

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

**RH05042749**

**November 14, 2006**

**Title 10**

**Proposed Revisions 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.**

**FINAL STATEMENT OF REASONS**

**UPDATE OF INITIAL STATEMENT OF REASONS: SPECIFIC PURPOSE AND REASONABLE NECESSITY FOR REGULATION**

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

The Commissioner has determined that the existing regulations must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. Other amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that the regulations must be amended for purposes of clarification and to ensure a consistent and fair application of these regulations. Every section of these regulations is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. The proposed regulations implement, interpret, and make specific the requirements set forth in California Insurance Code §1861.05

The initial amendments were proposed in response to comments made in the several workshops held before the July 18 Notice and / or due to experience gained in many years of case-by-case rate determinations. Further changes to the regulations were prompted by comments made during this rulemaking.

**Section 2642.4 Pure Premium**

The specific purpose of amending "[A]llocated loss adjustment" to read "defense and cost containment" is to conform to changes in the National Association of Insurance Commissioners ("NAIC") accounting terminology and methodology. This change is required in order to bring the regulations up to date and into conformity with the NAIC reporting requirements and other relevant standards. In this case the change is one that necessitates further modifications in other

sections of the regulation in something akin to chain reaction. Changes to the basic ratemaking formula and the efficiency standard may be tracked back to this change.

The specific purpose for this amendment is to bring the regulations up to date and into conformity with NAIC and other relevant standards. The Commissioner has also determined that deletion of this section is necessary for clarification purposes as the language is no longer necessary. The specific purpose for deleting this language is in response to public comments and to reflect this determination. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

### **2642.5 Rating Period**

“Rating Period” is a definition present in the current regulations. The specific purpose of this section is that a standard rating period is an essential component in this formulaic regulatory scheme. The Commissioner has determined the language contained in this section is necessary for purposes of clarity and to ensure consistent and fair application of these regulations. This section is also a necessary component in a regulatory scheme designed to keep the job of rate regulation manageable.

The specific purpose in amending the proposed regulations eliminating reference to existing § 2646.3., Generic Determinations is to reflect the Commissioner’s determination that generic determinations, as provided for in CCR § 2646.3, are no longer necessary or practical with respect to the rating period. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **2642.6 Recorded Period**

“Recorded Period” is a definition present in the current regulations. The specific purpose of this section is that a standard recorded period is an essential component in this formulaic regulatory scheme. The Commissioner has determined the language contained in this section is necessary for purposes of clarity and to ensure consistent and fair application of these regulations. This section is also a necessary component in a regulatory scheme designed to keep the job of rate regulation manageable.

The specific purpose in amending the proposed regulations eliminate reference to existing § 2646.3., Generic Determinations is that the Commissioner has determined that generic determinations, as provided for in CCR § 2646.3, are no longer necessary or practical with

respect to the rating period. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

Proposed § 2642.6 subsection (1) has no counterpart in the existing regulations. Additional language was added to the regulations in response to comments submitted during the rulemaking process. The specific purpose of the amendment is to allow greater flexibility in terms of the number of years of data required to reach credibility. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

Proposed § 2642.6 subsection (2) has no counterpart in the existing regulations. Additional language was added to the regulations in response to comments submitted during the rulemaking process. The specific purpose of the amendment is to allow greater flexibility in terms of the number of years of data required to reach credibility. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **2642.7 Lines of Insurance**

“Lines of Insurance” is a definition present in the current regulations. The specific purpose of this section as initially drafted is to provide details as to the various lines of insurance subject to these regulations. The specific purpose in allowing insurers to disaggregate a line of insurance is to enhance flexibility and improve accuracy.

The specific purpose of the amendments to this section was to update the regulations to recognize the reclassification, by the NAIC, of some lines of insurance for annual reporting statement purposes. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

Existing § 2642.7(a) was amended in response to comments, for clarification purposes and specifically to comply with new NAIC standards. In subsection (5) the word “liability” was added. Subsection (6), commercial multiple peril non-liability, was added. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

Proposed § 2642.7 subsection (b) has no counterpart in the existing regulations. The specific purpose for adding this language was to indicate how mechanical breakdown should be classified for ratemaking purposes. This language was added for clarification purposes as this issue had arisen in a number of case-by-case determinations. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

Proposed § 2642.7 subsection (c) was amended to make clear that the Commissioner as well as the insurer has the option of disaggregating lines. This language was added for clarification purposes in response to public comment. The Commissioner has determined that this clarification is necessary. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

Proposed § 2642.7 subsection (c) was further revised in response to comments made. Language was added to clarify the standards by which alternative ratemaking methodologies would be measured. The Commissioner has determined that since the regulations allow insurers to disaggregate a line of insurance into specialty lines, which in turn allows insurers to use alternative methodologies, it is essential that there be some standard by which those alternative methodologies are to be measured. The specific purpose of this language is to provide that standard. Without the the addition of this language, no standard would be provided. The Commissioner determined that this additional language was necessary. The proposed change is intended to enhance flexibility without sacrificing accuracy, fairness and consistent results which comply with the applicable legal standards. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The specific purpose in deleting proposed subsection (d)(4)(F) was to remove professional liability and errors and omissions coverages from the specialty category. Deleting this language also removed the specific specialty lines treatment for medical malpractice insurance. The Commissioner has determined that these lines should continue to be treated as they currently are. Instead the treatment of professional liability and errors and omissions coverages and medical malpractice insurance is now addressed in other sections of the regulation. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **Section 2643.2 Rating Basis**

“Rating Basis” is a definition present in the current regulations. This section has been deleted. The specific purpose for deleting the section is that the term “rating basis” no longer appears in the regulation so there is no need for a definition.

The Commissioner has determined that the existing regulations must be amended in order to bring the regulations up to date. The specific purpose for this change is to bring the regulations up to date and into compliance with relevant applicable standards. The Commissioner has also determined that deletion of this section is necessary as the language is no longer necessary. The

specific purpose for deleting this language is to reflect this determination. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

### **Section 2643.6 Interjurisdictional Allocations**

“Interjurisdictional Allocations” is a provision in the current regulations. The specific purpose in deleting the phrase “allocated lost adjustment” and replacing it with “defense and cost containment” was to update the regulation to meet with current NAIC reporting requirements and terminology.

