the coverage provided. There must be an acceptable transfer of risk, the reinsurer must be an authorized reinsurer and the reinsurance must comply with all applicable statutory accounting principles. A copy of the reinsurance agreements must be submitted with the rate application. Other risk financing mechanisms such as catastrophe bonds are considered in the same manner as reinsurance.

Even for those lines where reinsurance costs can be factored directly in to the rate application, if those costs make up 30% or more of the rate for those lines, upon timely request, a consumer or his or her representative is entitled to a hearing as a matter of right on whether those costs are reasonable or should be disallowed in whole or in part.

Section 2644.26 Reinsurance Recoverables

Reinsurance recoverables are defined in this section

Section 2644.27 Variance Request

Existing section 2646.4(c) specifies the bases for requesting a variance. The variance provisions are now 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 recognizes financial investment in underserved communities, while the existing regulation recognizes service to 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 insurer's rollback obligations. Pending rollback cases would still be governed by the old regulation.

Section 2644.50 Refiling of Approved Rates

This proposed new section implements, interprets, and makes specific the requirement in California Insurance Code Section 1861.05(a) that a rate may not remain in effect if it no longer complies with the applicable statutory standards. It permits the Commissioner, in certain situations, to require an insurer may make a rate filing.

As also set forth in section 2642.5, language proposed in this section clarifies that this section does not specify how often an insurer may file a rate change application.

Section 2646.3 Generic Determinations

Revised to reflect fact that only 4 generic determinations remain.

Section 2646.4 Hearing on Individual Insurers' Rates

Amendments proposed to this section delete the reference to generic determinations in section 2646.4(b) and proposed (c) since the generic determinations have, for the most part, been deleted. Subsection (c) is proposed for deletion since variances are now provided for in section 2644.27.