The specific purpose in adding the words “or the Commissioner” to subsection (c) was to remain consistent with proposed § 2642.7(c). This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **Section 2643.8 Factors Calculated by Commissioner**

Proposed § 2643.8 has no counterpart in the existing regulations. Application of the regulations requires certain numerical and other factors. The Commissioner has determined that in most instances the “generic factor” approach as provided for in CCR § 2646.3, is no longer necessary or practical. The specific purpose of this section is to make clear the Commissioner will calculate certain numerical and other factors. These calculations are essential to the regulatory scheme and for application of the ratemaking formula. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

Further changes were made to the language in the proposed section in direct response to comments made during the rulemaking. The specific purpose of this language is to provide clarification regarding the new values where the Commissioner does not publish the new values in the manner set forth in the regulations.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05.

These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **Section 2644.2 Maximum Permitted Earned Premium**

“Maximum Permitted Earned Premium” is a provision in the current regulations. The specific purpose in amending existing § 2644.2 is to bring the regulation up to date with NAIC reporting requirements. In some cases changes in NAIC reporting and other requirements that necessitated a change in one section of the regulation necessitated further modification in other sections of the regulation. That is the case here. The Commissioner has determined that new NAIC reporting requirements, among other things, require that the Maximum Permitted Earned Premium formula be modified. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

It was originally intended that the efficiency standard apply to all companies. The intent was that by applying the efficiency standard as opposed to actual expenses the efficient company would be rewarded while the inefficient company would be barred from passing its inefficiencies on to policyholders in the form of higher premiums. The rationale behind the redesign of the efficiency standard is to allow the efficiency standard to be applied as it was originally intended to be applied. Over time, arguments were made that the language did not reflect the original intent as reflected in the original rulemaking file. The original rulemaking file made it clear that the better-than-average-efficiency insurer would realize higher profits because the insurer is allowed to impute expenses at the efficiency standard. If its actual expense levels are lower, the difference inures to the benefit of the company. Amendments proposed to this section make that fact more explicit. It should also be noted that the elimination of allocated loss adjustment expenses and the use of defense and cost containment expenses in its stead, as well as replacing fixed and variable expenses with the efficiency standard, also impacted the amendment of the efficiency standard formula. Additionally, changes were made to investment income. No further change was made to the maximum allowable expense formula. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

### **Section 2644.3 Minimum Permitted Earned Premium**

“Minimum Permitted Earned Premium” is a provision in the current regulations. The specific purpose in amending existing § 2644.2 is to bring the regulation up to date with NAIC reporting requirements. In some cases changes in NAIC reporting and other requirements that necessitated a change in one section of the regulation necessitated further modification in other sections of the

regulation. That is the case here. The Commissioner has determined that new NAIC reporting requirements, among other things, require that the Minimum Permitted Earned Premium formula be modified. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

It was originally intended that the efficiency standard apply to all companies. The intent was that by applying the efficiency standard as opposed to actual expenses the efficient company would be rewarded while the inefficient company would be barred from passing its inefficiencies on to policyholders in the form of higher premiums. The rationale behind the redesign of the efficiency standard is to allow the efficiency standard to be applied as it was originally intended to be applied. Over time, arguments were made that the language did not reflect the original intent as reflected in the original rulemaking file. The original rulemaking file made it clear that the better-than-average-efficiency insurer would realize higher profits because the insurer is allowed to impute expenses at the efficiency standard. If its actual expense levels are lower, the difference inures to the benefit of the company. Amendments proposed to this section make that fact more explicit. It should also be noted that the elimination of allocated loss adjustment expenses and the use of defense and cost containment expenses in its stead also impacted the amendment of the efficiency standard formula. No further change was made to the maximum allowable expense formula. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

#### **Section 2644.4 Projected Losses**

“Projected Losses” is a provision in the current regulations. The specific purpose of deleting the language in existing subsection (b) relating to medical malpractice insurance is that claims-made policies are written in other lines besides medical malpractice. Making the change allows the proper actuarial method to be employed for all claims-made policies whether medical malpractice or other lines. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

Proposed subsection (c) has no counterpart in the current regulations. The specific purpose of adding this language is that although subject to the provisions of Proposition 103 and these regulations, many aspects regarding treatment of mechanical breakdown and other policies providing coverage on a multi-year basis is not specifically addressed in the current regulations. The question of the treatment of mechanical breakdown as it relates to projected losses has arisen in case-by-case rate determinations. The proposed language is intended to clarify how projected losses are to be calculated in mechanical breakdown and other multi-year coverages.

Originally proposed subsection (d) has no counterpart in the current regulations. The specific purpose of deleting the language relating to death, disability and retirement coverage was that the revised subsection (d) allows within it special treatment for death, disability and retirement coverage. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

Revised subsection (d) previously provided that the Commissioner would have the option to disaggregate a line. This language was deleted during the rulemaking as it was redundant. (See proposed § 2642.7(c)). The specific purpose of deleting this language was that it was redundant.

In general, subsection (d) provides that for professional liability and errors and omissions coverages insurers may tender an alternative computation of projected losses, which the Commissioner shall approve if made in “the most sound actuarial” manner. These changes were made in response to comments submitted during this rulemaking. As these lines of insurance are exempted from application of sections 2644.5 through 2644.7, the Commissioner determined that this language was needed to clarify the standards by which alternative ratemaking methodologies would be measured. The specific purpose of this language was to ensure that a reasonable standard relating to ratemaking was enunciated. Prior to the addition of this language the standard set forth was "a sound actuarial manner." This amendment is reasonably necessary to carry out the purpose for which it is proposed.

Proposed subsection (e) has no counterpart in the current regulations. New subsection (e) allows for the use of complex catastrophe models in specified circumstances. The rationale for this change is that, in connection with review of specific rate applications, the Commissioner has determined that models for earthquake and fire following are useful under the conditions specified. The specific purpose of this language is to make clear these models may be allowed under certain circumstances. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **Section 2644.5 Catastrophe Adjustment**

“Catastrophe Adjustment” is a provision in the current regulations. The reference to § 2646.3, Generic Determinations, has been deleted. The rationale for this change is that the Commissioner has determined that generic determinations, as provided for in CCR § 2646.3, are no longer necessary or practical with respect to the catastrophe adjustment. The specific purpose of the language replacing the generic determination language is to establish how catastrophe

losses are to be averaged by specifying the catastrophe adjustment methodology. The new language contained in this section is necessary for purposes of clarity and to ensure consistent and fair application of these regulations. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The initial language provided that the number of years over which the average shall be calculated shall be at “least 21 and 39 years for homeowners multiple peril fire and wind, respectively.” The proposed revision removed the 21 and 39 year requirements and replaced that language with a requirement of at least years 20 years for homeowners multiple peril. These changes were made in response to comments. The specific purpose of this language is to enhance flexibility without sacrificing fairness, consistency and accuracy. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The language deleting the differentiation relating to fire and wind was removed in response to comments as the Commissioner determined that differentiation was not necessary. Also eliminated was the reference to the advisory loss costs filing. This change was made in response to comments as the Commissioner determined this language was not necessary. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **Section 2644.6 Loss Development**

“Loss Development” is a provision in the current regulations. The specific purpose of adding language requiring loss-development triangles to be based on dollar weighted averages as opposed to straight averages was to enhance accuracy. The specific purpose of adding language expanding the type of data that might be relied upon in developing losses was to enhance flexibility. The specific purpose in eliminating the reference to § 2646.3., Generic Determinations, is to carry out the Commissioner’s determination that generic determinations relating to loss development are no longer necessary or prudent. The specific purpose for adding language specifying that catastrophe losses shall be excluded from loss development was to clarify the Commissioner’s position on this issue as including catastrophe losses in loss development tends to distort the calculation, leading to inaccurate results. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The specific purpose for adding language as a substitute for the deleted generic determination was to set forth the methodology to be employed for developing losses as no methodology was provided for. The Commissioner determined that the deletion of the generic determination language and the elimination of other specifics relating to the methodology to be employed in

developing losses required that a specific methodology be substituted. The Commissioner has determined that this new amended language enhances flexibility without sacrificing accuracy and consistency. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **Section 2644.7 Loss and Premium Trend**

“Loss Trend” is a provision in the current regulations. Premium trend has no counterpart in the current regulations. The definition of loss trend was amended to add specifics relating to the methodology to be used for calculating premium trend. The specific purpose for adding language relating to premium trend is to provide a methodology for premium trend in order to enhance accuracy and consistency. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The specific purpose behind deleting the reference to § 2646.3 generic determinations was due to the Commissioner’s determination that generic determinations relating to loss and premium trend were no longer necessary or prudent. The purpose of adding language to allow insurers to use company specific data instead of imputed trends was to allow more company-specific data into the process in response to “one-size-fits all” comments and to enhance flexibility in the ratemaking process. The Commissioner determined that, as the generic determination language was deleted in favor of a company-specific approach, in order to ensure consistency and accuracy the deletion of the generic determination language required that a specific methodology be substituted. The specific purpose of this language is to provide that methodology. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

Proposed subsection (a) was further refined in direct response to comments made during the rulemaking phase. Language relating to the number of quarters of data to be used, specifics as to the calculation of frequency and severity, and details relating to the type of premium data to be employed were added. The specific purpose of these further amendments was to provide sufficient detail as to the methodology to be employed for calculating trend. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The new language provides that where the trend factor within a given line significantly varies by sub-line, by policy limits, by region of the state, or by coverage, separate trend factors shall be calculated in accordance with that company-specific evidence. The specific purpose of this amendment is to enhance flexibility in the ratemaking process. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

All of existing subsection (d) was moved into proposed subsection (c) and eliminated. The Commissioner determined that the subject matter to which the existing language referred was no longer relevant. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The new language in proposed section (c) sets forth specific credibility standards. The specific purpose of this language was, as the generic determination language was deleted in favor of a company-specific approach, to ensure consistency and accuracy by providing specific credibility standards. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

#### **Section 2644.8 Projected Defense and Cost Containment Expenses**

Existing section 2644.7 is entitled: Projected allocated loss adjustment expenses. The initial draft of these regulations deleted the term “allocated loss adjustment expenses” and substituted the term “defense and cost containment.” The specific purpose in making this change is to recognize new NAIC reporting requirements. Subsection (a) added a requirement that defense and cost containment expenses be adjusted for catastrophes and pursuant to proposed § 2644.5 as the Commissioner has determined this adjustment is necessary. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

While there is a subsection (b) in the existing regulation, that language now appears in subsection (c) in an amended form. Proposed subsection (b) provides that for liability coverages, defense and cost containment expenses may be added to losses for loss development and trend or may be developed using ratios of defense and cost containment expenses to losses. The specific purpose of adding this language is to provide clear and concise instructions relating to calculation of these projected expenses. Subsection (b) was further refined by the addition of language which requires the selection of methodology be the most actuarially reasonable in order to make specific the actuarial standard required. The Commissioner determined that this language was required as the original language contained no such standard. The specific purpose in adding this language was to provide this standard. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

Proposed subsection (c) was former subsection (b). The initial proposed regulation refers to the disaggregation by the Commissioner of a line of insurance into commodity and specialty. The specific purpose of adding this language was to promote internal consistency with proposed

§2642.7(c). This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **Section 2644.9 Projected Fixed Expenses**

This section is proposed for deletion in accordance with the changes made to proposed § 2644.12, the import of which is discussed in that section. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

### **Section 2644.10 Excluded Expenses**

“Excluded Expenses” is a provision in the current regulations. Existing § 2644.10 sets forth various categories of expenses that are not recognized for purposes of ratemaking.

The current language referencing § 2646.3., Generic Determinations, was eliminated as the Commissioner has determined that generic determinations, as provided for in CCR § 2646.3, are no longer necessary or practical with respect to executive compensation. As this generic determination was eliminated the Commissioner determined that a standard for the determination of allowable executive compensation is required. The specific purpose of this language is to provide that standard. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

In subsection (c) the term “defense costs and cost containment” was substituted for the term allocated lost adjustment expenses. The specific purpose of this change has been explained.

Existing subsection (g) was also amended. The additional language provides that the disallowance of expenses shall be accomplished by reducing the efficiency standard by the ratio of the insurer’s national excluded expenses to its national direct earned premium. The specific purpose of including this language is to make clear the application of the efficiency standard. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to

keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **Section 2644.11 Expense Trend**

This section is proposed for deletion in accordance with the changes made to proposed § 2644.12, the import of which is discussed in that section. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

### **Section 2644.12 Efficiency Standard**

“Efficiency Standard” is a provision in the current regulations. Existing subsection (a) has been eliminated and replaced with a new formula. The specific purpose in revising the formula is to recognize changes to the NAIC reporting requirements and to clarify that by application of the efficiency standard, as opposed to the application of actual expenses, the efficient company will be rewarded while the inefficient company would be barred from passing its inefficiencies on to policyholders in the form of higher premiums.

Proposed subsection (a) eliminates the reference to § 2646.3., Generic Determinations, in keeping with the Commissioner’s determination that generic determinations are no longer necessary or practical with respect to the efficiency standard. The specific purpose in including language that provides that the Commissioner shall calculate the efficiency standard annually and sets forth the various factors he is required to consider in making that calculation is to replace the generic determination and to set forth the methodology for annual calculation of the efficiency standard. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

Existing subsection (c) is now proposed subsection (b). The specific purpose in amending the language relating to insurers “selling insurance on a direct basis” is clarification and a recognition that distribution systems, and the nomenclature associated with them, have evolved since the regulations were first promulgated. Subsection (b) also allows for the Commissioner to make generic determinations under certain specific circumstances. The specific purpose of this amendment is to enhance consistency and accuracy and to recognize the continuing evolution of distribution systems. Subsection (b) was further refined. For clarification purposes language was added to specify that where an insurer is using more than one distribution system, the efficiency standard shall consist of an average weighted by earned premium for each distribution system. This amendment was made in response to public comment and is reasonably necessary to carry out the purpose for which it is proposed.

There is no counterpart for proposed subsection (c) in the existing regulations. This proposed subsection provides that the efficiency standard shall be calculated as the arithmetic average of the latest three years for which data are available. The specific purpose of this amendment is to make clear how the calculation will be performed. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

Proposed subsection (d) is a minor modification of existing subsection (d) intended to be a clarification relating to how the calculation is to be performed. This amendment as made in response to public comment and is reasonably necessary to carry out the purpose for which it is proposed.

Proposed subsection (e) has no counterpart in the existing regulations. The specific purpose of adding this language new is to further clarify how the calculation is to be performed. There were no further modifications to this language.

Proposed subsection (f) has no counterpart in the existing regulations. The specific purpose of adding this new language is to further clarify how the calculation is to be performed. There were no further modifications to this language.

Proposed subsection (g) has no counterpart in the existing regulations. The subsection does not appear in the initial proposed regulations. The language contained in proposed subsection (g) is now found in proposed subsection (k). The specific purpose of adding this new language is to further clarify how the calculation is to be performed. There were no further modifications to this language.

Proposed subsection (h) has no counterpart in the existing regulations. The subsection does not appear in the initial proposed regulations. The specific purpose in adding the language in the new proposed subsection (h) is to provide further clarification relating to how the calculation is to be performed. This language was added in response to public comment.

Proposed subsection (i) has no counterpart in the existing regulations. The subsection does not appear in the initial proposed regulations. The specific purpose in adding the language in the new proposed subsection (i) is to provide further clarification relating to how the calculation is to be performed. This language was added in response to public comment.

Proposed subsection (j) has no counterpart in the existing regulations. The subsection does not appear in the initial proposed regulations. The specific purpose in adding the language in the new proposed subsection (j) is to provide further clarification relating to how the calculation is to be performed. It was also added in response to public comment.

Proposed subsection (k) has no counterpart in the existing regulations. The language in this subsection appears in the initial proposed regulations in initial subsection (g). The specific purpose in adding the language in the new proposed subsection (i) is to provide further clarification relating to how the calculation is to be performed.

It was originally intended that the efficiency standard apply to all companies. The intent was that by applying the efficiency standard as opposed to actual expenses the efficient company would be rewarded while the inefficient company would be barred from passing its inefficiencies on to policyholders in the form of higher premiums. The rationale behind the redesign of the efficiency standard is to allow the efficiency standard to be applied as it was originally intended to be applied. Over time, arguments were made that the language did not reflect the original intent as reflected in the original rulemaking file. The original rulemaking file made it clear that the better-than-average-efficiency insurer would realize higher profits because the insurer is

allowed to impute expenses at the efficiency standard. If its actual expense levels are lower, the difference inures to the benefit of the company. Amendments proposed to this section make that fact more explicit. It should also be noted that the elimination of allocated loss adjustment expenses and the use of defense and cost containment expenses in its stead also impacted the amendment of the efficiency standard formula. No further change was made to the maximum allowable expense formula. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

#### **Section 2644.15 Profit Factors**

“Profit Factor” is a provision in the current regulations. Changes proposed to this section clarify that the applicable income tax factor is the “underwriting federal income tax factor” as opposed to the “federal income tax factor.” Changing the regulation to provide for separate tax factors for underwriting and investment income is more actuarially accurate. This amendment is reasonably necessary to carry out the purpose for which it is proposed.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

#### **Section 2644.16 Rate of Return**

“Rate of Return” is a provision in the current regulations.

Initial subsection (a) provided that the maximum after-tax rate of return would be 11%. This language was modified. Subsection (a) now provides the maximum after-tax rate of return means the risk free rate, as defined in § 2644.20 (d), plus 6%.

The language in existing subsection (b) referring to generic determinations has been deleted. The rationale for this change is that the Commissioner has determined that generic

determinations, as provided for in CCR § 2646.3, are no longer necessary or practical with respect to the rate of return.

New subsection (b) provides for the minimum after-tax rate of return. Taken together subsections (a) and (b) provide for the range of reasonable rates of return.

The specific purpose in providing the minimum and maximum rates of return is to establish these key components of the ratemaking formula. 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.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

#### **Section 2644.17 Leverage Factor and Surplus**

“Leverage Factor and Surplus” is a provision in the current regulations. Existing § 2642.4 provides the definition of “leverage factor and surplus” and provides for a generic determination by the Commissioner of leverage factors by line of insurance.

As initially proposed, subsection (a) eliminated the use of net written premium in favor of earned premium. The amendment also specifies the use of the average of year-beginning and year-end surplus. The specific purpose of this amendment is the enhancement of accuracy, specificity and internal consistency.

Language in subsection (b) eliminates the existing § 2646 generic determination as the Commissioner has determined that generic determinations are no longer necessary or practical with respect to leverage factors and surplus. New language provides that the Commissioner shall calculate industry-wide leverage factors for each insurance line annually, within 45 days of the publication of the necessary source data. The specific purpose of including this language is to provide a substitute for the generic determination and to make specific the methodology to be employed in calculating the leverage factors. The Commissioner has determined that using the latest year overall leverage is more reasonable than using the 30-year average.

The specific purpose of including language setting forth distinct treatment for medical malpractice, other liability and product liability, providing for separate leverage factors for claims-made and occurrence, is to recognize the special characteristics of these lines and to provide specifics relating to the treatment of these lines.

Further changes were made to subsection (b). A requirement relating to a further mathematical step was eliminated. The purpose of this deletion was to reflect the Commissioner's determination that the language was no longer necessary, in response to public comments.

Existing subsection (c) was amended. The existing § 2646 generic determination was eliminated for the reasons set forth above.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **Section 2644.18 Federal Income Tax Factors**

“Federal Income Tax Factor” is a provision in the current regulations. Existing section 2644.18 was eliminated entirely. The Commissioner determined that the regulations relating to the impact of federal taxes needed to be updated.

Proposed subsection (a) provided a streamlined approach relating to the “underwriting federal income tax factor.” The specific purpose of this new language was to update the regulation and to provide specific guidance as to the new methodology.

Proposed subsection (b) provides the methodology relating to “investment federal income tax factor.” The specific purpose of this new language was to update the regulation and to provide specific guidance as to the new methodology.

Adding (a) and (b) to provide for separate tax factors for underwriting and investment income is more actuarially accurate.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed..

### **Section 2644.19 Investment Income Factors**

“Investment Income Factor” is a provision in the current regulations. Existing section 2644.19 was eliminated entirely. The Commissioner determined that the regulations relating to the impact of investment income needed to be updated.

Proposed 2644.19 provides for a much more comprehensive approach to the calculation of investment income. The specific purpose of adding this new language is to increase accuracy in measuring the impact of investment income in ratemaking. The new formula also recognizes and takes into account that investment income may be “fixed” or “variable.” Fixed investment income appears in the numerator and variable investment income appears in the denominator. The specific purpose of adding this new language is to increase accuracy in measuring the impact of investment income in ratemaking.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. The amendments to this section are reasonably necessary to carry out the purpose for which they are proposed.

### **Section 2644.20 Projected Yield**

“Projected Yield” is a provision in the current regulations. Existing section 2644.20 was eliminated entirely. The Commissioner has determined that given the important role investment income plays in insurance ratemaking, a new approach relating to the impact of investment income was necessary and required. As yield is a key factor in the calculation of investment income a more modern and comprehensive approach was needed. Using a prospective yield is more appropriate for ratemaking than the previous regulation that using the historical yield.

Proposed subsection (a) provides that the yield for each asset class shall be based on an average of the most recent available three complete months. This approach recognizes using a specific yield without the benefit of a weighted average is apt to produce anomalous results. The purpose for including this new comprehensive definition of “projected yield” is to insure accuracy and consistency in ratemaking.

Proposed subsection (b) allows bond asset classes to be subdivided and provides specifics as to the new, comprehensive classification process. The specific purpose for including this comprehensive approach is to insure accuracy and consistency in ratemaking.

Proposed subsection (c) defines “yields currently available on securities in US capital markets” and provides specifics as to the new, comprehensive classification process. The specific purpose for including this comprehensive approach is to insure accuracy and consistency in ratemaking.

Proposed subsection (d) defines the “risk-free rate.” Further amendments were made to this language during the rulemaking process. The word “medium” was deleted and was replaced

with the word “intermediate.” This specific purpose for including this comprehensive approach is to insure accuracy and consistency in ratemaking.

Proposed subsection (e) provides for further adjustment of the projected yield. The specific purpose for including this comprehensive approach is to insure accuracy and consistency in ratemaking.

Proposed subsection (f) provides the final adjustment made to projected yield. No further changes were made to this language. This specific purpose for including this comprehensive approach is to insure accuracy and consistency in ratemaking.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. The amendments to this section are reasonably necessary to carry out the purpose for which they are proposed.

### **Section 2644.21 Reserves Ratio**

“Reserves Ratio” is a provision in the current regulations. Existing section 2644.21 was eliminated entirely. The purpose of eliminating this section is to reflect the Commissioner’s determination that a new and more comprehensive approach is required. The amended regulation also utilizes an unearned premium reserves ratio and a loss reserves ratio, rather than the current single reserves ratio. The specific purpose of these amendments is to enhance accuracy and to ensure internal consistency as using an industry-wide by-line reserves ratio is consistent with using an industry-wide by-line leverage ratio

Proposed subsection (a) defines “unearned premium reserves ratio” and the section provides for a calculation. Proposed subsection (b) defines “loss reserves ratio” and the section provides for a calculation. The specific purpose of this amendment is to enhance accuracy and to ensure internal consistency.

Proposed subsection (b) defines “loss reserves ratio” and provides for a calculation. The specific purpose of this amendment is to enhance accuracy and to ensure internal consistency.

Proposed language also part of subsection (b) provides that there shall be one industry-wide unearned premium reserves ratio and one loss reserves ratio for each line of business and provides the source for the data to be used in these calculation as well as other relevant specifics. In addition, the subsection specifies that for other lines of business subject to catastrophes, mass torts and other unusual events, the Commissioner shall modify the industry-wide numbers where he finds that they do not provide a reliable estimate of future expectations of the reserve ratios, pursuant to section 2646.3. The specific purpose of including language setting forth distinct treatment for medical malpractice, other liability and product liability, providing for separate

leverage factors for claims-made and occurrence, is to recognize the special characteristics of these lines and to provide specifics relating to the treatment of these lines. Due to the special, catastrophic nature of earthquake, a loss reserves ratio is specified. The specific purpose of these amendments is to enhance accuracy and to ensure internal consistency.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. The amendments to this section are reasonably necessary to carry out the purpose for which they are proposed.

### **Section 2644.23 Credibility Adjustment**

“Credibility Adjustment” is a provision in the current regulations. Existing section 2644.23 has been significantly amended. The specific purpose of these amendments is to reflect the Commissioner’s determination that a new and more comprehensive approach is required and to enhance accuracy, fairness and consistency.

Proposed subsection (a) provides that where data lack credibility a credibility adjustment shall be made, but eliminates language that the Commissioner has determined is no longer necessary.

Proposed subsection (b) eliminates the § 2646.3 generic determination. The Commissioner has determined a generic determination relating to the credibility adjustment is no longer necessary or practical. As the generic determination has been eliminated a new formula for credibility was required.

The amended language provides that for homeowners and auto coverages, 3000 claims is sufficient for full credibility. The Commissioner has determined that 3000 is a reasonable standard, based on the variability of the frequency and severity of homeowners and private passenger auto claims. This section also provides the formula for credibility weight to be applied in subsection (c). As the generic determination has been eliminated a new formula for credibility was required. This is one factor in that formula.

In the initial draft subsection (c) was eliminated entirely. Amended subsection (c) provides the formula to be used when loss and defense and cost containment expense data is less than fully credible. As the generic determination has been eliminated a new formula for credibility was required. This is one factor in that formula.

There is no subsection (d) in the existing regulations. New subsection (d) provides the complement of credibility formula to be used as part of the credibility adjustment formula set forth in subsection (c). As the generic determination has been eliminated a new formula for credibility was required. This is one factor in that formula.

New proposed subsection (e) defines complement trend. As the generic determination has been eliminated a new formula for credibility was required. This is one factor in that formula.

New proposed subsection (f) defines annual net trend. As the generic determination has been eliminated a new formula for credibility was required. This is one factor in that formula.

New proposed subsection (g) allows for the use of an alternative complementary loss and defense and cost containment expense under certain circumstances provided that the alternative is actuarially sound and reasonable in the circumstance. The Commissioner recognizes that the regulations cannot take into account every contingency. The Commissioner has determined that this new language enhances flexibility without sacrificing accuracy and consistency. No further changes were made to this subsection.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. The amendments to this section are reasonably necessary to carry out the purpose for which they are proposed.

#### **Section 2644.24 Trended Current Rate Level of Earned Premium**

Proposed § 2644.24 has no counterpart in the current regulations. The proposed new section describes an “on-level adjustment” that is a standard in modern actuarial practice. The specific purpose in including this new language is to specify this adjustment is required. The language reflects the Commissioners determination this language is necessary as a clarification of the procedure that will be applied.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. The amendments to this section are reasonably necessary to carry out the purpose for which they are proposed.

#### **Section 2644.25 Reinsurance**

Proposed § 2644.25 has no counterpart in the current regulations.

Subsection (a) provides that for all lines other than those specified, ratemaking shall be on a direct basis. The specific purpose for including this language is to ensure there is no

misunderstanding relating to the fact that with the exception of those situations specified in this section, in general, there is no change from the current regulatory approach.

Subsection (b) provides that reinsurance shall be recognized in the ratemaking formula for earthquake and medical malpractice facultative reinsurance under certain circumstances. The specific purpose of this language is to reflect that due to experience gained in years of case-by-case rate determinations, the Commissioner has determined that in these specific circumstances, in these lines, the reliance on reinsurance is such that it is reasonable for the cost of reinsurance to be recognized.

Subsection (b) also sets forth a modified version of the maximum permitted earned premium calculation recognizing reinsurance. The specific purpose of this language is to reflect that due to experience gained in years of case-by-case rate determinations the Commissioner has determined that in these specific circumstances, in these lines, the reliance on reinsurance is such that it is reasonable for the cost of reinsurance be recognized.

Subsection (c) provides specifics as to the calculation of fixed investment income to be used in the modified formula. The specific purpose of this language is to reflect that due to experience gained in years of case-by-case rate determinations the Commissioner has determined that in these specific circumstances, in these lines, the reliance on reinsurance is such that it is reasonable for the cost of reinsurance be recognized.

Subsection (d) provides reinsurance costs shall be allowed for ratemaking purposes only if the reinsurance agreement was entered into in good faith in an arms-length transaction and at fair market value for the coverage provided. Additionally, there must be an acceptable transfer of risk, and the reinsurance must comply with all applicable Statutory Accounting Principles. The specific purpose of this language is to allow for the recognition of reinsurance under these limited circumstances, to ensure results are accurate and reasonable and to prevent abuses relating to the recognition of reinsurance.

Subsection (e) provides that reinsurance between affiliated entities shall not be recognized. The specific purpose of this language is to ensure that transactions between affiliated insurers are not done in such a way as to undermine the regulatory scheme.

Subsection (f) provides there will be no allowance for reinsurance through unauthorized reinsurers. The specific purpose for this language is to ensure that, for consumer protection reasons, some limitations be placed upon reinsurers not subject to Proposition 103 or the California Insurance Code..

Subsection (g) provides that copies of the reinsurance agreements shall be submitted with the filing. The specific purpose of this language is to safeguard California insureds by ensuring compliance with the provisions of this section.

Subsection (h) provides that reinsurance shall include other risk financing mechanisms, such as catastrophe bonds. This is a definition required for clarity purposes.

Subsection (i) relates to earthquake lines and provides for a hearing upon request under certain circumstances. The specific purpose of this language is to ensure consumer protection and prevent abuse in this area.

Subsection (j) relates to medical malpractice lines and provides for a hearing upon request under certain circumstances. The specific purpose for this language is consumer protection and to stave off potential abuse in this area.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. The amendments to this section are reasonably necessary to carry out the purpose for which they are proposed.

### **Section 2644.26 Reinsurance Recoverables**

Proposed § 2644.26 has no counterpart in the current regulations. Proposed new section 2644.26 defines reinsurance recoverables, and is included for clarification purposes.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **Section 2644.27 Variance Request**

“Variance Request” is a provision in the current regulations. The several variances in the existing regulations are found in § 2646.4(c). In the proposed regulations, the variance provisions have been moved. The several variances are now found in proposed § 2644.27.

Subsection (a) contains language found in existing 2646.4(b)(2). While proposed subsection (a) is “new,” it contains language contained in the current regulation is therefore not the subject of this rulemaking. The definition is included for clarification purposes.

Proposed subsection (b) has no counterpart in the existing regulations. This subsection provides the procedure to be employed in making a variance request and is necessary to clarify that procedure. The initial language was amended. The word “or” was deleted and the words “loss development factors or trend is being proposed” were added to the end of subsection (b)(iv). The language "on the maximum and minimum permitted earned premium" was added to (b)(iii) for clarification. The specific purpose of including this language is to provide procedural guidelines.

Proposed subsection (c)(d) and (e) have no counterpart in the existing regulations. These subsections provide further information regarding the timing and procedure to be employed in making a variance request and are necessary to clarify that procedure. The specific purpose of including this language is to provide procedural guidelines.

Proposed § 2644.27(f) corresponds to § 2646.6(c) in the current regulations.

Proposed § 2644.27(f)(1) corresponds to § 2646.4(c)(1) in the current regulations.

Proposed § 2644.27(f)(2) corresponds to § 2646.4(c)(2) in the current regulations.

Proposed § 2644.27(f)(3)(A) corresponds to § 2646.4(c)(3)(A) in the current regulations.

Proposed § 2644.27(f)(3)(B) corresponds to § 2646.4(c)(3)(B) in the current regulations.

Proposed § 2644.27(f)(3)(C) has no counterpart in the current regulations. Due to the experience gained in years of case-by-case rate determinations and in response to comments made in the rulemaking process, the Commissioner has determined that this variance is reasonable and necessary. The Commissioner has determined that this new language enhances flexibility without sacrificing accuracy and consistency.

Proposed § 2644.27(f)(4) has no counterpart in the current regulations. Due to the experience gained in years of case-by-case rate determinations and in response to comments made in the previous workshops the Commissioner has determined that this variance is reasonable and necessary. The Commissioner has determined that this new language enhances flexibility without sacrificing accuracy and consistency.

Proposed § 2644.27(f)(5) is a variant of § 2646.4(c)(4) in the current regulations. This variance was expanded to apply even if only 90% of the direct premium was in one line and it was also expanded that if 90% of its direct premium was in California, even if more than one line was involved, the variance would still be available for the insurer.

Proposed § 2644.27(f)(6) corresponds to § 2646.4(c)(5) in the current regulations.

Proposed § 2644.27(f)(7) corresponds to § 2646.4(c)(7) in the current regulations

Proposed § 2644.27(f)(8) corresponds to § 2646.4(c)(8) in the current regulations

Proposed § 2644.27(f)(9) has no counterpart in the current regulations. Due to the experience gained in years of case-by-case rate determinations and in response to comments made in the previous workshops, the Commissioner has determined that this variance is reasonable and necessary. The Commissioner recognizes that the regulations cannot take into account every contingency. The Commissioner has determined that this new language enhances flexibility without sacrificing accuracy and consistency. The language in this section was further refined in response to comments made during this rulemaking. In subsection (9)(C) the word “settling” was deleted and replaced by the word “closing.” In addition, subsection (9)(E) was added, also

in response to comments made during the course of this rulemaking. This change was made for clarification purposes.

Proposed § 2644.27(f)(10) has no counterpart in the current regulations. Due to the experience gained in years of case-by-case rate determinations and in response to comments made in the previous workshops, the Commissioner has determined that this variance is reasonable and necessary. The Commissioner recognizes that the regulations cannot take into account every contingency. The Commissioner has determined that this new language enhances flexibility without sacrificing accuracy and consistency. The language in this section was further refined in response to comments made during this rulemaking. In subsection (10)(D) the word “settling” was deleted and replaced by the word “closing.” This change was made for clarification purposes.

Proposed § 2644.27(f)(11) has no counterpart in the current regulations. The Commissioner determined that this language was necessary in response to public comments and for clarification purposes.

Note: Existing section 2646.4(d) is proposed for deletion as it pertains only to past rate rollbacks.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **Section 2644.50 Refiling of Approved Rates**

Proposed § 2644.50 has no counterpart in the current regulations. 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 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. The rationale for this proposed section is to clarify the means by which the Commissioner may determine whether the rates being applied are excessive.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes

specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **Section 2646.3 Generic Determinations**

There is no change proposed relating to existing § 2646.3(a)

Proposed § 2646.3(b) amends the existing § 2646.3(b). The Commissioner has determined that portions of that subsection relating to notice and other procedural language are unnecessary and the remaining language makes clear generic determinations are to be adopted as a regulation pursuant to the Government Code. As the Government Code provides all the necessary notice and procedural requirements the deleted language was determined to be unnecessary.

Existing subsection (c) and (d) were unchanged. Subsection (e) was deleted as the procedures relating to petitions made to the Commissioner are found elsewhere in the law.

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

### **Section 2646.4 Hearing on Individual Insurers' Rates**

Existing subsection (a) was unchanged.

There were minor amendments to subsection (b). Language in subsections (b)(1) and (2) referring to generic determinations was deleted. The rationale for this amendment was that in almost all instances the factors referred to in the subsection will not have been calculated as generic determinations.

Existing § 2646.4(c) sets forth the valid bases for requesting a variance. As previously described, the variances are now found in §2644.27. The changes in section numbers is the rationale for the language referencing §2644.27 in proposed § 2646.4(b)(2).

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

The Commissioner has determined that this section must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. These amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that this section must be amended for purposes of clarification and to ensure a consistent and fair application. This section is a necessary component in a formulaic regulatory scheme designed to

keep the job of rate regulation manageable. This section implements, interprets, and makes specific the requirements set forth in California Insurance Code §1861.05. These amendments are reasonably necessary to carry out the purposes for which they are proposed.

#### **Section 2648.4. Complete Application**

New subsection (c) provides the form incorporating the requirements found in section 2644.27. It is necessary to provide a consistent format for insurers to request variances.

#### **SPECIFIC PURPOSE OF THE REGULATION**

This specific purpose of these regulations is to implement, interpret, and make specific the requirement in California Insurance Code Section 1861.05.

#### **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 *20<sup>th</sup> Century Insurance Company v. Garamendi* (1994) 8 Cal.4<sup>th</sup> 216, in which,, among other things, the Court recognized that the Department's use of a ratemaking formula could help reduce the task of reviewing rate applications to a "manageable size."

The Commissioner has determined that the existing regulations must be amended in order to bring the regulations up to date with NAIC reporting requirements and other applicable ratemaking standards. Other amendments are based on experience gained in years of case-by-case rate determinations and are intended to enhance accuracy. The Commissioner has also determined that the regulations must be amended as a result of public input, for purposes of clarification, and to ensure a consistent and fair application of these regulations. Every section in these regulations is a necessary component in a formulaic regulatory scheme designed to keep the job of rate regulation manageable.

These regulations are necessary in order to implement, interpret, and make specific the requirements set forth in California Insurance Code § 1861.05.

#### **UPDATED TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDY, REPORTS, OR DOCUMENTS**

The Commissioner relied on various reports and studies prepared by his staff. Please see "Update to Material Relied On" directly below.

#### **UPDATE TO MATERIAL RELIED ON**

1. Opinion, Findings and Decision on 2006 Private Passenger Automobile Insurance Rates, issued December 15, 2005, by the Massachusetts Commissioner of Insurance in Docket Nos.

R2005-09, R2005-10, R2005-11; Title Page, Appearances Page, Introduction Page, and Item 2. Asset Returns, Pages 35 - 43.

This material is included in the rulemaking file as support for the calculation of § 2644.20., Projected Yield.

2. ROE & Beta Study of Appel & Derrigs' 30 Cos - data from S&P's 9/16/ 2006 report.

This material is included in the rulemaking file as support for the calculation of § 2644.16., Rate of Return.

3. 2004 Annual Rate of Return (ROR).

This material is included in the rulemaking file as support for the calculation of § 2644.16., Rate of Return.

4. Property & Casualty Risk-Premium.

This material is included in the rulemaking file as support for the calculation of § 2644.16., Rate of Return.

This material is included in the rulemaking file as support for the calculation of § 2644.16., Rate of Return.

5. Minimum Rate of Return - Change in Surplus vs. ROR with After Tax Unrealized Capital Gain/Loss.

This material is included in the rulemaking file as support for the calculation of § 2644.16., Rate of Return.

6. Calculation Explanation (Reserve Ratios).

This material is included in the rulemaking file as support for the calculation of § 2644.21., Reserve Ratio.

7. 2004 Summary of By-Line Unearned Premium Reserve Ratio.

This material is included in the rulemaking file as support for the calculation of § 2644.21., Reserve Ratio.

8. Summary of Year 2004 CA P&C Annual Statement State Page For All Insurers.

This material is included in the rulemaking file as support for the calculation of § 2644.21., Reserve Ratio.

9. Summary of Year 2003 CA P&C Annual Statement State Page For All Insurers.

This material is included in the rulemaking file as support for the calculation of § 2644.21., Reserve Ratio.

10. California Loss Reserve Ratio.

This material is included in the rulemaking file as support for the calculation of § 2644.21., Reserve Ratio.

11. Calculation Explanation (Efficiency Standards).

This material is included in the rulemaking file as support for the calculation of § 2644.12., Efficiency Standard.

12. 2002 - 2004 Summary Worksheets

This material is included in the rulemaking file as support for the calculation of § 2644.12., Efficiency Standard.

13. 2004 Data

This material is included in the rulemaking file as support for the calculation of § 2644.12., Efficiency Standard.

14. Calculation Explanation (Leverage Ratios)

This material is included in the rulemaking file as support for the calculation of § 2644.17., Leverage Factors.

15. Leverage Factor Worksheet.

This material is included in the rulemaking file as support for the calculation of § 2644.17., Leverage Factors.

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

While many comments submitted during the rulemaking were incorporated into these regulations no alternatives to the regulation (including alternatives to lessen any adverse impact on small business), other than those submitted during the course of this workshop and rulemaking proceeding, 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. Because the tri-modal efficiency standard is retained, the regulations do not directly impact insurance producers.

### **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 insurance is generally written based upon the state in which the risk is located, this action does not affect the ability of California insurers to compete with insurers in other states.

### **SUMMARY AND RESPONSE TO COMMENTS**

The summary and response to comments are set forth directly after this page.